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Finance Reporting

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Conceptual Framework

Purpose

The purpose of framework to IASB in following matters

- Developing future IFRSs
- Reviewing existing IFRSs
- Promoting harmonization of regulations by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs
- To assist the users in preparing financial statements
- To assist auditors whether financial statements are prepared according to IFRSs
- To assist users of financial statements to interpret the information in the financial statements

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Rules Vs Principle

In rule based there is rule advised for every transaction and if there is not any rule then new rule will be prescribed. However in principle based approach no rule is given. In principle based approach a guidelines have been given which Users has to follow. In principle based there is flexibility. However rule based are rigid. Due to flexibility in principle based approach there is chances that manipulation can be done in accounts which is known as creative accounting. However standard board consistently working on the flexibility as well as closing the doors for creative accounting.

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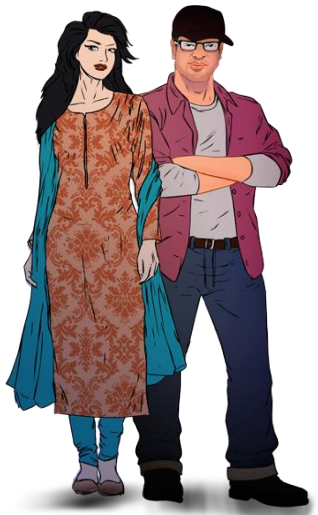
Scope

- Objective of Financial statements
- Underlying assumption
- Definition recognition and measurement of elements
- Qualitative characteristics of useful information
- Concepts of capital and capital maintenance.

Financial statements:

Following are the set of financial statements:

- Statement of financial position
- Statement of profit and loss and other comprehensive income
- Statement of changes in equity
- Statement of cash flows
- Notes to the accounts , integral notes , other statements and explanatory notes.



Information which is not included in conceptual framework are:

- Reports by directors
- Statement by chairman
- Discussion and analysis by management and other similar information which is included in financial statements and annual reports.

Application:

The framework applies to financial statements of all commercial, industrial and business reporting entities whether public or private.

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Users and their Financial Information needs:

User	Information
Employees	Profitability of employers
Lenders	Whether loan and interest will be paid when due
Investors	Risk and return on investment
Customer	Innovation , products, continuation
Government	Allocation of resources and activities of organisation.

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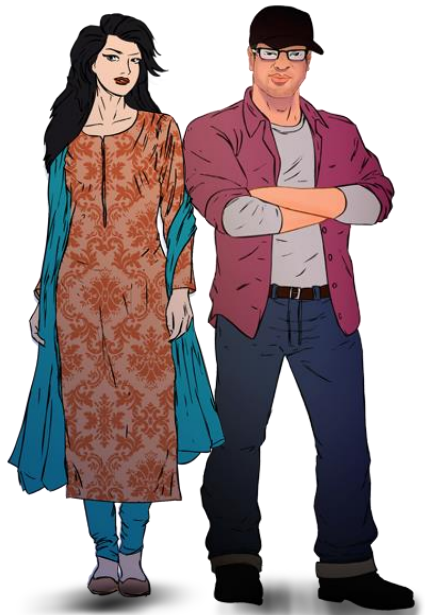
General Purpose of Financial Reporting

Objective and Usefulness:

- To provide the information about company's financial position so that users can take their economic decisions
- To show the results of management accountability towards the shareholders investment
- Company's stakeholders has to relay on Published financial statements as they donot have any other source to obtain the information about organization directly.



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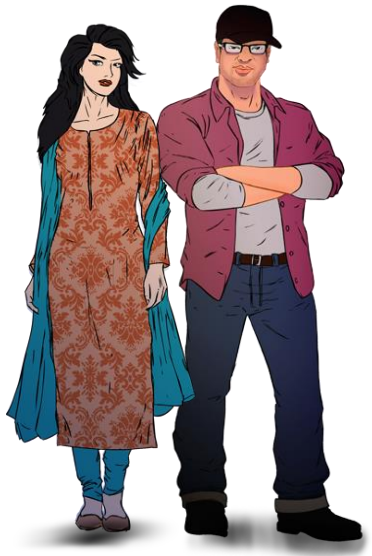
Limitations:

- Financial statements largely based on Estimations and judgments
- Its difficult for the users to understand company financial statements who do not have IFRS knowledge
- Financial statements do meet primary users needs only



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Statement of Financial position	Statement of profit and loss and other comprehensive income	Statement of Cashflow
It is effected by: ▪ Economic resources controlled ▪ Financial structure ▪ Liquidity and solvency ▪ Capacity to adapt changes	It predicts capacity to generate cash flows from existing resources base It form judgment about effectiveness with which additional resources might be employed	It evaluate operating, investing and financing activities Assess ability to generate cash flows Indicate how cash is obtained and spent and how it is financed

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Accrual accounting:

Under accrual accounting effects of accounting and other events will be recorded when they are occurred not when cash is given or received.

Prudence Accounting:

According to prudence accounting Expense will be recorded when it is probable that it will occur and income will not be recorded until or unless it is received

Going concern:

It is a Assumption by management that that business will continue in foreseeable future

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Qualitative Characteristics of Financial statements

Following are the characteristics of Financial statements:

Relevance:

Information should be relevant to the purpose for which it is required.

Timeliness:
Information should be presented to the user of Information when it is required timely. If it is provided later then it is useless

Faithfull representation:

Financial statements must represents the information what it suppose to do so and should not exclude anything which could effect the users decision.

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Comparability:

The information of the financial statements should be comparable consistently with the prior years financial statements of the company and with industry's competitors so that users can evaluate the relative trends in the industry and can evaluate company performance.

Verifiability:

It means that independent observer reach to a conclusion that financial statements/information presents faithful presentation.

Understandability:

Information should be present in such a way that it will be understandable for the user of the financial statements.

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Elements of the Financial Statements:

Following are the elements of Financial statements

Assets:

Resources controlled by the entity in a results of past events from which it is expected that economic benefits will flow to the entitiy.

Liability:

Present obligation on entity resulting from the past events and which will settle through the outflow of economic benefits

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

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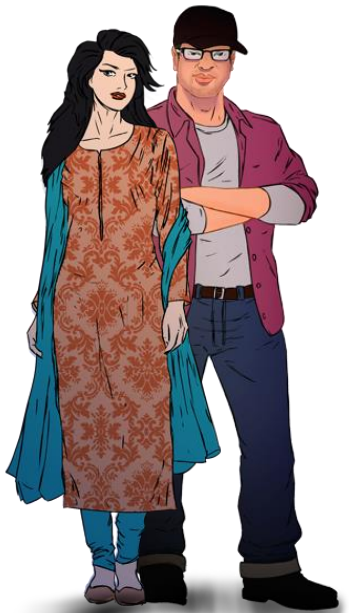
Income:

Increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decrease in liabilities which result in increase in equity other than those relating to contributions from equity participants.

Expense:
Decrease in economic benefits during the accounting period in the form of outflows or decrease in value of assets or increase in liabilities which result in decrease in equity other than those relating to distributions to equity participants.



Recognition:

The process of incorporating in the SOFP or in Statement of profit or loss and other comprehensive income an item which meets the definition of element and satisfies the criteria

Meassurement Basis:

There are two types of measurement choices:

- Historical cost
- Current Cost

Historical cost:
The cost which was pasid at the time of purchase.

Current Cost:
The cost which would have been paid or received if Asset is bought at present time or sell at present time

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Fair Value:

The price which would be received to sell an asset or paid to transfer an liability in an orderly transaction between market participant at the measurement date.

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IAS 2 Inventories

Inventories:
Assets which are held for sale in the ordinary course of business for example goods purchased for resale

Net realisable value:
The estimated selling price in the ordinary course of business less the estimated cost of completion and the necessary cost to make the sale.

Inventories are measured at lower of cost or NRV

Cost:
Costs include all the costs which are necessary to bring the asset into working condition and at present location.

- ✓ Purchase cost
- ✓ Cost of conversion
- ✓ Other costs

Purchase cost	Conversion cost	Other cost
Purchase price Import duties Taxes Trade discounts(deductable)	Production cost Overhead costs Joint production cost	Non production overheads… such as delivery cost Borrowing cost

The following expenditures are excluded from the cost of inventory:

- Abnormal cost such as wasted material, labor, overhead costs
- Administrative overheads
- Selling cost
- Storage cost unless necessary for production process

Techniques for measurement of cost:

There are two techniques which can be use for measuring of cost

Standard cost	Retail Method
-standards must be regularly reviewed and revised - Takes in to account normal level of material , labour, capacity and efficiency	Reduces sales value by by appropriate percentage gross margin - For inventories of large number of rapidly changing items wih similar margins

Formulae:
Formulae are permitted where specific identification of individual costs to individual items are not practiceable

There are two formulae which are allowed

- FIFO
- Weighted average

FIFO Formulae	Weighted Average Formulae
It assumes iventory which purchased first is sold first Therefore the inventory which is unsold at period end is the latest one	Determined from weighted average cost of: Items at beginning of period And cost of similar items purchased/ produced during the period - It may be calculated on periodic basis or on each additional shipment

EXAMPLE: MOIZ

Moiz Sets up in business on 1st november by buying and selling toys. These were purchased during the month:

On 25th November, Moiz sold consignment of 250 toys for $ 50,000

Calculate gross profit and value of closing inventory using

1) FIFO
2) Weighted average

Solution:

FIFO	weighted Average
Sale: 50000	50000
Cost(w) (39250)	(40000)
10750	10000

Working:

200 units x 150s.p = $30000	200units x 150 u.p= 30000
50 Units x 185s.p = $9250	80units x 185 u.p=14800
39250	44800

Closing Inventory

FIFO 30 x 185= $5550

Weighted average = 30 x 160= 4800

Net realisable Value:

Cost of inventories may not be recoverable due to

- Damage
- Obsolence
- An increase in estimation cost to be incurred in completion
- Decline in selling price

Estimations of net realisable value take into account due to :

- The purpose for which inventory is held
- Fluctuations of price or cost relating to events after the period end.

The inventory valuation should be assessed in every accounting period and should be updated in financial statements

Example:

Cheeema is trying to calculate year end inventories figure for inclusion in his accounts. Details of his three stock lines are as follows:

Product	Cost	Realisable Value	Selling exp
A	$100	$120	$25
B	$50	$60	$5
C	$75	$85	$15

Calculate the value of closing inventories which cheema should use for his accounts.

Solution:

A 120- 25 = 95
B cost 50
C 85-15= 70

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IAS 8 Accounting Policies, changes in accounting estimates and errors

The objective of the financial statement is to provide information about the financial position, performance and cash flows of an entity which is useful to an wide range of users is making economic decisions.

Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information which focuses on financial position, performance and cash flows of an entity.

Information about organisation is required in order to :

- Predict the capacity of the organisation to generate cash flows from its existing resources
- Assess potential changes in the economic resources it is likely to control in the future
- Form judgment about the effectiveness with which the entity might employ addition resources.

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In order to make economic decision users of the financial statements require the details of the composition of figures in as much detail as possible

Example:

- Segmental reporting
- Information on discontinued operations
- Disclosure of material and unusual items which are part of ordinary activities

Scope:

IAS 8 is applied in:

- ✓ Selecting and applying accounting policies
- ✓ Accounting for changes in accounting policies and estimates
- ✓ Correction of prior period errors

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Accounting Policies:

Specific principles, conventions, bases, rules and practices applied in preparing and presenting financial statements

Change in accounting estimate:

An adjustment to the carrying amount of an asset or liability which include:

- Results from the current assessment of expected future benefits and obligations
- These changes arise due to new information or developments

for example:

✓ A recievable balance that becomes irrecoverable
✓ Change in estimated useful life of an asset of depreciable asset.

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Prior Period Error:

Omissions, or misstatements, relating to the financial statements of the previous period which arose from the failure to use or miss use of the information.
If any prior period found in the financial statement it need to be correctified retrospectively.

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Accounting Policy:

When an IFRS applies to a transaction the accounting policy or policies applied to that transaction is determined by applying the relevant IFRS and any relevant implementation guidance issued by the IASB.

Where tthere is no applicable IFRS for transaction management must use its judgement in developing and applying an accounting policy which will provide information that:

1. It is relevant to economic decision making of users
2. It represents faithfully
3. It reflects the economic substance of the transaction
4. It is neutral
5. It is complete in all material aspects.

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Management should consider the following:

1. Requirements of accounting standards dealing with similar transactions
2. Definition and recognition criteria in the framework
3. Any other accounting treatment denoting best practice in particular industry.
4. Recent pronouncements of other standard setting bodies which use similar framework.

Changes in accounting policy:

An organization can change accounting policy if:

- It is required by IFRS to do that means it is mandatory to do so
- Or It can be change if it would result in financial statements provide more reliable information.

Example:
If organization change from Cost model to revaluation model its change in accounting policy.

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Retrospective:

Retrospective change means account balances should be change from earlier years.
The changes need to make from opening balances to latest financial statements.
However if it is not possible from opening balances then IAS 8 allows that change should be made from the earliest period from the change is possible.

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Change due to new IAS/IFRS:

1. Tittle of new IAS/IFRS and nature of change in policy
2. When applicable when the change is made in accordance with the IFRS transitional provisions, a description of those provisions and the effects that the provisions may have on future periods.
3. For the current period and each period presented, the amount of the adjustment for each line item affected in the financial statements.
4. The amount of the adjustment relating to periods before those presented.
5. If retrospective restatement is not practicable, that led to the existence of the condition and a description of how and from when the change has been applied.

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Voluntary Change in Policy:

1. Nature of the change in policy
2. Reasons why the new policy provides more reliable and relevant information
3. For the current period and each prior period presented, the amount of the adjustment for each line item affected in financial statements.
4. The amount of the adjustment relating to periods before those presented
5. If retrospective re statement is not possible, the circumstances that led to the existence of the condition a description of how and from when the change has been applied.

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Changes in Accounting Estimate:

Many items in the financial statements must be measured with an element of estimation attached to them:

1. Non current assets are depreciated the charge takes into account the expected pattern of consumption of the asset and its expected useful life. Both depreciation method reflect consumption pattern and useful life are estimates.
2. As per IAS 37 “Provisions” is often a **Best estimate** of future economic benefits which need to be paid out.
3. Inventory is measured at lower of cost or NRV with allowance made for obsolence etc
4. Trade receivables are measured after allowing for estimated irrecoverable amounts.

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Accounting Treatment:

When the change in estimates occurs which effects the estimates previously made the effect of that change is recognized prospectively in the current and future where relevant periods profits and loss.

A change is estimate is not error or change in accounting policy and therefore does not effect prior period statements.

If the change in estimate affects the measurement of assets or liabilities then the change is recognized by adjusting the carrying amount of asset or liability.

Organization should disclose about the nature and amount of change in estimate which has an effect in the current period or is expected to have an effect in future periods.

If it is not possible to estimate the effects on future periods, then that fact must be disclosed.

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Prior period Errors:

Omissions from organisations financial statements and miss statements in the organisations financial statements for one or more prior periods arising from the failure to use miss use of, reliable information that was available and could reasonably be effected to have been obtained when those prior period financial statements were authorized for issue.

Accounting treatment:

The amount of the correction of an error which relates to prior periods is reported by:

- ❑ Adjust the opening balance of retain earning
- ❑ Restate comparative information

IAS 10 Events after the reporting period

Events after the reporting period:

Events both favorable and unfavorable which occur between the end of reporting period and the date on which financial statements are authorized for issue.

There are two types of events which can be identified after the reporting period:

- **Adjusting events:** those which provide further evidence of conditions which existed at the end of reporting period
- **Non adjusting events:** those which are indicative of conditions which arose after the end of reporting period

Measurement:

Adjusting events:

An entity should adjust its financial statements for adjusting events after the end of reporting period

Following are the examples of adjusting event:

1. The discovery of fraud and error which shows that financial statements were incorrect
2. The bankcruptcy of a customer which occurs after the end of reporting period and which confirms that a loss already existed at the end of the reporting period on trade recievable account
3. The sale of a inventories after the year end at an amount below their cost
4. The resolution after the end of the reporting period of a court case which tit confirms that entity already had a present obligation at the end of the reporting period , requires entity to recognize a provision instead of merely disclosing contingent liability or adjusting the provision already recognized

Non adjusting events:

No adjustment is made in the financial statements for non adjusting events after the end of the reporting period

However non adjusting events should be disclosed if they are of such importance that non disclosure coulf effect the decision of the users of the financial statements

Examples:

1. The destruction of major production plant by a fire after the end of reporting period
2. A major business combination after the end of reporting period
3. A decline in market value of investments between the end of the reporting period and the date on which financial statements are authorize for issue
4. Abnormally large changes after the end of the reporting period in asset prices or foreign exchange rates

Going concern:

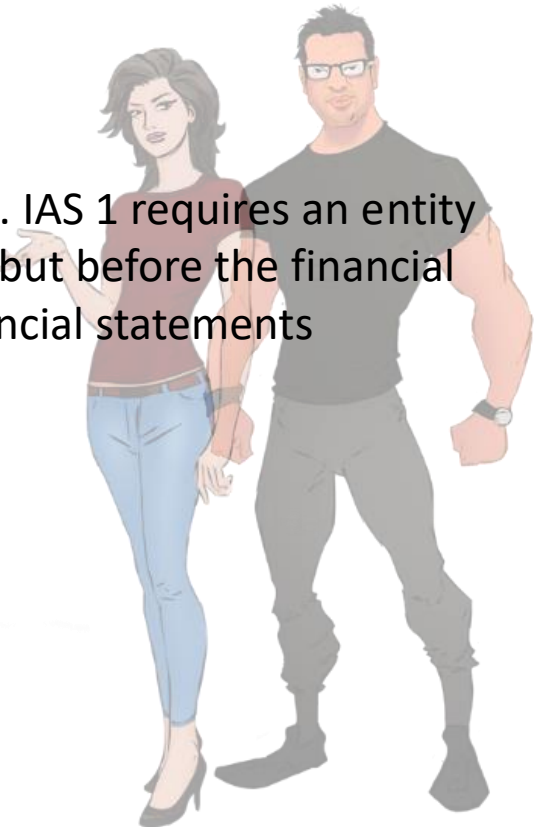
Financial statement should not be prepared on going concern basis if management determines after the end of the reporting period that

- It intends to liquidate the organization or cease trading
- It has realistic alternative but to do so

Deterioration in operating results and financial position after the reporting period may require reconsideration of going concern assumption

Dividends:

Dividends proposed or declare after the end of the reporting period can not be recognized as liabilities. IAS 1 requires an entity to disclose the amount of dividends which were proposed or declare after the end of reporting period but before the financial statement are authorize for issue. The disclosure must be made in notes to the account and not in financial statements



Example:

Which of the following events after the reporting period provide evidence of the conditions existed at the end of the reporting period

1. Discovery of fraud
2. Sales of inventory at less then cost
3. Earthquake
4. Strike by workers
5. Announcing a plan discontinue a operation
6. Closure of one of 20 retail outlets
7. Right issue of equity shares
8. Exchange rate fluctuation
9. Out of court settlement of legal claim
10. Privatisation by government

Answer

1. Adjusting event
2. Adjusting event
3. non adjusting event
4. Non adjusting event
5. non adjusting event
6. Non adjusting event
7. Non adjusting event
8. non adjusting event
9. Adjusting event
10. Non adjusting event

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IAS 16 Property Plant and equipment

Property, Plant and equipment are tangible assets that are held for use in the production or supply of the goods, for administrative purposes or for rental to others and are expected to use for more then one accounting period

IAS will not be apply to Biological assets and mineral rights and reserves

Recognition:
Property Plant and equipment will be recognised in the financial statements if:

- It is probable future economic benefits will flow to the organisation and
- Cost can be measured reliably

For recognition:

Asset Dr xxx
Cash Cr xxx

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Which cost to capitalise in the Initial cost of recognition?

List Price	xxx
Less: Trade Discount	(xxx)
Add: Freight charges	xxx
Add: Import duties	xxx
Add: Dismentaling cost	xxx
Add: Installation cost	xxx
Add: Pre production testing	xxx
Add: Handling cost	xxxx

And all the costs which are necessary to bring asset into present location where it has to operate and necessary to bring it in working condition.

Which cost not to capitalise ?

Following cost of asset will not be capitalise while bringing it into working condition:

- Start up and similar pre production cost
- Administrative and other general overheads
- Initial operating losses before the asset reaches planned performance

All of these costs will be recognised as an expense in Profit and loss statement.

Subsequent Expenditure:
Such costs which incurred during the life of the asset and due to them:

1. It increases the efficiency of the asset
2. It increases the useful life of the asset or
3. It decreases the operating cost of the asset.

These costs need to capitalise in the cost of the asset and such expenditures are known as subsequent expenditure.

Example:
Aircrafts interiors require replacement at regular intervals.

Revaluations:
The market value of land and building usually represent their fair value.
According to IAS 16 revaluation test should be carried out annually.
And if there is any revaluation indication asset should be revalued immediately

Revaluation model is available only if the fair value of the item can be measured reliabely
Where there is no market value is not available, depreciated replacement amount should be used

Example:

On 1st january 2010 Land was bought for $1000 and at 31st Dec 2010 it upward revalued to 1500

Answer

1st january 2010

Asset Dr 1000
Cash Cr 1000

31st December 2010

Asset Dr 500
Revaluation reserve Cr 500

Revaluation reserve is equity component

Example 2

Land was bought on 1st January 2010 for $1000 and on 31st December it downward valued to $750

Answer

1st January 2010

Asset Dr 1000
Cash Cr 1000

31st December 2010

P&L Dr 250
Asset Cr 250

Example:
On 1st january 2010 Land was bought for $1000 on 31 December 2010 it was got revalued to $1500 and on 31st December 2011 it got revalued to 750

Answer

1st january 2010	31 December 2010	31st Dec 2011
Asset dr 1000 Cash cr 1000	Asset Dr 500 Rev Res Cr 500	P&L Dr 250 Rev Res Dr 500 Asset Cr 750

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Example:
Land was bought for $1000 on 1st january 2010 it revalued downward on 31st December 2010 to $750 and on 31 December 2011 it got upward revalued to 31st December 2011

Answer

1st Jan 2010	31st Dec 2010	31st Dec 2011
Asset Dr 1000 Cash Cr 1000	P&L dr 250 Asset Cr 250	Asset Dr 750 P&L Cr 250 Rev.Res Cr 500

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Example: Revaluation and Depreciation

CoCo company bought an asset for $10000 at the beginning of 2005. it had a useful life of five years. On 1st January 2007 the asset was revalued to $12000. the asset life is remain unchanged i.e three years remain.

Account for revaluation and state treatment for depreciation from 2008 onwards.

Answer

On 1st January 2007 the carrying value of the asset is:

10000/5=2000 per year depreciation
Two year depreciation 2000 x 2= 4000
Asset carrying value = 6000

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Acc. Depreciation Dr 4000
Asset Dr 2000
Revaluation Reserve Cr 6000

Depreciation for next three years will be 12000/3=4000, compared to depreciation on cost extra $2000 can be trated as part of surplus

Revaluation Surplus Dr 2000
Retain earning Cr 2000

Review of Useful Life:
As per IAS 16 the asset useful life should be reviewed each year and any changes should be recognised immediately

Impairment:

Assets should be reviewed for impairment losses annually and if there is any hint of impairment loss it should be recognised immediately.

Complex Asset:

Asset which has more then one component and every component has different useful life. For example assets like Aircraft, Ships, Train etc has different components and their life is different such assets are known as complex Asset.

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IAS 20 Government Grant

IAS 20 applies to government grants and all forms of the assistance provided by the government aimed at providing an economic benefit to the organisation or group of organisations qualifying under certain criteria.

These grants can be of any time some of the examples are as follows:

- ✓ Grants
- ✓ Forgivable loans
- ✓ Capital grants
- ✓ Revenue grants

When government grants can be capitalised?

Government grants can only be capitalised when there is a resonable assurance that

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- ✓ The organisation will comply with any conditions that are attached to the grant
- ✓ The grant will be received.

Capital grants:

These are non monetory grants such as land or building in remote area or money towards purchase of the asset and usually account for at the fair value.

It can be presented in the financial statements in either of two ways

- As deffered income liability and transfer a portion of revenue each year
- By deducting the grant in arriving the at the asset carrying amount. Depreciate the asset at reduced cost.

At initial recognition of asset, It will be recorded as

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Bank Dr xxx
Deffered Income cr xxx

At recognition of grant

Deffered Income dr xxx
P&L cr Xxx

To recognise revenue for the year

Revenue for the year will be recognise on straight line basis for each year

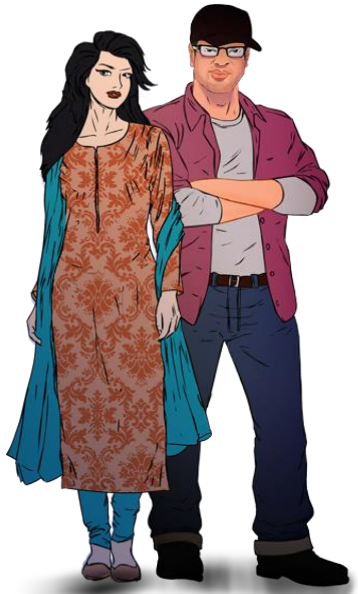

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Illustration 1

Machine cost $100000

Life 4 years
Grant received 20% of cost

Solution

Asset recognition
Machine Dr 100000
Cash Cr 100000

Grant:

Bank Dr 20000
Deffered Income cr 20000

Amortisation of grant/
Revenue for the year

20000
_____
4 years = 5000 per year

P&L extract

Dep expense $25000
Amortisation of grant $5000

Revenue Grant:

Revenue grants which is also known as grant related to income. Grant related to income needed to be recognised in profit and loss statement as “ other income” or deduct from the related expense

Illustration 2:
Salary Expense: $300000
Grant is 30% of labour cost

Solution:

Salary expense Dr 300000
Bank Cr 300000

Grant:

Deffered income Dr 90000
P&L cr 90000

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Repayment of grant:

When organisation breach the condition which are related to government grants organisations often has to back. In this condition it should be treated as a change in estimate under IAS 8 and accounted for prospectively

When the grant is related to income, the repayment should be dealt as an expense

When the grant is related to asset, the repayment should be treated as increasing the carrying amount of the asset or reducing the deffered income balance.

Illustration 3:

Cost of the asset $10000
Life2 years
Grant received 40% of cost = $4000

Solution:

Bank Dr 4000
Deffered income Cr 4000

Amoritsation of grant= 4000
_____
2
= 2000 x 6/12 = 1000

Condition: if asset is sold with in two years then full payment need to be paid and in this scenario. Repayment will be recognised as follows

Deffered Income Dr 1000
P&L Dr 3000
Bank Cr 4000

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IAS 23 Borrowing Cost

Borrowing cost:

As per IAS 23, borrowing cost are directly incurred on qualifying asset and such cost must be capitalised as part of the asset.

What is qualifying Asset?

A qualifying asset can be tangible or intangible asset that takes substantial period of time to get ready for its intended use or eventual sale. Intangible asset during development period or construction property are the example for it.

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What is borrowing cost?

Borrowing cost include interest based on its effective interest which includes the premiums, amortisation of discounts and certain expenses on loans, overdrafts and some financial interests, It also includes financial charges on Leased assets.

If organisation has borrowed funds specially for the construction of the asset, then the amount to be capitalised is actual finance cost incurred. Where borrowing includes general borrowing of the organisation. Then the capitalisation rate that represents the weighted average borrowing rate of the organisation should be used.

Illustration 1:

Mobango has $500000 of borrowings. All are outstanding for the full financial year. The borrowings are from following sources:

Loan from bank - $100000 @ 5% P.A
Bonds 200000 @ 6%
Shareholders loan 200000 @ 3%

The capitalisation rate =

(100000 X 5%) + (200000 X 6%) + (200000 X 3%) = 23000/500000 X100= 4.6%

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When to start capitalisation of Borrowing cost ?

An organisation should start capitalisation of borrowing cost when following conditions meet:

1. Expenses has been incurred
2. Borrowing cost are being incurred
3. Activities to prepare the asset are in progress

When to suspend capitalisation of borrowing cost ?

Capitalisation of borrowing cost should be suspended during the period in which active development is interrupted

When to stop capitalisation of borrowing cost?

Capitalisation of borrowing cost need to be stopped when substantially all activities needed to complete the asset are complete.

When suspending the work is normal process of the work, capitalisation of borrowing cost will not be suspended

Any borrowing cost that are not eligible for capitalisation must be expensed and costs can not be capitalised for assets measured at fair value.

Illustration 2

On 1.1.2011 Zoii Ltd borrowed $1 million at rate of 10% per annum to finance the Football stadium construction. Which is expected one year to complete. Whole 1 million was drawn on 1.1.2011. but only $500000 of this 1million was used immediately on 1.1.2011. the remaining $500000 was utilised on 1.7.2011. As A result $500000 d been invested temporarily at the rate of 8% per annum.

Calculate the borrowing cost which may be capitalised and cost of the asset as at 31.12.2011

Solution:

Borrowing costs
1m X 10%=100000

Investment income

500000 X 8% X 6/12= 20000

Net borrowing cost

100000-20000 = 80000

Cost of Asset 1 Million + borrowing cost 80000 = 1080000

Capital items:

Capital items are those which are brought into business for long term usage such as machinery, computers, shop fittings costs, productive equipment etc.

Revenue items:

Revenue items are the normal day to day running cost of the business such as material cost, labour cost and wages cost etc.

Bang Bang Co has three sources of borrowing in the period.

	outstanding liability	Interest Charge
7 year loan	8000	1000
25 year loan	12000	1000
Bank overdraft (avg)	4000 avg	600

Required:

a. Calculate the appropriate capitalisation rate if all of the borrowings are Used to finance the production of qualifying assets but none of the borrowings relate to specific qualifying asset.

b. If the seven year loan is the amount which can be specifically identified with a qualifying asset, calculate the rate which should be used on the other assets.

Solution:

Capitalization rate:

a. $$\frac{1000 + 1000 + 600}{8000 + 12000 + 4000} = 10.8\%$$

b. $$\frac{1000 + 600}{12000 + 4000} = 10\%$$

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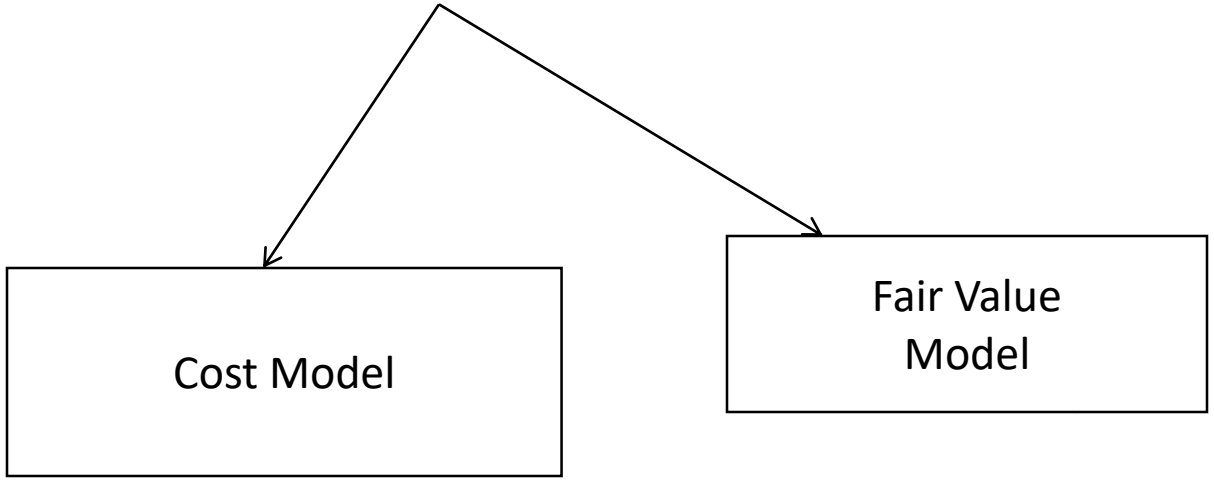
IAS 40 Investment Property

Investment Property:
It is a property (land or building) held by the owner or lessee under finance to earn rentals or for capital appreciation or for both.

For Investment Property IAS 40 allows choice between two models:



Fair Value:

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

Cost:

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

Recognition:

1. It is probable that the future economic benefits will flow to the entity
2. Cost can be measured reliably

Measurement:

For Measurement IAS 40 Allows to choose between two models

1. Cost Model
2. Fair Value Model

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Cost Model:

In cost model we will record at Asset at carrying value i.e. is cost – residual value – depreciation – less any Impairment Losses

Fair Value:

In Fair Value Model asset will be record at Current Market Value of the Asset and changes will be recognised in the Profit and Loss statement.

Example

Mojia Ltd Bought an asset for 1000 on 1st January 2010 and on 31st December 2010 Asset value is 1500 .

Req: Prepare the extracts

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Answer

1st January 2010

Asset Dr 1000 Cash Cr 1000

31st December 2010

Asset Dr 500 P&L Cr 500

The gain related to the Asset will be recognised in Profit and loss statement as an income

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Example:

Mojia company bought an asset for $1000 on 1st January 2010 and on 31st December its value is $750.

Required: Prepare the extracts

1st Januaar 2010	31st December 2010
Asset Dr 1000 Cash Cr 1000	P&L Dr 250 Asset Cr 250

The Loss related to the asset will be recognised to Profit and loss statement as an expense

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Asset for own use and Rental:

If organisation has asset which it is using for own use and as well for rental purposes then the question is which standard we should apply?
IAS 16 or
IAS 40 ?

First we will look at that either we can sell these two parts separately? If yes ! Then we will apply IAS 16 to the part which we are using for our own use and
We will apply IAS 40 to the part which we will use for Rental purposes.
And If we cant sell it separately then

We will look at the significance, Significance can be seen in terms of revenue as well as in terms of Area as well

Example:

I Have a building of AccountanSea where I do teach from morning 9:00 am to Night 10:00 PM. And student came to me and asked Sir ! After the end of the classes in night can I sleep in this building. As where ever I went for rent space rent is $200. I said ok! You do give only rent of $50.

Now in this scenario, My main activity is providing teaching services to the students as I do earn my major part of income from teaching. So I will apply IAS 16 on this building.

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Group Scenario:

Let us suppose parent company give building to Subsidiary company on rent. In parent company individual financial statements. Parent company will recognise Asset under IAS 40 as an investment property. But in Consolidated financial statements Asset will be recognise as an asset.

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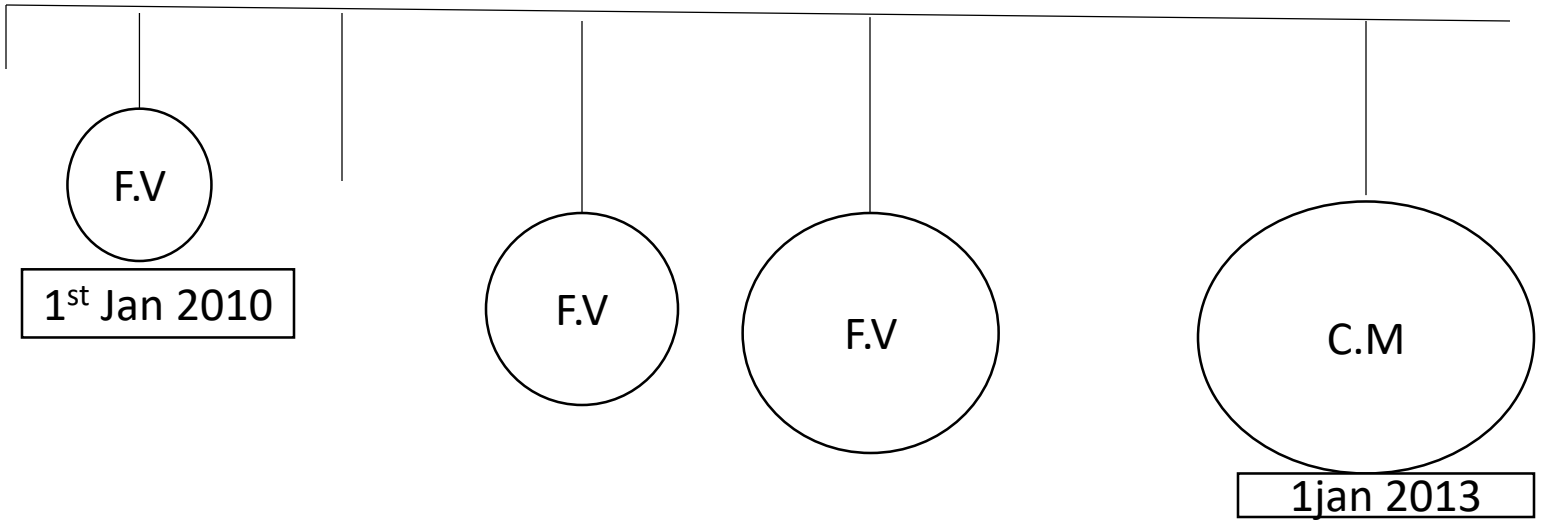
Change from Fair Value model to Cost Model:



From first January 2010 since start we were using fair value model and on 1st January 2013 we r switching from fair value model to Cost Model. 1st January 2013 fair Value will be the carrying value of Cost model and onwards Cost of the asset and from 1st January onwards cost model treatment will be followed.

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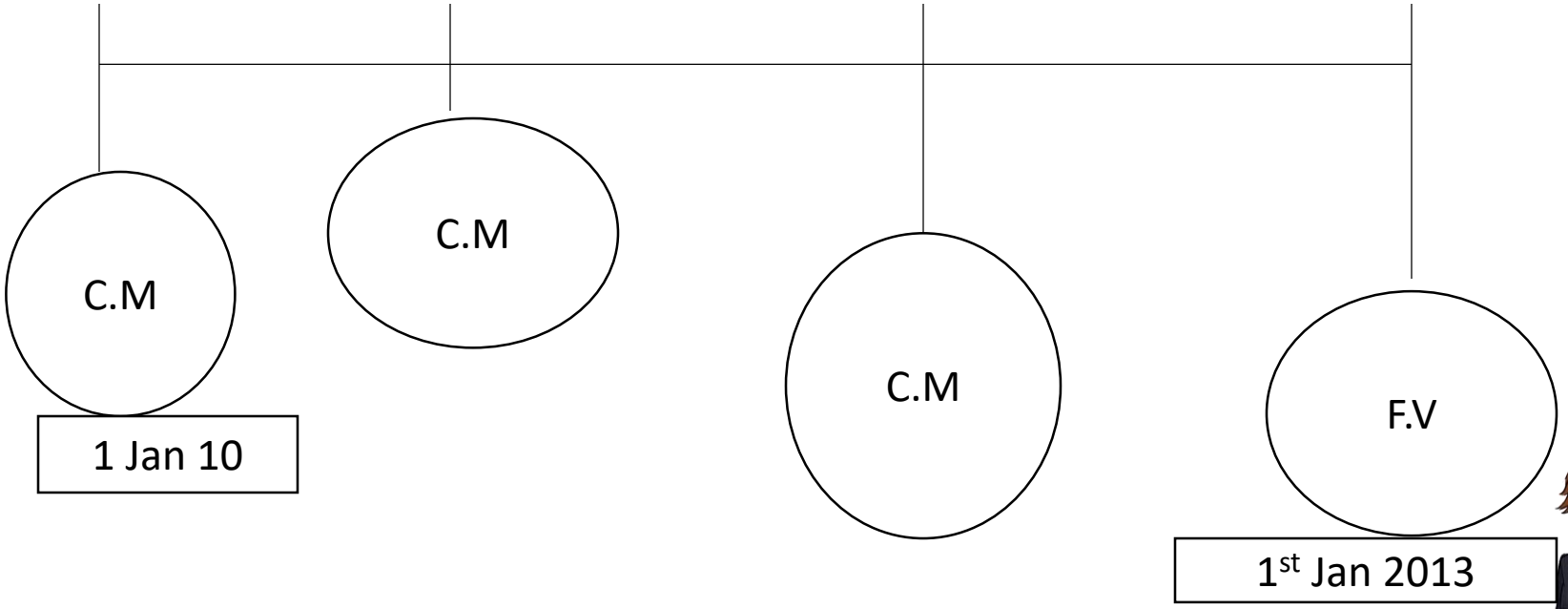
Cost Model to Fair Value Model:



Since January 2010 organisation was applying cost model on its asset, On 1 january 31st December 2013 organisation decided to switch from cost model to fair value model. On 1st January 2013 Cost model carrying value will become asset fair value and then onwards fair value model rules will be apply.

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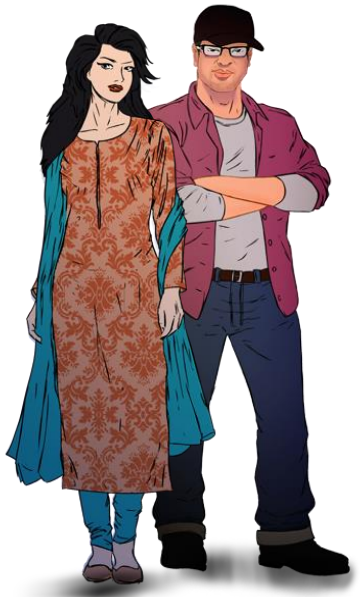
IAS 41 Biological Assets

IAS 41 explains the accounting treatment , presentation and disclosures related to the agriculture activity including:

- Agriculture produce at the time of harvest
- Related government grants
- Biological assets except for bearer plants

Biological Asset: A living plant or animal
Biological transformation: includes the processes of growth, degeneration , production and procreation that give rise to qualitive and quantitive changes in biological asset.
Agriculture produce: the product harvest from a biological asset
Harvest: the detachment of produce from a biological asset or the cessation of biological assets life.



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

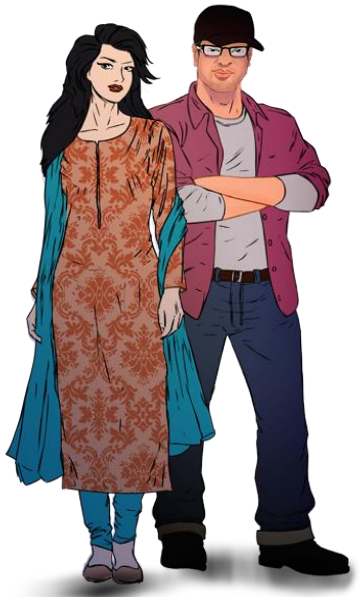
Bearer Plants: Bearer plants, which are used solely to grow produce for example apple trees or grapes vines are accounted for under IAS 16 Property, Plant and equipment

Recognition:

A biological Asset should be recognised when, and only when:

When assets are controlled as a result of past event and it is probable that future economic benefits will flow the entity

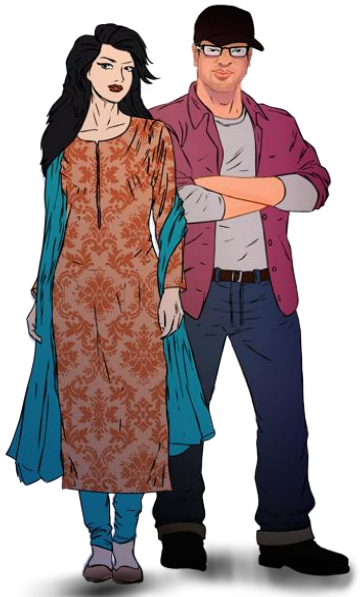
Cost of the asset can be measured reliabely.



Measurement:

A biological asset should be measured at its fair value less cost to sell

- On initial recognition and at end of each reporting period.

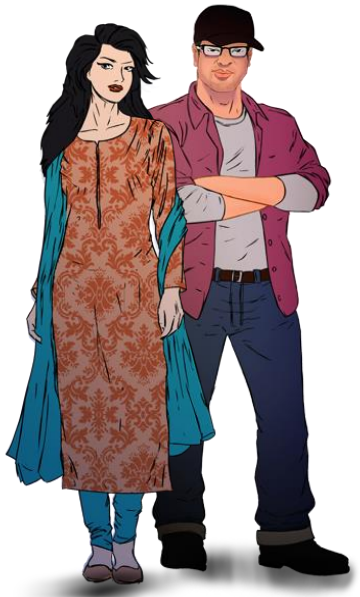


Example:

A Farmer owns a Diary Herd at 1st January 2015. the number of cows in the herd is $5000. the fair value of 2 year old animals and 31 December 2014 and 3 year old animals at 31 December 2015 are $60 and 75 respectively:

Separating out the value increase of the herd into those relating to price change and those relating to the physical change gives the following valuation:

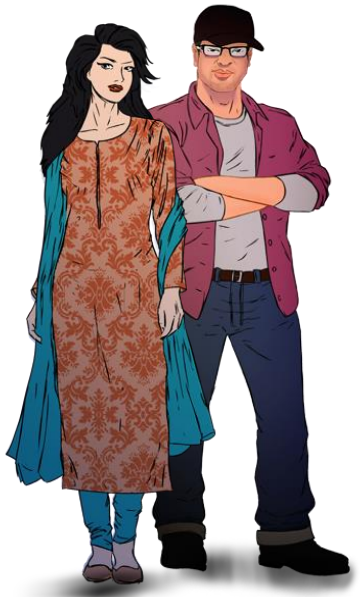
Fair value a 1 January 2015	$5,000
Increase due to price change (100 x ($60-$50))	1000
Increase due to physical change (100x(($75-$60))	$1500
Fair value at 31st December 2015	7,500



Gains and Losses:

A gain or loss arise on the initial recognition of biological asset is included in profit or loss for the period in which it is arises

Any change in fair value less cost to sell at the end of each reporting peirod are similarly recognised in profit or loss for the period.



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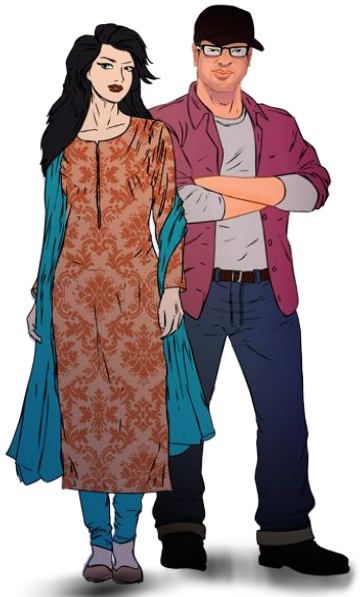
As at 31 december 2015, a plantation consists of 100 Insignis pine trees that were planted 10 years earlier. Insignis Pine take 30 years to mature and will ultimately be processed into building material for house or furniture.

Only mature trees have established fair values by reference to quoted price in an active market. The fair value is inclusive of transport cost to deliver 100 logs to market. For mature trees for same type as in market is

As at 31 december 2015= 171
As at 31 december 2016= 165

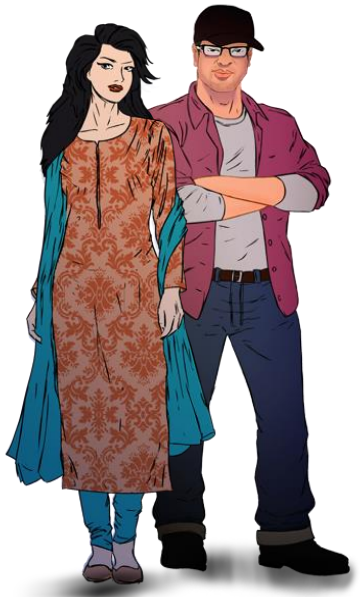
The organisation weighted average cost of capital is 6% per annum.

Require:
Calculate the fair value of the plantation as at:
1. 31 December 2015 and
2. 31 December 2016



Calculate the gain between the two period ends:

1. A change in price
2. A physical Change



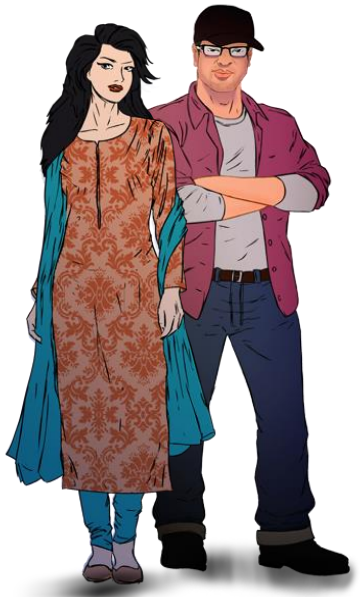
Solution:

Fair Value computation

The mature plantation would have been valued at $17100
The estimation for the immature plantation is
17100/1.06^20=5332

31 december 2016
The mature plantation would have been valued at 16500.
The estimate for the immature plantation is 16500/1.06^19=5453

Analyses of gain:
The gain identified in part a is analysed as follows:
Price change:
Reflects the change in price on biological asset over the period

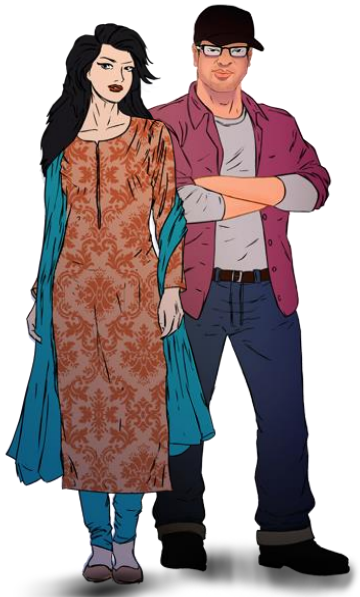


Prior period asset restated at current price 16500/1.06^20	= 5145
Less: prior year estimate at previous price	=(5332)
Loss	(187)

2. Physical Change

Reflects the change in state of maturity of biological asset at current price

Current year estimate as per current year price from (a)	5453
Prior year estimate re stated at current price from b	5145
Gain	308



IFRS 5 Held for Sale and Discontinued Operations

Component Of an entity:

A portion of an organization with operations and cash flows clearly distinguishable from the remainder of the organization for both operational and financial reporting purposes.

Discontinued operation:

A component which has either been disposed off or is classified as held for sale

- ❑ Represent a separate major line of business or geographical area of operations
- ❑ Is a part of single co ordinated plan for its disposal
- ❑ Is a subsidiary acquired with a view of re sale.

Disposal Group:

A group of assets to be disposed of collectively in single transaction and directly associated liabilities which will be transferred in the transaction.

The asset in disposal group include goodwill acquired in a business combination if the group is:
- A cash generating unit in which goodwill has been allocated or an operation with such cash generating unit.

Definition Criteria:

Distinguishable:

A discontinued operation is distinguishable operationally and for reporting purposed if:

1. Its assets and liabilities is directly attributable to it
2. Its income can be directly attributable to it
3. Its expenses can be directly attributable to it

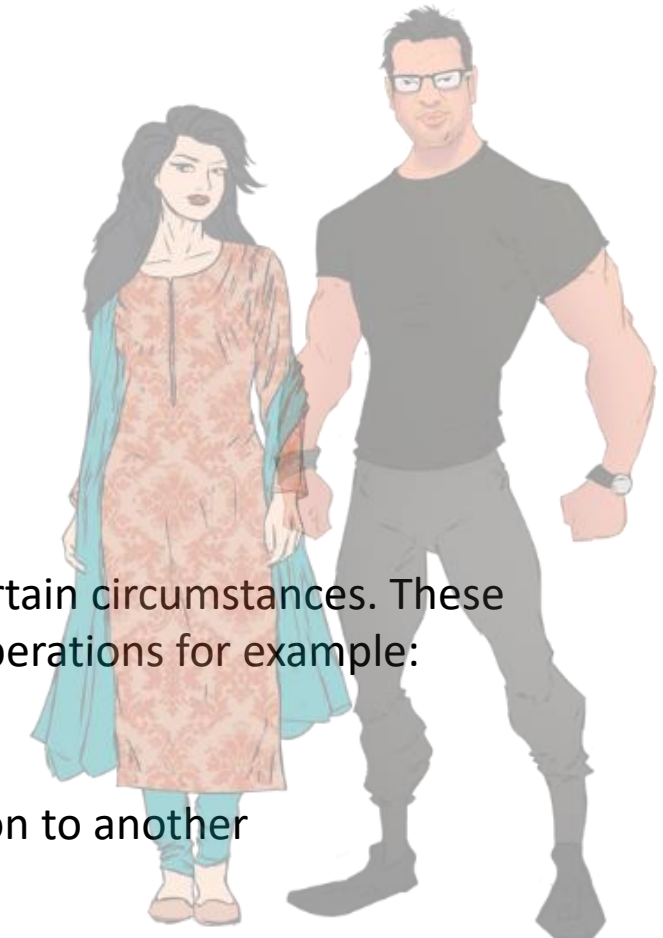
Separate:

A discontinued operation must be a separate:

- Major line of business for example major product or service line
- Geographical area of operations.

Business organizations frequently close operations, abandon products or service line due to certain circumstances. These changes are not usually discontinued operations but they can occur along with discontinued operations for example:

- Discontinuance of several products in ongoing line of business
- Moving some production or marketing activities for a particular line of business from location to another
- Closing of facility to achieve productivity improvement or other cost saving



- Sale of a subsidiary whose activities are similar to those of the parent or other subsidiaries or associates within a consolidation group.

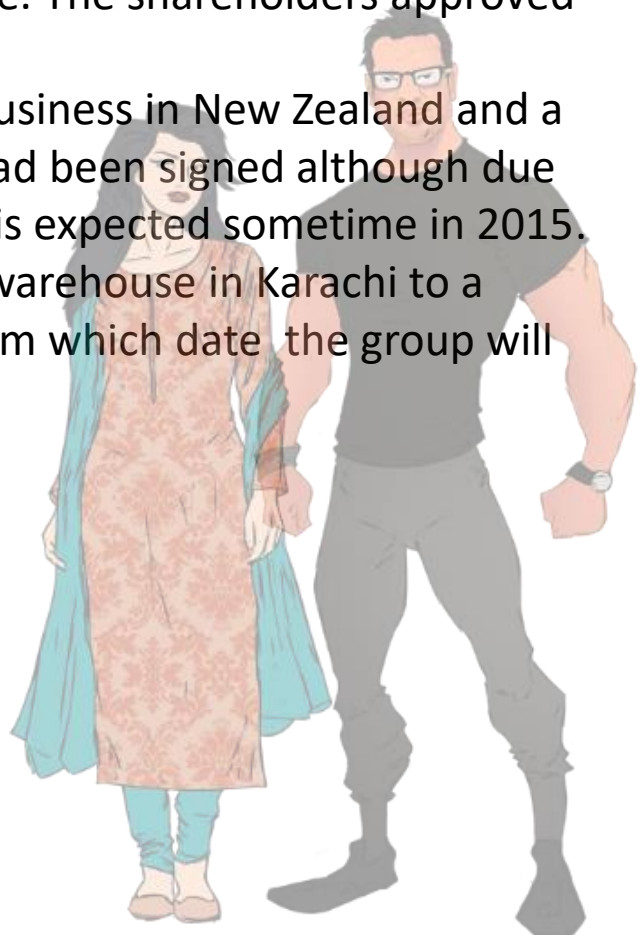
A single co ordinated plan:

A discontinued operation may be disposed of in its interity or peacemeal, but always pursuant to an overall coordinated plan to discontinue the entire component.

Example:

Identify which of the following is a disposal group at 31st December 2015:

1. On 21st December 20015 Saba company announced the board intention to sell its shares in Emo company, upon the approval of Emo other shareholders. It seems unlikely that approval will be granted in near future and no specific potential buyer has been identified.
2. On 31st December 2015 the Bobi management decided to sell its 50 supermarkets in Singapore. The shareholders approved the decision at an extraordinary general meeting on 20th January 2016.
3. On 15 October 2015 Shazee management and shareholders approved a plan to sell its retail business in New Zealand and a working party was set up to manage the sale as at 31st December 2015 heads of agreement had been signed although due diligence and the negotiation of final terms are still in process. Completion of the transaction is expected sometime in 2015.
4. Dhoondoo has entered into contract to sell the entire delivery fleet of cars operated from its warehouse in Karachi to a competitor Bingo on 17 December 2015. the assets will be transferred on 28 January 2016 from which date the group will outsource its delivery activities to another company Kaka.



Answer:

The retail business and the car fleet disposal groups because each of them is collection of assets to be disposed of by sales together as a group in single transaction.

The sale of the supermarkets is not classified as disposal group as there is no indication that the supermarkets are to be sold as a package each could be sold as separate item

In emo company scenario it is not clear how much shares they are intent to sell, also it is unlikely that they get the approval therefore it cant be recognize as disposal group.

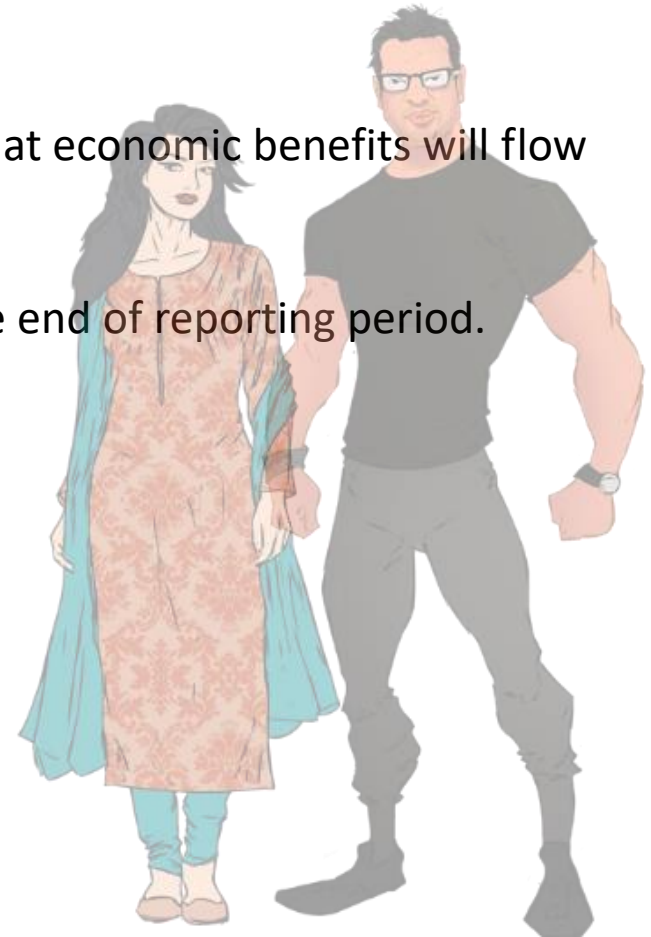
Held for Sale classification

Definitions:

Non current Asset:
Resources controlled by organization for more then one accounting period and it is expected that economic benefits will flow to the entity
For example, Building, Plant, Land etc.

Current Assets:
Resources controlled by the organization for equal to or less then 12 months and it is expected that economic benefits will flow to the entity. These are the assets which satisfies any of the following criteria

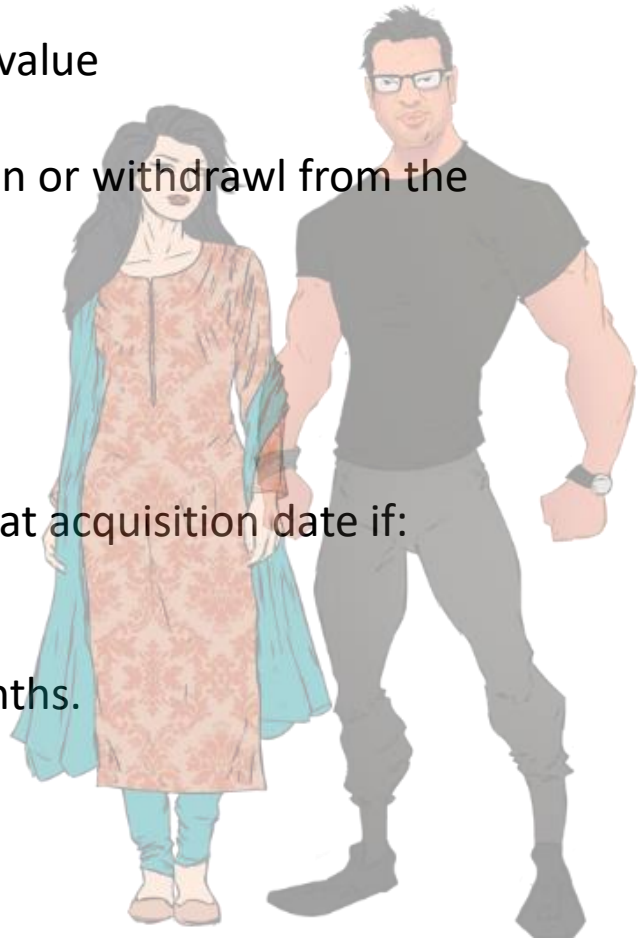
- Expected realization sale or consumption in normal operating cycle that is 12 months after the end of reporting period.
- Cash or cash equivalent
- Held for trading purposes.



Held for Sale non current Asset:

The asset must be available for immediate sale in its present condition
In addition to above following conditions need to be meet:

1. The sale of the asset must be highly probable
2. Management must be committed to plan to sale the asset
3. An active program to locate a buyer and complete the plan must have been initiated.
4. The asset must be actively marketed for sale at a reasonable price relative to its current fair value
5. The asset will be sell within one year from the date of classification.
6. The actions required to complete the plan should indicate that significant changes to the plan or withdrawl from the plan are unlikely.



Assets acquired with view of Disposal:

Non current assets acquired with view to subsequent disposal are classified as held for disposal at acquisition date if:

- One year criteria is met
- It is highly probable that any other criteria not met at that date will be met within three months.

Events after the reporting period:

- Assets are not classified as held for sale if held for criteria not met at the end of reporting period
- However, if the criteria are met before the financial statements are authorized for issue, the notes to the account should disclose the facts and circumstances.

Example 2:

Assume all criteria are met, explain which of the events and transactions in example one give rise to the classification of non current assets held for sale as at 31 December 2015.

Answer:

Dhoondoo fleet classified as held for sale because it constitutes as group of assets to be sold in their present condition and sale is highly probable at reporting date.

Bobee sale of retail business will not be completed until the final terms are agreed, however the business is ready for immediate sale and the sale is highly probable unless other evidence after the reporting date, before the financial statements are authorized for issue comes to light to indicate the contrary.

Emo shares are not available for immediate sale as shareholders approval is required, taking this into account sale is not highly probable there fore it can not be classified as held for sale.

Shazee supermarkets are not available for immediate sale at the reporting date. As the shareholders approval was required. The held for sale criteria not met therefore it can not be recorded as held for sale.

Abandon Non current Assets:

An asset which is to be abandoned can not be classified as held for sale. However a disposal group which is to be abandoned is treated as discontinued operation. When it ceases to be used. Provided that definition of discontinued operation is met.

Non current assets or disposal groups to be abandoned include those which are to be:

- Closed rather then used and
- Used to the end of their economic life.

An organization does not account for a non current asset which has been temporarily taken out of use as it had been abandoned.

Measurement:

Held for sale non current asset are carried at lower of

1.Carrying amount and
2.Fair value less cost to sell

Time Value:

If sale is expected to occur beyond one year, costs to sell are discounted to their present value

Subsequent measurement:

Assets and liabilities in disposal group are measured in accordance with applicable IFRSs before the fair value less cost to sell of the disposal group is re measured.

Impairment Losses:

Impairment losses for initial or subsequent fair value less cost to sell must be recognized.

Depreciation:

Held for sell non current assets are not depreciated.

IAS 36 Impairment

Impairment:

Sudden fall in the value of asset is known as Impairment

Impairment Loss:

The amount by which carrying amount of an asset exceeds its recoverable amount

Fair value:

The price which would be received to sell an asset or to transfer a liability in an orderly transaction between market participants at the measurement date.

Recoverable amount:

The higher of fair value less cost to sell and value in use

Value in Use:

The present value of future cash flows expected to be derieved from an asset or cash generating unit

Cash generating unit:

The smallest identifiable group of assets which generate cash inflows that are largely independent of the cash inflows from other assets or group of assets.

Basic rules for all assets:

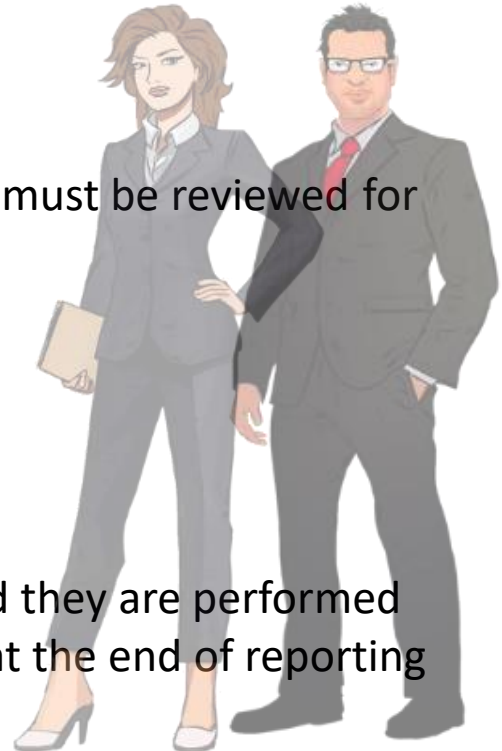
At the end of reporting period an organization should assess whether there is any indication that an asset or cash generating unit may be impaired. If there is any such indication, the organization should estimate the recoverable amount of asset.

If there is no indicators for impairment there is no need for organization to estimate a recoverable amount of asset.

Intangible assets:

In case of intangible assets, whether there is indication for impairment or not following intangible assets must be reviewed for impairment annually:

- Goodwill acquired in business combination
- Those not yet available for use
- Those with an indefinite useful life.



The impairment test for these types of assets can be performed at any time in the financial year provided they are performed at same time every year. The point to note here is that intangible assets which are amortised are tested at the end of reporting period only.

Intangible assets with an indefinite life forms part of cash generating unit and can not be separated, that cash generated unit must be tested for impairment at least once in year or whenever there is indication that cash generating unit may be impaired.

Indicators of impairment loss:

There are two types of indicators of impairment loss

- External indicators
- Internal indicators

External Indicators

- Increase in interest rates
- Increase in industry tax rates
- Recession
- Sudden fall in value of asset
- Technological change
- Change in fashion
- Adverse change in legal environment.

Internal Indicators:

- Physical damage to the asset
- Change in use of asset
- Cash flows for acquiring the asset is more then the budgeted
- Cash flows for maintaining the asset is more then the budgeted

Measurement of recoverable amount:

Recoverable amount

Fair value less cost to sell

Higher of

Value in use

Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows from continuing use which are largely independent of those from other assets or group of assets. If this is the case, recoverable amount is determined for the cash generating unit for which the asset belongs.

Example

Recoverable amount is the greater of

Value in use	Fair value less cost to sell	recoverable amount is:	Carrying amount	Comments
900	1050	1050	1000	No comments
900	980	980	1000	Impairment loss of $20 need recognize and carrying value to $980
960	925	960	1000	An impairment loss of $40 must be recognized and asset carrying value to $960

It is not always necessary to determine both fair value less cost to sell and value in use to determine asset recoverable amount.

- If any of these value exceeds carrying value that means there is no impairment and in that case there is no need to calculate other value.

Fair value less cost to sell:

Fair value is assessed using the fair value hierarchy in IFRS 13 Fair value measurement

Definition:

Active Market:

A market in which transactions of the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

Cost of disposal:

Incremental costs directly attributable to the disposal of an asset, excluding finance cost income tax expense and cost which has already been included as an liability for example:

- Cost of removing the asset
- Stamp duty
- Legal costs.

Example:

Meez operates in leased primises. It owns a glass plant which is situated in a single factory unit. Glass plants are sold periodically as complete assets.

Professional valuers has estimated that the plant might be sold for $100000. they have charged fee of $1000 to providing these services.

Meez would need to dismantle the asset and ship it to any buyer. Dismetaling and shiping would cost $5000. specialist packaging would cost $4000 and legal fees of $1500

Fair value less cost to sell

	$
Sale price	100000
Dismantling and shipping	(5000)
Packaging	(4000)
Legal fees	(1500)
	89500

Value in Use:

Value in use is the present value of future cash flows expected to be derived from an asset. Estimating the value in use includes:

- Estimating the future cash inflows and outflows to be derieved from continuing use of the asset and from its ultimate disposal
- And applying the appropriate discount rate

Fair value would not reflect the following factors:

- Additional values derived from the grouping of assets
- Legal rights or restrictions specific to the current owner of the asset
- Synergies between the asset being measured and other assets.
- Tax benefits or burdens specific to the current owner of the asset.

Example:

Rcg holds a patent on medicine drug. The patent expires in five years. During this period demand for the drug is forecast to grow at 5% per annum.
Experience shows that competitors flood the market with generic versions of profitable drug as soon as it is no longer protected by patent to generate significant cash flows after five years.

Net revenues from the sale of the drug were $100 million last year.

The organization has decided that 15.5% is the appropriate discount rate for the appraisal of cash flows associated with this product:

Time	Cash flow m	Discount factor @15.5%	Present Value ($m)
1	100 x 1.05 = 105	0.865	91
2	100 x 1.052 = 110.3	0.749	83
3	100 x 1.053 = 115.8	0.649	75
4	100 x 1.054 = 121.6	0.561	68
5	100 x 1.055 = 127.6	0.486	62
	Value In use		379

Cash flow projections:
Projections should be based on reasonable and supportable assumptions which represent management's best estimate of the set of economic conditions which will exist over the remaining useful. Greater weight should be given to external evidence.

They should be based on most recent financial budgets/ forecast approved by management.

Projection based on these budgets should cover maximum period of five years, unless longer period can be justified.

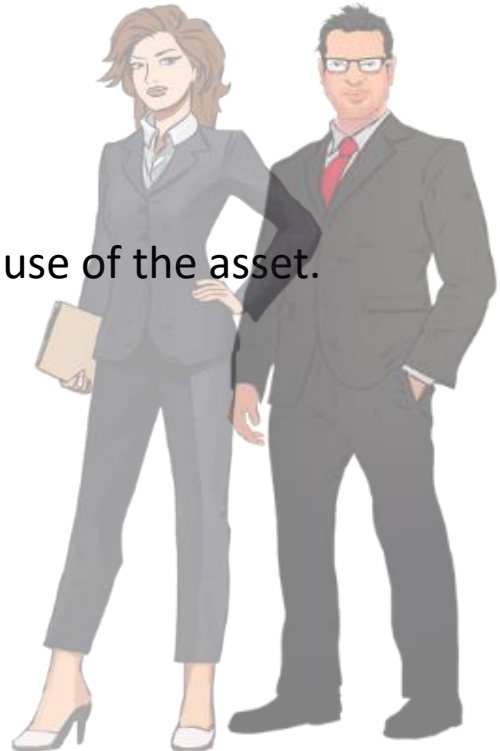
The growth rate should not exceed the long term average growth rate for the products, industry or countries or countries in which the organisation operates or for the market in which asset is used, unless a higher rate is justified.

Estimate of future cash flows should include:

- Projected cash flows including disposal proceeds
- Projected cash outflows which are necessarily incurred to generate the cash inflows from continuing use of the asset.

Estimate of future cash flows should not include:

- Cash flows relating to imporovement or enhancement of assets performance
- Cash inflows and outflows from financing activities
- Cash outflows required to settle obligations which have already been recognized as liabilities
- Cash flows which are expected to occur due to future restructuring which are not yet confirmed.



Discount Rate:

The discount rate is pre tax rate which reflects current market assessment of:

- The time value of money
- The risk specific to the asset

Example:

ZeeSha is testing a machine, which makes a product called CASA, for impairment Zeesha has gathered the following information in respect of the machine

	$
Selling price of CASA	100
Variable cost of production	70
Fixed overhead	10
Packing cost per unit	1

All costs and revenue expected to inflate at 3% per annum
Volume growth is expected to be 4% per annum. Last year 1000 units were sold. This is in excess of the long term growth in the industry ZeeSha's management has valid reasons for projecting this level of growth.
The machine originally cost $400000 and was supplied on credit terms from another group organization Zeesha is charged $15000 interest per annum on this loan.

Further expenditure:
In two years time, the machine will subject to major servicing to maintain its operating capacity. This will cost $10000

In three years time the machine will be modified to improve its efficiency. This improvement will cost $20000 and will reduce unit variable cost by 15%.

The asset will be sold in eight years time. Currently the scrap value of machines of similar type is $10000.

All values are given in real terms to exclude inflation.

Required:

Identify which cash flows should be included and excluded in the calculation of value in use of the machine and explain why?

Answer:

Net revenue will be included as this is a variable cash flow 100 – 70 – 1 = 29 in the first year will be inflated by 3%

Fixed overhead will be excluded as this is the sunk cost and not relevant to the cash flows. It will be incurred if company use machine or not that's why its irrelevant.

Management expects to increase the volume by 4% each year and this volume should be incorporated in the calculation for five years after this IAS 36 prohibit the use of management growth rate that exceeds the industry average. Inn the above of further information zero growth will be assumed.

Capital cost of machine will be excluded as this is sunk cost and therefore it is irrelevant.

Depreciation will be excluded as it is notional and not a cash flow.

Loan interest will be excluded as IAS 36 states that cash flows ignore financing costs.

Major servicing will be included as this is necessary to maintain operating capacity. This current value need to inflated for two years inflation adjustment.

Machine Modification will be excluded as this is a enhancement cost and its not related to the present condition of the asset. The resulting savings in variable cost will also be exclude.

Scrap proceeds will be included as this is future cash flow relating to the asset as this amount is a current value and it will need

And it will need to be inflated to a future value reflecting the expected cash flow in eight years time.

Cash Generating Unit:

When asset has more then one component and every small component of organization helps organization to generate the revenue this is known as cash generating unit for example restaurant.

Basic concept:

If there is any indication that asset is impaired the recoverable amount must be estimated for individual asset.

However it may not be possible to estimate the recoverable amount of an individual asset because:

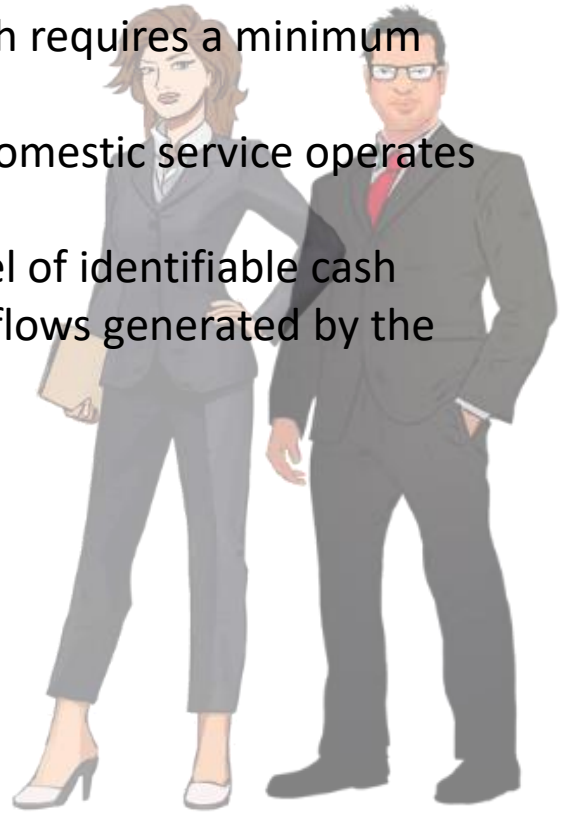
- Its value in use can not be estimated to close to its fair value less cost to sell for example when the future cash flows from continuing use of the asset can not be estimated to be negligible.
- It does not generate cash inflows which are largely independent of those from other assets
- In this case recoverable amount of the cash generating unit to which asset belong must be determined.
- Identify the lowest aggregation of assets which generate largely independent cash inflows may be a matter of considerable judgement
- Management should consider various factors including how to monitor organisations operations for example product lines, individual locations etc or how to make decisions about continuing or disposing of the organisations assets and operations.
- Some times it is possible to identify the cash flows from the main part of specific asset but these can not be earned independently from other assets. In such cases assets can not be reviewed independently and must be reviewed as part of cash generating unit.

- If an active market exists for the output produced by an asset or group of assets this asset or group of asset should be identified as cash generating unit if some or all of output is used internally.

- Cash generated unit must be identified consistently from period to period for same asset or group of asset, unless change is identified.

Example
Airport: Cash generating Unit

An organization operates an airport which provides services under contract with a government which requires a minimum level of service on domestic routes in return for licence to operate in international routes.
Assets devoted to each route and the cash flows from each route can be identified separately. The domestic service operates a significant loss.
Because the organization does not have the option to abandon the domestic service, the lowest level of identifiable cash inflows are largely independent of the cash inflows from other assets or groups of assets are cash inflows generated by the airport as a whole. This is therefore is a cash generating unit



Accounting for Impairment Loss:

If the recoverable amount is less then the carrying value of asset then impairment loss need to be recognized in statement of profit and loss

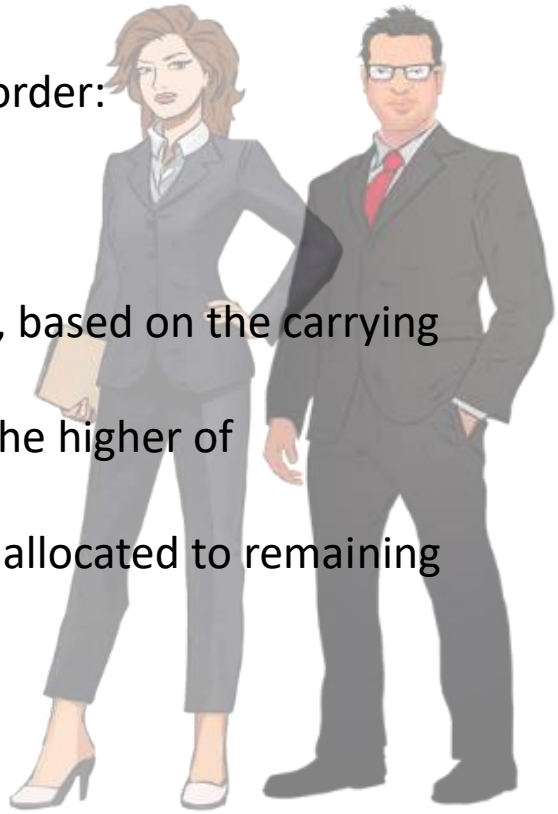
After the impairement the carrying amount of the asset less any residual value is depreciated over its remaining expected useful life

Allocation of impairment within cash generating unit:

The impairment loss should be allocated between all assets of cash generated unit into the following order:

- Write off good will allocated to cash generated unit if any
- Write off the asset completely which is completely damaged.
- Then remaining impairment should be allocated between other assets of the unit on pro rata basis, based on the carrying value of each asset in the unit.
- While allocating the impairment loss the carrying value of the asset should not be reduced below the higher of

Fair value less cost to sell or Value in Use. In this scenario remaining impairment loss should be allocated to remaining assets of the unit. On pro rata basis



Example:

At January Panda co paid $2800 for a company whose main activity consist of refuse collection. The acquired company owns four refuse collection vehicles and a government license without which it could not operate

At January the fair value less cost to sell of each lorry and license is $500. the company has no insurance cover.

At 1st February one lorry crashed because of its reduced capacity the organization estimates the value in use of the business at $2220

Required:

Show how the impairment loss is allocated to the assets of the business.

Answer:

Impairment loss

	1 January	Immpairment Loss	1st February
Goodwill	300	(80)	220
Intangible Business	500	-	500
Lorries	2000	(500)	1500

Reversal of Impairment:

In case of Goodwill impairment can never be impaired

In case of the assets if indicators of impairment not apply any longer impairment can be reversed.

In case of revaluation model. Impairment can be reversed up to the maximum to carrying value which asset had the time of first time impairment.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Before IAS 37 there was no standard which govern Provisions. And What companies use to recognize Provision is companies good economy times and used to reverse them in bad economy times. As un settled liabilities are Income. This practice was carried on by many companies Just to book Profits in bad economy time. This practice is exercise of creative accounting and which is also known as cherry picking.

To stop this Practice IASB issued the standard IAS 37.

The objective of IAS 37 to ensure the appropriate recognition criteria and measurement basis applies to

- Provisions
- Contingent Liabilities
- Contingent Assets

To ensure sufficient information is disclosed in the notes to the financial statements in respect of each of these items

Definitions:

Provisions:

Provision is the liability of uncertain timing and amount

Liability:

A present obligation of the entity arising from the past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits

Obligating event:

An event which creates a legal or constructive obligation which results in an entity having no realistic alternative to settle down that obligation.

Legal obligation:

An obligation which derives from:

- Contract
- Legislation
- Other operation of law

Constructive obligation:

An obligation which derives from an entity's action where:

- By an established pattern of past practice published statement, or suffieciently specific current statement. The organisations has indicated to other parties that it will discharge those responsibilities

Contingent Liabilities:

A possible obligation which arises from an past events and whose existence will be confirmed only on the occurance or non occurrence of one or more uncertain future events which are not wholly in the control of organization.

Contingent Asset:

A possible asset which arises from an past events and whose existence will be confirmed only on the occurance or non occurrence of one or more uncertain future events which are not wholly in the control of organization

Onerous Contract:

A contract in which unavoidable cost of meeting the obligations under the contract exceed the economic benefits expected to be received from it

Restructuring:

A plan which is planned and controlled by management and materially changes either:

- The scope of business undertaken by an organization
- The manner in which that business is conducted

Provisions:

provision must be recognized when following conditions have been met:

1. Present Obligation
2. Probable outflow
3. Reliable estimate

Example: A organization give warranties to the buyers of its product. Under the terms for the contract of sale. The organization undertakes to make goods by repair or replacement, manufacturing defects which apparent within five years of purchase from the date of sale. Based on past experience it is probable that there will be some claims

In this scenario sale under warranties give rise to present obligation.

It provide for the best estimate of the cost of making goods under the warranty of goods Sold by the end of reporting period

Example In wedding of 2015 20 guests got ill due to food poisoning from fppd catering of Duba cattering. After few legal proceeding the Lawer told to Duba cattering it is likely that you have to pay damages of $50000

So in this scenario there is Present obligation , there is probable outflow and reliable estimate as well so Provision need to be recognize

Example: A super market has policy of refund of goods by dissatisfied customers. Though it is no under legal obligation to do so. Its policy of making refunds is generally known.

In this scenario present obligation occurs when sales has been made which gives rise to constructive obligation as valid expectations has been created
It is also probable that portions of goods will be return and reliable estimate can be made so provision need to be recognized

Example: An organization operates in a oil industry in which contamination occurs and it operates in a country where there is no environmental policy. However organization has published policy in which it clearly states it is the responsibility of the organization that they will clean up the contamination that it causes

In this scenario present obligation occurs when contamination occurs. Therefore it's a constructive obligation because entity's past practice creates a valid expectation
Also there is a probable outflow and reliable estimate as well so Provision need to be recognized

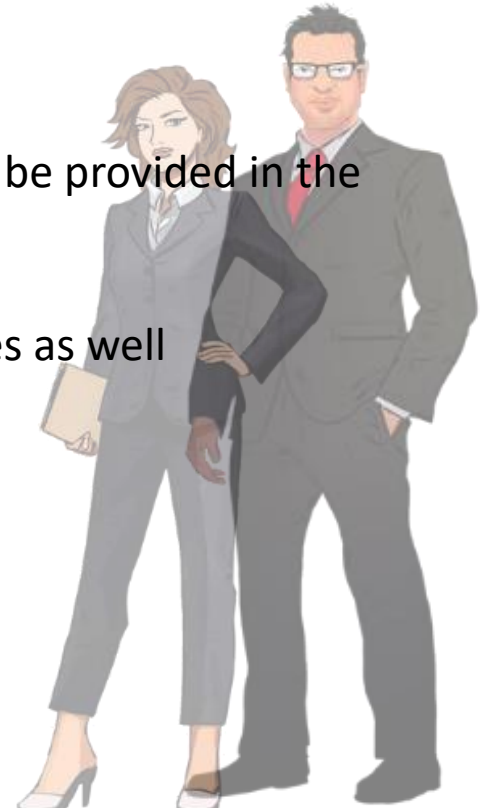
Contingent Liabilities and Assets:

In case of Contingent Liabilities these should not be recognized but disclosures related to then should be provided in the statement of financial position

In case of contingent Asset These should not be recognized also there is no need to provide disclosures as well

Measurement:

The amount provided should be the best estimate at the end of the reporting period of the expenditure required to settle the obligation. The amount is often expressed as:



- The amount which could be spent to settle the obligation
- To pay to a third party

It may be derived from management judgment which has been gathered by:

- Experience of similar transaction
- In some cases experts evidence

Uncertainty:

An organization should take account of any uncertainty surrounding the transaction which may include:

- The use of the most likely outcomes in the situations in which single obligation is measured
- An expected value calculation in which there is a large population.

Factors:

The following factors should be considered when estimating the amount of the obligation:

- The present value of future expected cash flows
- Evidence of future expected events such as
- Improve or new technology
- Changes in law

Changes in provisions:

The provisions should be reviewed regularly and if there is any change in the estimation of provisions. Provision should be revised immediately.

Self Insurance:

The cost of business become prohibited for many businesses that why they choose to self insure rather than take out insurance policies against various risks that they face

Instead of paying insurance payments they may keep cash a side to meet those future expenses. IAS 37 does not allow such provisions to be recognizes. Such expenses can only be expense in profit and loss statement when they actually occur.

Onerous contract:

If an organization has onerous thee present obligation under that contract should be recognize as provision.

Restructuring:

Examples:

- ❑ Closure of business location in region
- ❑ Changes in management structure
- ❑ Sale or termination of line of business

- Relocation from one region to another

Application of recognition criteria:

A constructive obligation to restructuring only arises when :

1. When entity has detailed formal plan for restructuring
2. Entity has create a valid expectation that it will carry out the restructuring

A detail formal plan must identify the following:

- The business or part of the business concerned
- The principal locations affected
- When the plan will be implemented
- The expenditure which will be undertaken
- The location, function and approximate number of employees who will be compensated for terminating their services

A management decision to restructuring does not create the constructive obligation until or less entity start to implement the restructuring plan

Announced the main feature of the plan to those affected in a sufficiently specic manner to raise a valid expectation that restructuring will incur

Decommissioning cost:

Sometimes organizations has to spend money when they has to close down or dispose of the asset. According to IAS 37 when organization has to incur such costs provisions are required and such provisions should be made using present value of future cash flows

Such provisions should be made at the initial recognition of the asset

Example:

Ben Plc is committed to dismantle the asset in 10 years and the estimated cost to dismantle the asset is 10 million. The obligation satisfies the recognition criteria of IAS 37.

The interest rate is 8%

1 January 2015

Initial recognition

$10m x 1/(1 + 0.08)^10 = 4631935

Asset Dr 4631935
Provision Cr 4631935

At 31 December 2015 Measurement of the provision:

$10 million x 1/(1 + 0.08)^9 = 5002490

Which will be presented as follows

Balance brought forward	4631935
Borrowing cost (8% x 4631935)	370555
	5002490

IAS 38 Intangible Asset

This standard applies to all intangible assets except for IAS 2, IFRS 5, IFRS 3, IAS 12, IAS 19, IAS 32 and IFRS 15.

Intangible Assets:

These are identifiable non monetary assets without physical substance

Following are the examples of Intangible Assets:

- Licenses
- Copyrights
- Intellectual property
- Trademarks
- Patents

Example:

Classify each of the following as either tangible asset or Intangible asset:

Asset:

1. Specialised software embedded in computer controlled machine tools
2. The operating system of personal computer
3. A firewall controlling access to restricted sections of an internet website
4. An of the shelf integrated publishing software package.

Answer:

1. Specialised software integerated to the production line “robots” is an integral part of the related hardware and should be accounted for under IAS 16 property plant and equipment and it’s a tangible asset.

2. The operating is a integral part of the related hardware and should be accounted for under IAS 16 property plant and equipment and its an tangible asset.
3. Companies developing firewall software to protect their own website may also sell the technology to other companies therefore it is an intangible asset.
4. Such computer software is not an integral part of the hardware on which it is used there it is an intangible asset.

Recognition:

An intangible asset should be recognise when it complies with the definition of intangible asset and meets recognition criteria sets out by the standard:

Recognition criteria:

- It is probable future economic benefits will flow to the entity
- Cost can be measured reliably.

Goodwill Vs other Intangible Assets:

Goodwill as an general terms describes such things as brand name, patents, competitive advantage. It is generated over many years with expenditure on promotion, the creation and maintenance of good customer and supplier relations

The provision of high quality goods and services, skilled workforce and experienced management.

Goodwill accounting treatment:

Expenditure can be recognised in only two ways:

It can be either recognised as an asset or as an expense.

A business does not incur cost specific to build goodwill but to the related activities such as promotion, client services, quality control etc.

An entity can not recognise internally generated goodwill as an in its financial statement because it does not meet the definition of Intangible asset as it is not **Identifiable,** In particular it is clearly **inseparable.** It only can be disposed of with the business as a whole.

However when business is acquired as a whole, the buyer will usually pay a price in excess of the fair value of all the assets. (net of liabilities) which can be separately identified including other intangible assets such as intellectual property.

This premium not only represents the future economic benefits expected to arise from the intangible asset which is goodwill in the acquired company but also those which arise from expected synergies for example cost savings and other benefits of acquications.

Here are the accounting treatment for goodwill as purchased asset in the consolidated financial statements of an acquirer are:

- ✓ Immediate write off
- ✓ Carry at cost(with or without annual impairment review)
- ✓ Carry at cost with annual amortisation
- ✓ Carry at revalued amount.

Measurement:

The cost of the intangible asset usually can be measured reliably when it has been separately acquired for example purchase of computer software.

The price paid normally will reflect expectations of future economic benefits, the probability recognition criteria is always considered to be satisfied for separately acquired intangible asset.

Every cost of the asset will be capitalise which is necessary to bring asset into working condition or to sell

Following expenditures will not be capitalised and need to expensed in profit and Loss statement:

- Advertising and promotion cost
- Administration and other general overheads
- Cost incurred in redeploying the asset
- Initial opperating cost and losses

Example:

Sallo Company on 31st December 2005 it was successful to bid to acquire exclusive rights of patent which was developed by another organisation.

The amount payable for the rights are $60000 immediately and $400000 in one year time. Sallo has incurred legal fees of $87000 inn respect of the bid. In jurisdication where sallo company operates the government charges stamp duty of $1000 for the registration of patent rights. Sallo co cost of capital is 10%

Required: Calculate the initial cost of patent right on initial recognition of patent rights.

Solution:

	$
Cash paid	600000
Deffered consideration (400000 x 1/1.1)	363636
Legal fees	87000
Stamp duty	1000
Cost of initial recognition	1051636

Business combination:

The cost of an intangible asset acquired in a business combination is its fair value at the date of acquisation, irrespective of whether the intangible asset had been recognised by the acquiree before the business combination

The fair value of itangible assets acquired in business combinations normally can be measured with sufficient reliability to be recognised separately from goodwill

The fair value will reflect market participants expectations at the acquisation date about the probability that the expected future economic benefits embodied in the asset will flow to the organisation.

Example:
Mogambo Plc on 31st December it paid 10000000 for 100% interest in Balanca Co.
At the date of acquisition the net of the Balanca as shown on its statement of financial position had a fair value of 6000000. In addition, balanca had the following rights:

1.The brand name Nimma, a middle of the range fragrance. Balanca. Balanca had been considering the sale of his brand just prior to its acquisation by Mogambo. The brand had been valued at $300000 by brand Moja a reputable firm of valuation specialist which had used a discounted cash flow technique.

2. Sole distribution rights to a product called xoxo. It is estimated that the future estimated that the future cash flows generated by this right will be $250000 per annum for the next 6 years. Mobango has determined that the appropriate discount rate for this right is 10% for 6 year and 10 year annuity factor is 4.36

Required: Calculate goodwill arising on acquisition.

Answer:

		‘000
Cost		10000
Net asset recognised in Balanca:		
Statement of financial position	6000	
Brand acquired	300	
Distribution right (250000 x 4.36)	1090	
		(7390)
Goodwill		2610

Subsequent expenditure:
In case of subsequent expenditure need to be expensed in research cost cases. In Development cost it will be expensed as well.
However if it meets Development cost criteria it will be capitalised.

Internally Generated Goodwill:

Internally generated good will not be capitalised because it is not an identifiable resource i.e. it is not separable also it is not arise from contractual or other legal rights.

Other Internally generated Goodwill:

Sometimes it is difficult to assess whether an internally generated intangible asset qualifies for recognition specifically if is often difficult to:
Identify whether there is an identifiable asset which will generate probable future economic benefits
And cost of the asset can be measured reliabely.

Specific recognition criteria:

In addition to general recognition criteria Intangible asset are required to meet specific criteria as well which is divided into two components

1. Research Cost:

Research cost will always be expensed in Statemet of profit and loss

Examples of research cost are as follows:

- Activities aimed at obtain new knowledge
- The search for alternatives such as material, product design, specification etc
- The formulation such as design, evaluation and final selection of possible Alternatives.

Accounting treatment In Development Phase:

An intangible asset arising from development phase can be capitalized if it meets the following criteria:

1. Probable that the future economic benefits will flow to the entity
2. Resources are available to complete the asset
3. Intention to complete the asset
4. valuable for the organisation to complete and sell the asset
5. Availability of resources to complete the asset for sell and use
6. Technical feasibility to complete the asset so that it can be use or sell.
7. Economic outflow can be reliably measured.

Example

- Design, construction and testing pre production
- New or improved material, devices, products.
- Processes, systems or services.

Illustration

ABC co developing a production process the amount of expenditure in the year to 31 December 2016 was as follows:

	$
1 january to 30 November	2160
1 december to 31 December	240

On 1st December the organisation was able to demonstrate that the production process met the criteria for recognition as an intangible asset. The amount estimated to be recoverable from the process including future cash outflows to complete the process before it is available for use is $1200

At 31st December, the production process is recognised as an intangible asset at a cost of $240. the intangible asset carried at this cost is less than the amount expected to be recoverable

The 2017 expenditure incurred before 1st December is recognised as an expense because the recognition criteria were not met until that date. This expenditure will never form part of the cost of the production process recognised in statement of financial position.

Expenditure in 2017 is $4800 at 31 december 2017 , the amount estimated to be recoverable from the process including future cashflows to complete the process before it is available for use is $4500.

At 31st December the cost of the production process is $5040 (240 + 4800) The organisation recognises an impairment loss of $540 to adjust the carrying amount before impairment loss. $5040 to its recoverable amount which is $4500

This impairment loss must be reversed subsequently it the requirement of IAS 36 are met.

Measurement after recognition:

Cost Model
Revaluation Model

Cost Model:

Cost less accumulated depreciation less Impairment losses

Revaluation Model:

Fair value at the date of revaluation less any amortisation less impairment

Fair Value must be measured by reference of market value

Revaluations of the asset can be review annually and if there is any material difference then it should be recognized in the financial statements immediately.

The accounting treatment for revaluations of intangible assets is same as other assets.

Useful Life:

The useful life of an intangible asset should be assessed as finite or indefinite.

A finite useful life is assessed as period of years or number of production or similar units. An intangible asset with a finite life is amortized

Useful life is regarded as indefinite when there is no foreseeable limit to the period over which asset is expected to generate net cash flows.

Factors to include in determining cash flows include:

- Typical product life cycle by the organisation
- Expected usage of asset by the organisation
- Public information on estimates of useful lives of similar types of assets
- Legal limits on the use of assets
- Technical, technological, commercial or other obsolescence;
- Stability of the industry in which the asset operate.

Amortisation:

The depreciable amount of an intangible asset should be allocated on systematic basis over the best estimate of its useful life

The amortisation of the asset begins when asset is available for use and it will be cease as soon as asset is derecognise or it is held for sale under IFRS 5.

The amortisation charge for each period will be include in statement of profit or loss

Residual value:

The residual value of an asset is assumed to be zero until or less it is committed by some one to purchase asset at the end of its useful life

Or there is active market of the asset.

Review:
Amortisation method and period should be reviewed at each year end.

Example:
Mishi Co on 1st january established a new research and development unit to acquire specific knowledge about the use of chemicals for pain relief.

The following expenses were incurred during the year ended 31 December:

1. Purchase of building for $400000. the building is to be depreciated on straight line basis at the rate of 4% per annum.
2. Wages and salaries of research staff are 2355000
3. Scientific equipment costing $60000 is to be depreciated using a reducing balance rate of 50% per annum.

Required: Calculate the amount of research and development expenditure to be recognised as an expense in the year ended 31 December

Answer:

The following cost should be written off:

	$
Building depreciation (400000 x 4%)	16000
Wages and salaries of research staff	2355000
Equipment depreciation (60000 x 50%)	30000
	2401000

Example:

Panda Co in its first year of trading to 31 December they have incurred the following expenditure on research and development, none of which related to purchase of property plant and equipment

1. $12000 on successfully devising processes the sap extracted from mangroves into chemical x , y and z.
2. $60000 on developing an analgesic medication based on chemical z.
3. No chemical uses yet has been discovered for X and Y.

Commercial production and sales of analgestic commenced on 1 september and are expected to produce steady profitable income during a five year period before being replaced. Adequate resources exist for the company to achieve this.

Required:
Assuming no impairment, determine the maximum amount of development expenditure which may be carried forward at 31 December under IAS 38.

Answer:

Cost:

1.This is research cost which can not be capitalised under any circumstances and must therefore be expensed to profit or loss.

2. Initially recognised cost is $60000. residual value presumed to be zero.

Amortization:

Amortisation from 1 September for period of 5 years

4 month amortisaion is 4/60 x $60000 = $4000

Carrying amount

$60000 - $4000 = $56000

IFRS 9 Financial Instrument

Financial Instrument:

Any contract which give rise to financial asset to one entity and financial liability or equity instrument to another entity is known as financial instrument.

For Example A company sell goods to B company and in return A company asked either to Pay cash or Debt instruments of Apple company held by B company to settle the debt. In this scenario. It is financial asset to A company and financial Liability to B company.

Financial Asset:

Financial asset which 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 the conditions which are favourable for entity.
- An equity instrument of another entity.
- Certain contracts which will or may be settled in the entity own equity instruments.

Financial Liability:

Any liability which is a contractual obligation:

- To deliver cash or another financial asset to another entity.
- To exchange financial instrument with another entity under conditions that are potentially unfavourable
- Certain contracts that will or may be settled in the entity ‘s own equity instruments.

Physical assets, liabilities which are not contractual in nature for example taxes, operating lease, prepayments are not financial instruments.

Equity Instrument:

Any contract which give rise to a residual interest in the assets of the company after deducting all of its liabilities.

Fair value:

The price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Derivative:

Derivatives are the financial instruments which depends on other factors or instruments such as commodity, oil prices, foreign currency exchange rates, interest rates etc. Derivates initially have very low investment or nil investment and they always settle in the future.

Convertible bonds are the example of derivates as well. As they have element of liability and as well as equity and also they settle in the future date.

As per IAS 32 following assets are not the financial instruments :

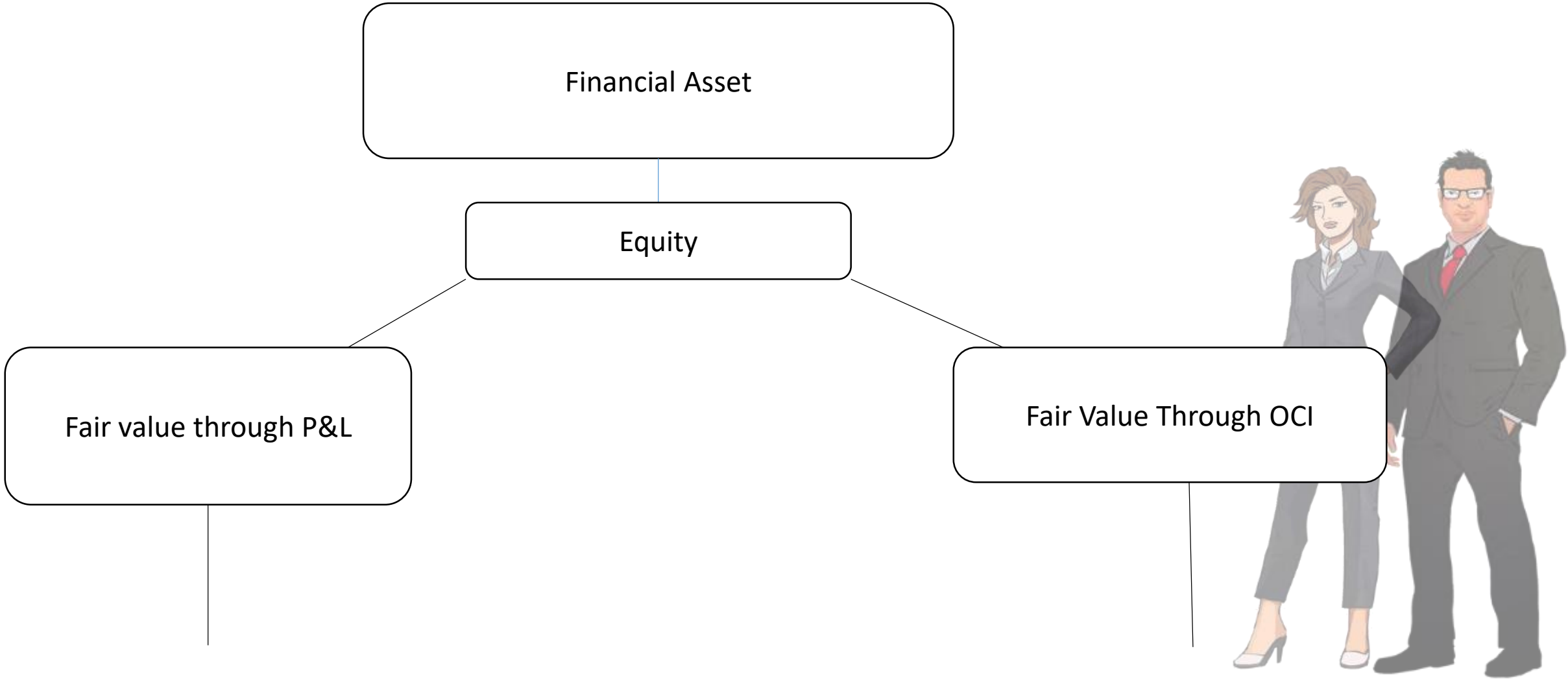
Physical assets such as:
- Inventory
- Plant and equipment
- Leased assets
- Intangible assets

Prepaid expenses such as deferred revenue and most warranty obligations

Liabilities or assets that are not contractual in nature.

Presentation of Financial statement:

IAS 32 should be applied in the presentation and disclosures of all financial instruments but certain items are excluded from it for example subsidiary,associates, joint venture, pension and insurance contracts.



- All short term investments need to be recognise in fair value through P&L model
- All changes will be recognise according to fair value
- Changes in fair value will be recognise in P&L immediately.

- All long term investments will be recognise in fair value OCI model
- All changes in fair value will be recognise according to fair value
- Changes in fair value will recognise in OCI equity

Example 1:

ABC company bought short term investment for $1000 in 2005 and in 2006 its fair value is $1500 but at the end of 2007 its fair value is $1200.
Required:
Determine which model to use and make journal entries:

Is it difficult ???? Naa…….

In 2005 ABC bought it so entry will be

Financial asset Dr 1000
Cash Cr 1000

In 2006 its value went up so

Financial asset dr 500
Cash Cr 500

And in 2007 its value went down so:

P&L Dr 300
Financial Asset 300

Now don't tell its difficult you Hunks and Hotties :D

Relax here it is a example on OCI:

Bips Bought A Financial asset for $10000 for long term investment in 2011 as she want to buy Ferrari after 3 years and is transaction cost is $500. In 2012 its value is $13000 and in 2013 she sold it for $15000.

Required: Prepare the journal entries

In 2011 when she bought it

Its simple Hot pants:

Financial asset Dr 10500
Cash Cr 10500

In 2012 when it went up:

Financial asset dr 2500
OCI Cr 2500….. So its easy as well Panda Boys :D

Now when she sold her asset in 2013 it will be

Cash Dr 15000

P&L Cr 2000

Financial asset Cr 13000

Ok ReLAX Chicky gal am telling you that what we will do the reserve of OCI

Its Simple:

OCI Dr 2500

Retain Earning Cr 2500…….. Bingoooooo Itas easy as well ☺

Hey Zee……What about Financial Asset Liability side then ???? Relax…… Donut Bouyyyyyyy…….. It's a next part I m gonna discuss about ☺

Financial Asset

Liability

Amortise Cost Model

Fair Value through P&L model

Amortized cost model

Amortize cost model is for long term investment and to enter into this model one has to pass two tests

1. Business model test
2. Cashflow charteristic test

Fair value through P&L model

Changes will be recorded according to fair value

Fair value changes will be recorded in P&L.

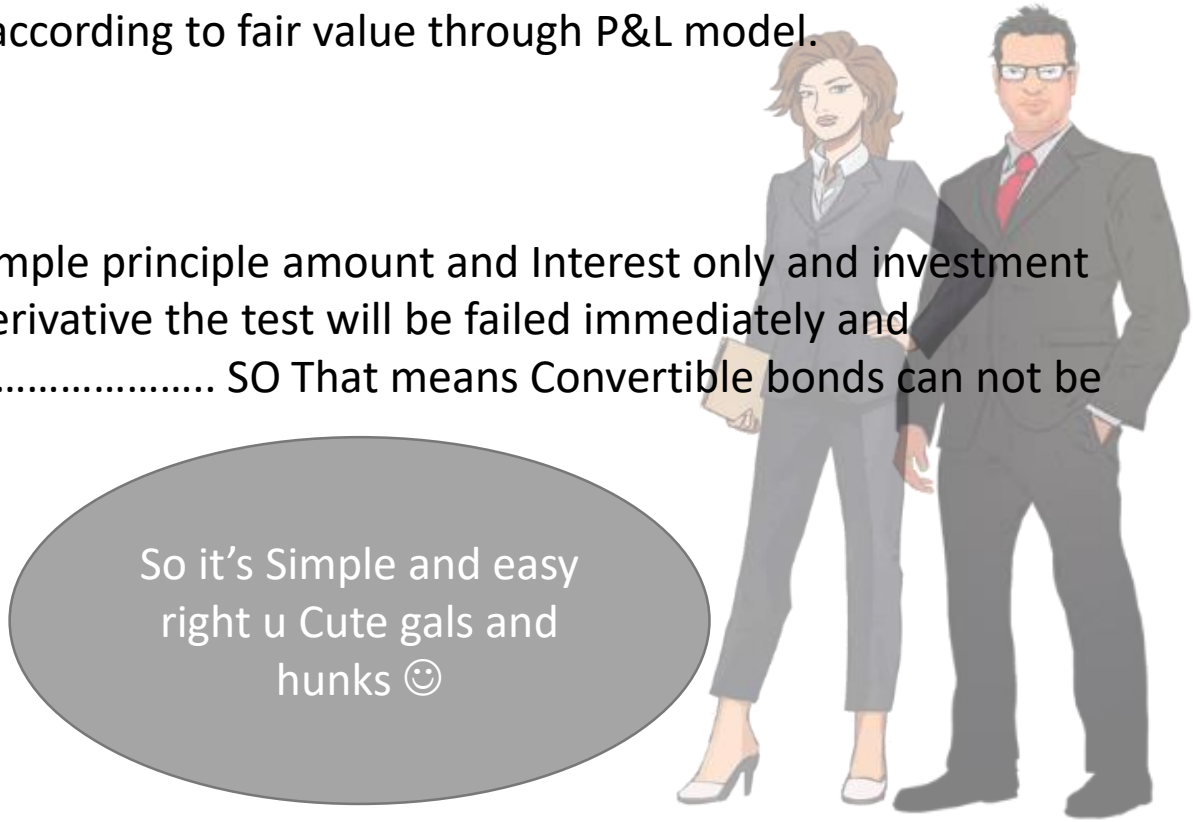
Amortize Cost Model:
he
To enter into amortize cost model individual has to pass two tests

Business model test
Cashflow characteristic test

Business model test:

To pass the business model test individual has to ensure that investment is for long term. If individual sell it in short term test will be failed and than individual has to account for the transaction according to fair value through P&L model.

Cashflow characteristic test:
is
To pass this test Individual has to ensure that investment contains simple principle amount and Interest only and investment must not contain any sort of derivative. If they got little bit hint of derivative the test will be failed immediately and individually has to account for it according to fair value through P&L…….. SO That means Convertible bonds can not be recorded in amortize cost model ever as it is a derivative ……..



Financial Liability

Fair value through P&L Model

Changes will be recorded according to fair value

Changes will be recorded in P&L

Changes will be based on Market interest rate

Amortize cost model

Need to pass two test

1. Business model test
2. Cash flow characteristic test

Example:

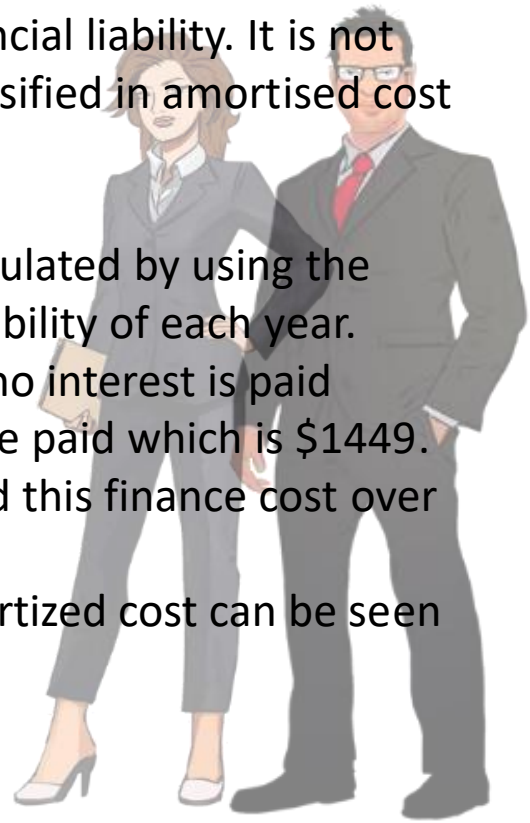
Lala raises finance by issuing zero coupon bonds on par at the first day of the current accounting period with a nominal value of $10000. the bond will be redeemed after two years at a premium of $1449. the effective rate of interest is 7%

Required:

Explain and illustrate how the loan is accounted for in the financial statements of Lala.

Solution:
Lala is receiving cash and will be obliged to repay it so this financial instrument will be classified as financial liability. It is not stated in the question that it is for trading purposes or it is for short term so this transaction can be classified in amortised cost model.

While applying the amortize cost model the finance cost charge to the statement of profit or loss is calculated by using the effective interest rate which is 7% in the example it is applying to the opening liability to the opening liability of each year. Where as bond is zero coupon bond which means no actual interest is paid during the year. All though no interest is paid during the year still there is a finance cost in this example as in the end redemption premium need to be paid which is $1449. the finance cost recognized in the statement of profit or loss as an expense. It is inappropriate to spread this finance cost over the life as this would ignore the compound nature of the finance cost.
In final year there is a single cash payment that would settle whole obligation. The working for the amortized cost can be seen below.



Year	Opening balance	Plus statement of profit or loss finance charge @7% on opening balance	Less: cash paid	Closing balance: being the liability on statement of financial position
1	$10000	$700	Nil	$10700
2	10700	$749	($11449)	NIL

Relax relax….. Buddies…. I know its tough topic and it is regularly tested by the examiner of F7 and P2…….. So I am giving another example on it and Complex one as well

Example:

Mishi raises a finance by issuing $20000 6% four year loan notes on the first day of the current accounting period. The loan notes are issued on the discount of 10% and will be redeemed after three years at a premium of $1015. the effective rate of interest is 12%. The issue costs were $1000.

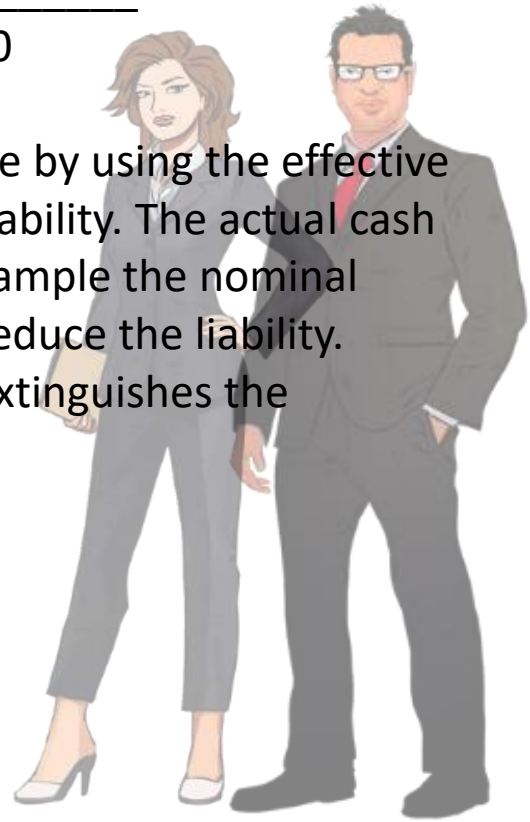
Required: Explain and illustrate how the loan is accounted for in sofp of mishi.

Solution:

Mishi is receiving cash which she is obliged to repay, so this transaction is financial liability and this transaction will be recorded under amortized cost. Thouh it will be initially measured at fair value of the consideration received less the transaction cost.
With both discount on issue and transaction cost first step is to calculate the initial measurement of the liability.

Cash received – the nominal value less the discount on issue ($20000 x 90%)	$18000
Less the transaction cost	($1000)
Initial recognition of the financial liability	$17000

While applying amortize cost the finance cost to be charge to the statement of profit or loss is calculate by using the effective interest rate 12% in this example to the opening liability each year. The finance cost will increase the liability. The actual cash is paid at the end of the reporting period and it is calculated by applying the coupon rate 6% in this example the nominal value of the liability in this example is $20000. the annual cash payment of ($20000 x 6%) $1200 will reduce the liability.
In final year there is an additional cash payment of $21015. (the nominal is $2000 and $1015) which extinguishes the remaining balance of the liability. The working for amortized cost can be seen below:



Year	Opening balance	Plus statement of profit or loss finance charge @12%on opening balance	Less: the cash paid 6% on $20000	Closing balance, being the liability on the statement of financial position
1	$17000	$2040	($1200)	$17840
2	$17840	$2141	($1200)	$18781
3	$18781	$2254	($1200)	$19835
4	$19835	$2380	($1200) ($21015)	NIL

The cash paid each year is less than the finance cost, each year the outstanding finance liability will be growed and for this reason the total finance cost charged to the income each year over the period of loan comprises not only on the interest paid but also discount on the issue, the premium on the redemption and the transaction cost.

Interest paid (4 years X $1200)	= $4800
Discount on issue (10% x $20000)	=$2000
Premium on redemption	= $1015
Issue cost	=$1000
Total finance cost	$8815

Financial liability at fair value through P&L :

Financial liabilities are only classified as fair value through P&L if they are held for trading the organisation so chooses. The option to designate a financial liability as measured at fair value through P&L will be made if doing so significantly reduces an accounting mis match that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases or if the liability or group of financial liabilities or financial assets and financial liabilities that is managed and its performance is evaluated on a fair value basis according to the investment strategy. Also financial liability still required to recognised under financial liability if it contains onw or more embedded derivates in it.

Financial liabilities which are recorded under FVTPL are initially measured at fair value and any transaction cost are immediately written off to the statement of profit or loss.

As far as accounting for financial liability at FVTPL is concerned. The financial liability is also

Increased by the finance cost and reduced by the cash repaid but is than revalued at each reporting date with any gains and losses immediately recognised In the statement of profit or loss. The measurement of the new fair value at the year end will be its market value or if not known the present value of the future cash flows using the current market interest rate. The interest rate subsequently to calculate the finance cost will be this new current rate until the next revaluation.

Example:

On 1 January 2011 Sara issued three year 5% $30000 loan notes at the nominal value when the effective rate of interest is also 5%. The loan notes will be redeemed at par. The liability is classified as FVTPL. At the end of the first accounting period market rates have been risen to 6%

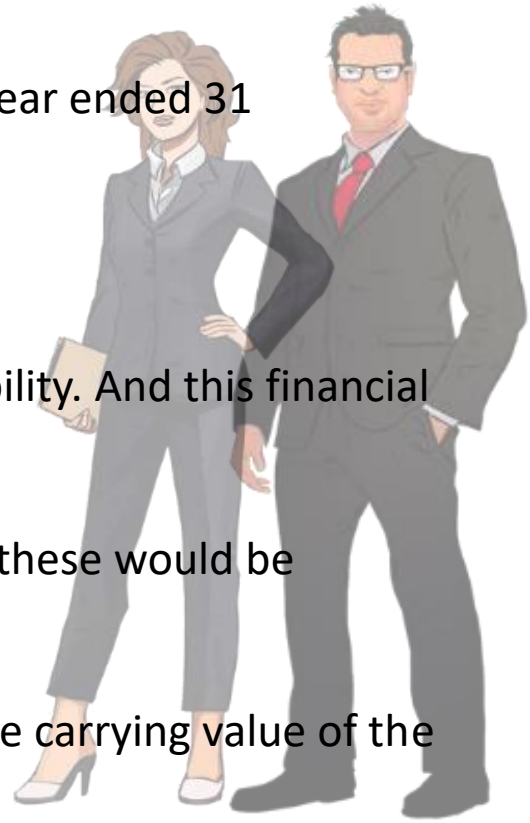
Required: Explain and illustrate how the loan is accounted for in the financial statement of Sara in the year ended 31 December 2011.

Solution:

Sara is reciving cash and so obliged to repay and so this financial instrument is classified as financial liability. And this financial instrument is either for trading purposes or it is intended to classify as FVTPL

Initial measurement is at $30000 received and although there are no transaction costs in this example, these would be expensed rather than taken into account in arriving at the initial measurement.

With an effective rate of interest and the coupon rate both being 5% at the end of accounting period the carrying value of the



Liability will still being be $30000. this is because the finance cost that will increase the liability is ($3000 x 5% applied on the opening balance of the liability , multiplied by the effective interest rate) and the cash paid reducing the liability is also $1500 (5% x 30000) – the coupon rate applied to the nominal value)

As the liability has been re classified as FVTPL this carrying value at 31 December 2011 now has to be revalued. The fair value of the liability at this date will be present value using the new rate of interest 6% of the next two year payments

	Cash flow	**6% discount factor**	**Present value of the future cash flow**
Payment due 31 December 2012 only	$1500 X	0.943	1415
Payment due 31 December 2013. the final interest payment and the repayment of the 30000	$31500 X	0.890	$28035
Fair value of the liability at 31 Dec 2011			**$29450**

As far as accounting for the remaining two years is concerned the finance of the statement of profit or loss will be 4% x 300288 =$1212 increasing the liability to $31500 before the final cash payment of 31500

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IFRS 15 Revenue Recognition from Contract with customers

IFRS 15 revenue from contracts with customer outline the five steps to recognise the revenue which are as follows:

- Identify the contract with customer
- Identify the separate performance obligation
- Determine the transaction price
- Allocate the transaction price to the performance obligation
- Recognize revenue when or as a performance obligation is satisfied.

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Identify contract with customers:

Contract:

An agreement between two or more parties that creates enforceable rights and obligations, contracts can be written, verbal or implied based on an organisation's customary business practices.

The revenue recognisation principle of IFRS 15 apply only when a contract meet all of the following criteria:

1. The parties to contract approved the contract
2. The organisation can identify each party rights and obligation regarding the goods or services in the contract.
3. The payment terms are identified
4. The contract has commercial substance
5. It is probable that entity will get the economic inflows from the contract

Identify performance Obligation:

Performance obligation: it's a promise to transfer to customer

- ✓ A goods or service
- ✓ A series of goods or service that are substantially the same and are transferred in same way

However if promise to transfer good or service is can not be differentiate from each other in the contract, then the goods or service will be combined in to single performance obligation.

A good or service is same if both of the following criteria are met:

- ➢ The customer can benefit from good or service on its own or with combined with customer available resources.
- ➢ The promise to transfer good or service is separately identifiable from other good or service in the contract.

A good or service is not separately identifiable if:

- Goods or service is not integrated with other goods or service in the contract
- Does not modify or customise another good or service in the contract.
- Does notdepend on other goods or services promised in the contract

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Determine the transaction price:

Transaction Price: the amount of consideration to which an organisation is entitled in exchange for transferring goods or services.

- The transaction price does not include the price collected for third parties for example Sales tax or VAT.
- The effects of the following must be considered when determing the transaction price:
  - The time value of money
  - The fair value of any non cash considerations
  - Estimates of variable consideration
  - Consideration payable to the customer.

Consideration payable to the customer is treated as reduction in transaction price unless the payment is for good or services received from the customer.

Example:

On 1 january 2015, Benzee sold car to a customer for $ 4000 with three years interest free credit. The customer took delivery of the car on 1st january 2015. the amount $4000 is payable to Benzee on 31st december 2017. Benzee's cost of capital is 8%

Required:

Determine the transaction price for the sale of the furniture and calculate interest income to be recognized over three years

Solution:

($4000 x 1/1.08^3)=3175$

Interest income will be recognised as follows:

2015: $3175 x 8%= 254
2016: 3175+254 x 8%= 274
2017: ($3175+$254+$274)x8%= 297

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Allocation of Transaction Price:

The transaction price is allocated to the all separate performance obligations in proportion to the stand alone selling price of the goods or services.

Stand alone selling price:

The prce at which organisation would sell promised good or service separately to customer.

The best evidence of the stand alone selling price is the observable price of good or service when it is sold separately

The stand alone selling price should be estimated if it is not observable

The allocation is made at the start of the contract and there will be no adjustment need to be made for subsequent changes made in the stand alone selling price of the good or service

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Example:

Mayoo enter into contract with customer to transfer software licens, perform installation and provide software update and technical support for five years in exchange for $240000.
Mayoo has determined that each good or service is seprate performance obligation. Mayoo sells the license, installation, updates and technical support separately, so each has a directly observable stand alone selling price

Software installation	$150000
Installation service	$60000
Software update	$40000
Technical update	$50000
	========
	$300000
	=========

Required:
Allocate the $240,000 transaction price to the four performance obligations.

Solution:

Software solution 240000 x 150/300 = 120000
Installation service 240000 x 60/300= 48000
Software updates 240000x 40/300= 32000
Technical support 240000x 50/300= 40000
========
Total 240
========

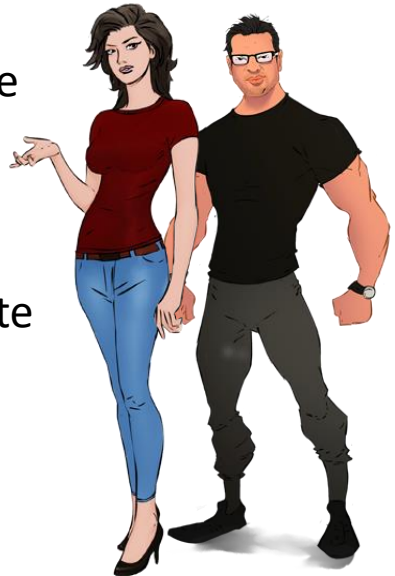
Revenue Recognition:

- Recognise revenue when or a performance obligation is satisfied transfering performance a promised good or service (an asset) to the customer
- A asset is trandferred when customer gets the control of the asset
- The organisation must determine that performance obligation is determine at point in time or overtime.

Performance obligations

Satisfied over time:
A performance obligation is satisfied over time if one of the following criteria is met:

- The customer recieves and consumes the benefits from the organisation ‘s performance as organisation’s performs for example monthly payroll processing service
- The organisation’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced for example work in progress asset.
- The organisation’s performance doesnot create asset with alternative use to the organisation and the organisation has an enfoceable right to payment for performance completed to date for example construction contract
- Revenue is recognised over time by measuring progress towards complete satisfaction of the performance obligation.
- Output and input can be used towards measuring progress
- Revenue for performance obligation satisfied over time can only be recognised if the organisation can make reasonable estimate of progress



- Revenue is recognised to the extent of the costs incurred if there is no reasonable estimate of progress, but organisation expects to cover its cost.

Satisfied at point in time:

- A performance obligation which is not satisfied over time is satisfied point in time
- Revenue should be recognised point in time when customer posses the control of the goods
- Indicator of transfer of goods include:

✓ The customer has obligation to pay for an asset
✓ The customer has legal tittle to the assset
✓ The organisation has legally transferred the asset to customer
✓ The customer has significant risk and rewards of the asset
✓ The customer has accepted the asset.

Presentation of statement of financial position:

A contract asset or contract liability should be presented in sofp when either party is performed in the contract.

Contract liability: An obligation to transfer goods or services to a customer for which the entity has received consideration from the customer or consideration is due from customer that is consideration pays or owes from the customer before organisation performs

Contract Asset: an organization right to receive consideration in exchange for the goods or services provided that means organization has complete the task before consideration received.

In addition any unconditional right to consideration should be presented separately in recievable according to IFRS 9

Example:

On 1st april Mika entered into non cancellable contract with Charlie for the sale of an machinery for $350,000. the machinery will be delivered to Charlie on 1st June. The contract requires Charlie to make payment on 1st may but Charlie makes the payment on 1st June.
Required:
Prepare the journal entries make by the Mike to account for this contract

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Solution:

On 1st May Mika recognise a recievable as it has an non cancellable right to consideration

Receivable Dr 350,000
Contract Liability Cr $350,000

On 1st June Charlie Make a payment , Mika recognise the cash collection:

Cash Dr $350000
recievable Cr 350000

On 1st July Mike will recognise the revenue when machinery is delivered to Mika

Contract liability Dr $350000
Revenue Cr $350000

Example (Contract Asset and recievable)

On 1st April Mika enters into contract with Charlie for the sale of two machinery for $350000 each. The contract requires 1st machinery to be delivered on 1st May and payment of the first machinery is conditional on the delivery of second machinery. The second machinery is delivered on 1st September.

Required:

Prepare the journal entries that would be require by Mika to account for this contract.

Solution:

On 1st may , Mika recognises a contract asset and revenue when it satisfied the performance obligation to deliver first machinery:

Contract Asset Dr $350000
revenue Cr $350000

A receivable is not recognised on 1st may as it has no unconditional right.

On 1st September when it satisfies the condition receivable will is recognised:

Receivable Dr 700000
Contract asset Cr 350000
Revenue Cr 350000

Measuring Progress towards completion:

Output method recognise revenue on the basis of the value to the customer of goods or services transfers to date relative to the remaing goods and services promised.

Example:

- Units produced or delivered
- Milestone achieved
- Appraisals of result achieved
- Surverys of performance completed to date
- Time elapsed.

The value of the work certify is use to measure of the degree of completion so that revenue can be recognised in profit or loss.

Input methods:

Input method recognise revenue on the basis of the organisation's efforts or inputs to the satisfaction of the performance obligation relative to the total expected output.

Examples:

- Cost incurred
- Resources consumed
- Time elapsed
- Labor hours worked

Revenues can be recognised on straight line basis if inputs are used evenly throughout the performance period.

Example:

Samba Beauty center enters into a contract with a customer for unlimited Beautician services through out the year for $5000the beauty center determine that as customer receive and consume the services throughout the year the contract performance obligation satisfies over time.

So now revenue will be recognised $5000/12= **$416.67 per month.**

Cost recognition:
Cost recognise in the same way proportion was applied to the revenue recognition. Except for the following:

1. Abnormal cost for example rectification process in the production of goods or providing services. It will be **expensed** in P&L simple and easy
2. Input cost that are not proportionate to the construction process

If incurred cost is not proportionate to the progress in the satisfaction to the of the performance obligation that cost **shall not be excluded** in the when measuring progress of the contract. Such cost should be excluded from the measuring progress of the contract

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Cheeko building a residential apartments building , last year cheeko entered into contract with a customer for specific unit which is under construction. Cheeko has determined that the contract is single performance obligation satisfied over time. Cheeko gathered following information related to the contract for the year:

Cheeko Company year ended 31 December

Cost to date $1500
Future expected cost $1000
Work certified to date $1800
Expected sales value $3200

Revenue taken in earlier periods $1200
Cost incurred in earlier date $950

Requuired:
Calculate the figures to be included in statement of profit or loss related to revenue or cost for the year ended 31 dec on both:

1. A sale basis (input method)
2. A cost basis (output method)

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Solution:

Total expected profit

	$
Revenue	3200
Less: contract cost to Date	(1500)
Less: Future expected Cost	(1000)
Profit	700

Measure of progress towards completion

Sale Basis
1800/3200=56.25%

Cost Basis

1500/2500=60%

Sale basis		cost basis	
Revenue to date 3200x.56.25%= 1800		3200x60%= 1920	
Revenue last year 1800-1200=	600	last year 1920-1200=	720
Cost of sales to date 2500x56.25%= 1406		2500x60%=1500	
Cost of sales Last year 1406-950=	(456)	1500-950=	(550)
Profit	144		170

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Recognition of Contract Costs

Incremental cost of obtaining contract: costs to obtain a contract that would have not been incurred if contract was not obtained

- The incremental cost of obtaining a contract, such as sales commissions, are recognised as an asset if the entity expects to recover them.
- Costs to obtain the contract that would have been incurred regardless of whether the contract was obtained are charge to expense when incurred

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Example:

Pepper enters into a contract with customer to transfer a computer software license, perform installation and provide software updates and technical support for three years for $240000

Pepper Incurred the following cost:

Legal fees $10000
Comission to sales employee $12000
Cost to deliver proposal $20000
Total

42

Determine which cost should be recognised as an asset and which should be expensed.

Answer

Assuming developer will recover the cost of legal fees and sales commission it would be recognissed as an Asset.
While the traveling cost will be expensed as it would have been incurred if contract was not obtained.

Cost to fulfill a Contract:

Cost incurred to fulfill a contract that are not within the scope of any other standard should be recognised as an asset if they meet all of the following criteria:

- ✓ Cost will increase the economic benefits for the organisation
- ✓ Cost are expected to recovered
- ✓ Costs are directly to contract

Costs that must be expensed when incurred include:

- Cost of wasted material, labor and other resources
- Costs that related to satisfied performance obligations
- General and administrative costs

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CoCo enters in to contract with a customer to transfer a computer software license, perform installation and provide software updates and technical support for three years in $300000. in order to fulfill the technical portion of the project, Coco purchases an additional work station for the technical support team. For $8000 and assigns one employee to be primarily responsible for providing customer a technical support. This employee also provide services to other customers. The employee is paid an annual salary of $ 30000 and is expected to spend 10% of his time supporting this customer.

Req:
Determine which cost should be recognised as an asset and which should be expensed.

The work station cost should be recognised as an asset Under IAS 16 PPE.
While employee cost will be recognised as an expense in P&L. as employee is already working for Coco and not specific to contract also Coco have no control over employee.

Principle Vs Agent:

When organisation use another party to provide goods or services to a customer, the organisation need to determine whether it is acting as principal or agent.

Prinicipal:
The organisation controls the good or service before it is transferred to customer and their revenue is gross consideration

Agent:
The organisation arranges for another to provide good or services and their revenue is sales commission.

Following are the indicators organisation is an agent and does not control the good or service before it is provided to customer include:

- The organisation is not exposed to credit risk
- The consideration is in the form of comission
- The organisation does not have inventory risk
- The organisation does not have the discreation in establishing for the other party ‘s good or services
- Another party is responsible for fullfilling the contract.

Repurchase agreement:

A contract in which entity sells an asset and also promises or has option to repurchase the asset

There are three types of repurchase agreement:

1. An organisation’s obligation to repurchase the asset at the customer request (put option)
2. An organisation’s right to repurchase the asset (call option)
3. An organisation obligation to purchase the asset (a forward)

Forward Or Call Option:

When an organisation has an option or right to re purchase an asset, the customer does not obtain control of the asset and organisation account for the contract as either:

- ❑ A lease if entity or must have to repurchase the asset lower then its selling price
- ❑ A financing agreement if organisation can or must have to repurchase asset equal to or higher than it original selling price.
- ❑ If repurchase agreement is financing agreement then organisation will
- ✓ Continue to recognise asset
- ✓ Recognise as interest expense, which increases the financial liability, equal to the difference between amount of consideration received from the customer and the amount of the consideration to be paid to the customer
- ✓ Recoginse financial liability for any consideration received from the customer.

At the time of recognising the liability it will be:

Cash Dr xxx
  Financial liability cr xxx

at the time of recognising interest expense it will be:
Interest expense Dr xxx
Fiancial liability Cr xxx

At the time of derecognising the liability it will be:

Financial liability Dr xxx
Revenue Cr xxx

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Put option:

If any entity has the option to repurchase the asset at the customer's request for less than the original price, the entity account for the contract as either:

- A sale with the right of return if the customer does not have significant economic incentive to exercise the right
- A lease, if the customer has the significant economic incentive to exercise the right.

If the re purchase right is equal to or greater than the original selling price, the organisation account for the contract as either:

- A fiancing agreement if the re purchase price is more than the expected market value of the asset.
- A sale with right of return, if the repurchase price is less than or equal to the expected market value of the asset and the customer does not have the significant economic incentive to exercise the right.

Bill and hold arrangement:

A contract in which organisation bills a customer for a product that has not yet delivered to a customer

- ➢ Revenue can not be recognised in a bill an hold arrangement until control is transferred to organisation
- ➢ Generally, control is transferred to a customer when product is delivered to customer
- ➢ In bill and hold arrangement, customer considered to obtain the control when all of the conditions will be met.
- ✓ There must be strong reason for bill and hold arrangement for example customer asked to hold the product because of storage issue
- ✓ The product has been separately identified as belonging to the customer
- ✓ The product is currently ready for the transfer to the customer
- ✓ The organisation can not use the product or send it to another customer.

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Consignments:

When an entity delivers it products to a dealer or distributor for sale to end customers, the entity needs to determine whether contract is a sale or consignment arrangement

Sale:

The dealer or distributor obtained the control of the product

Recognise the revenue when the product is shipped or dilevered to the dealer or distributor (depends on the terms and conditions of contract)

Consignments:

When the dealer or distributor does not obtained the control of the product

Recognise the revenue when the dealer or distributor sells the product to customer , or when dealer or distributor obtains the control of product.

Following are the indicators of consignment arrangement:

- The organisation controls the product until the a specified event occurs, for example sale of product or specified period expires
- The organisation can require the return of the product or transfer the product to another party.
- The dealer does not have the unconditional obligation to pay the entity for the product. (though it might be required to pay the deposit.

IFRS 16 Leases

Lease

Definition:

A contract that gives the right to use an asset for a period of time in exchange for consideration

IFRS 16 gets rid of the operating lease, so now every lease shows the liability.

Now let's see more detail.

To find out either transaction is lease or not there is 3 tests to see.

1. **The asset must be identifiable**

This can be explicity – Its in the contract
Or Implicitly – the contract only makes sense by using only particular asset

There is no Identifiable asset if the supplier can substitute the asset and would benefit from doing so

2. The customer must be able to get substantially all the benefits while it uses it

3. The customer must be able to direct how and for what asset is used

Example:

A contract gives Mr A exclusive use of a specific car
MR A can decide when to use it and for what
The car supplier can not substitute / change the car

So does the contract contain a lease?

Does it pass the 3 tests?

Yes the car is explicitly reffered to and the supplier can not substitute the car

2. Does the customer have substantially all the benefits during the period?

Yes

3. Does the customer direct the use ?

Yes he can use it for whatever and whenever he choose

So this contract contains a lease because……

A contract that give right to use an asset for period of time in exchange for consideration

Example:

A contract Give Miss S exclusive use of Airoplane

She can decide when it flies and what she fly (passenger or cargo)

The airplane supplier though operates it using its own staff

he airplane supplier can substitute the airplane for another but it must meet specific conditions and would, in practice, cost a lot to do so

So does the contract contain a lease?

Does it pass the # tests?

he airplane supplier can substitute the airplane for another but it must meet specific conditions and would, in practice, cost a lot to do so
So does the contract contain a lease?

Is **there an Identifiable asset?**

Yes the airplane is explicitly referred to and the substitution right is not substantive as they would incur significant costs

Does the customer have substantially all benefits during the period?
Yes it has exclusive use

Does the customer direct the use?

Yes the customer decides where and when the airplane will fly

So, yes this contract contains a lease because it's...

A contract that gives the right to use an asset for a period of time in exchange for consideration

Lessee Accounting

Basic Rule:

Lessees Recognise a right to use asset and associated liability on its sofp for most leases

How to Value the Liability

Present value of the lease payments

where the lease payments are:

1.Fixed Payments
2.Variable Payments (if they depend on an index / rate)
3.Residual Value Guarantees
4.Probable purchase Options
5.Termination Penalties

How to Value the Right of Use asset?

Includes the following:

1.The Lease Liability (PV of payments)
2.Any lease payments made before the lease started
3.Any Restoration costs (Dr Asset Cr Provision)
4.All initial direct costs

After the initial Measurement – Asset

Cost - depreciation (normally straight line) less any impairments
Any subsequent remeasurements of the liability

After the initial Measurement – Liability

Effective interest rate method (amortised cost)
Any remeasurements (e.g. residual value guarantee changes)

Example

Abc co. Enters into 3 years lease term
Annual lease rentals in Arrears $5000
Rate Implicit in Lease 12.04%
P.V of lease payments 12000

Solution:

The lease liability is initially the PV of future lease payments - given here to be 12,000
Double entry: Dr Asset 12,000 Cr Lease Liability 12,000
The Asset is then depreciated by 4,000pa (12,000 / 3)
The lease liability uses amortised cost:

Opening	Interest 12.04%	Payment	Closing
12000	1445	(5000)	8445
8445	1017	(5000)	4463
4463	537	(5000)	0

Example - Variable lease payments (included in Lease Liability)
(Remember only include those linked to a rate or index)
So the lease contract says you have to pay more lease payments of 5% of the sales in the shop you're leasing - should you include this potential variable lease payment in your lease liability?

Answer

No - because it is not based on a rate or index
(They are just put to the Income statement when they occur)

Example

ABC company enters into 10 year Lease contract:
500 payable at the start of every year
Increased payments every 2 years to reflect the change in the consumer price index
The consumer price index was 125 at the start of year 1
The consumer price index was 130 at the start of year 2
The consumer price index was 135 at the start of year 3
(so these are variable payments based upon an index / rate)

Solution:

Start of year 1

Asset Dr 500 Cash Cr 500
Asset Dr 4500 Lease liability Cr 4500 (9 x 500)

End of year 2

Asset will be 5000 – 1000 straight line depteciation =$4000

Lease liability will be 8 x 500 = $4000

End of year 3:

Lease payments are now different – 500 x 135/125 = 540
So the lease liability will be 7 x 540 = 3,780
Asset will be 4,000 - 500 (depreciation) + 280 (remeasurement of Liability) = 3,780
(Please note that this example ignored discounting - which would normally happen as the liability is measured as the PV of future payments)

Variable payments that are really fixed payments
These are included into the liability as they're pretty much fixed and not variable
e.g. Payments made if the asset actually operates (well it will operate of course and so this is effectively a fixed payment and not a variable one)

Exemptions to Leases treatment
So now we know that all lease contracts mean we have to show
1.A right to use Asset
2.A Liability
So remember we said there was no longer a concept of operating leases - all lease contracts mean we need to show a right to use asset and its associated liability
Well.. there are **some exemptions..**

Exemption 1 - Short Term Leases
These are less than 12 months contracts (unless there's an option to extend that you'll probably take or an option to purchase)
Treat them like operating leases
Just expense to the Income Statement (on a straight line / systematic basis)
Each class of asset must have the same treatment
This exemption ONLY applies to Lessees

Exemption 2: Low Value Assets
e.g. IT equipment, office furniture with a value of less than $5,000
Treat them like operating leases
Just expense to the Income Statement (on a straight line basis)
Choice is made on a lease by lease basis
This exemption ONLY applies to Lessees

Measurement Exemptions:

Exemption 1: Investment property

If it uses the fair value model in IAS 40

Measure the property each year at Fair value

Exemption 2: PPE

If revaluation model is used

Use revalued amount for asset

Exemption 3: Portfolio Approach

Portfolio of leases with Similar characteristics

Use same treatment for all leases in the portfolio

Sale and Lease Back:

Let’s have a little ponder over this before we dive into the details…
So - the seller makes a sale (easy) BUT remember also leases it back - so the seller becomes the lessee always, and the buyer becomes the lessor always
Seller = Lessee (after)
Buyer = Lessor (after)

However, If we sell an item and lease it back - have we actually sold it? Have we got rid of the risk and rewards?
So the first question is..
Have we sold it according to IFRS 15? (revenue from contracts with customers)

Option 1: Yes - we have sold it under IFRS 15
This means the control has passed to the buyer (lessor now)
But remember we (the seller / lessee) have a lease - and so need to show a right to use asset and a lease liability
Step 1: Take the asset (PPE) out
Dr Cash
Cr Asset
Cr Initial Gain on sale
Step 2: Bring the right to use asset in
Dr Right to use asset
Cr Finance Lease / Liability
Dr/Cr Gain on sale (balancing figure)

How much do we show the Right to Use asset at?
The proportion (how much right of use we keep) of our old carrying amount
The PV of lease payments / FV of the asset x Carrying amount before sale
How much do we show the finance liability at?
The PV of lease payments

A seller-lessee sells a building for 2,000. Its carrying amount at that time was 1,000 and FV 1,800
The seller-lessee then leases back the building for 18 years, for 120 p.a in arrears.
The interest rate implicit in the lease is 4.5%, which results in a present value of the annual payments of 1,459
The transfer of the asset to the buyer-lessor has been assessed as meeting the definition of a sale under IFRS 15.

Notice first that the seller received 200 more than its FV - this is treated as a financing transaction:
Dr Cash 200
Cr Financial Liability 200
Now onto the sale and leaseback..
Step1: Recognise the right-of-use asset - at the proportion (how much right of use we keep) of our old carrying amount
Old carrying amount = 1,000
How much right we keep = 1,259 / 1,800 (The 1,259 is the 1,459 we actually pay - 200 which was for the financing)
So, 1,259 / 1,800 x 1,000 = 699
Step 2: Calculate Finance Liability - PV of the lease payments
Given - 1,259
So the full double entry is:
Dr Cash 2,000
Cr Asset 1,000
Cr Finance Liability 200
Cr Gain On Sale 800
Dr Right to use asset 699
Cr Finance lease / liability 1,259

Dr Gain on sale 560 (balance)
Option 2: It's not a sale under IFRS 15
So the buyer-lessor does not get control of the asset
Therefore the seller-lessee leaves the asset in their accounts and accounts for the cash received as a financial liability.
The buyer-lessor simply accounts for the cash paid as a financial asset (receivable).

IAS 7 Statement of Cash flow statement

- Users of financial statement are interested in cash generation regardless of the nature of the entity's activities.
 Entities need cash for essentially the same reasons:
- to conduct operations;
- to pay obligations; and
-to provide returns to investors.

Importance of Cash Flow:
- Not all profitable companies are successful; many fail due to a lack of cash.
- Profit or loss is based on the accruals concept and also includes non-cash items (e.g. depreciation).
- A major function of the statement of cash flows is to inform the users of accounts whether or not the reported profits are being realised (e.g. that trade receivables are being recovered).
- The statement also helps to identify the availability of cash to:
- pay dividends;
- finance further investment (which will generate more cash).

Usefulness of Cash Flow Information

Benefits Suggested by IAS 7

Provides information enabling users to evaluate changes in:

- net assets;
- financial structure (including its liquidity and solvency); and
- ability to affect amounts and timing of cash flows (to adapt to changing circumstances and opportunities).

Useful in assessing ability to generate cash and cash equivalents.

Users can develop models to assess and compare the present value of future cash flows of different entities.

Enhances comparability of operating performance reported by different entities by eliminating the effects of alternative accounting treatments.

Historical cash flow information may provide an indicator of the amount, timing and certainty of future cash flows.

A focus on cash management can improve results (e.g. with lower interest charges) and lead to having cash resources available on a timely basis (e.g. for investment).

Comparison With Profit or Loss:

The cash flow statement provides a link between items reported in the statement of profit or loss (or statement of profit or loss and other comprehensive income) and the statement of financial position.

The statement of profit or loss is presented in accordance with accounting policies which are based on the accruals concept. These accounting policies may involve a degree of judgement in how and when revenue and expenses (and hence profits) are recognised. As cash accounting does not involve such judgements, it provides a more objective reflection of how a company is performing. Cash flows allow more meaningful comparison between companies.

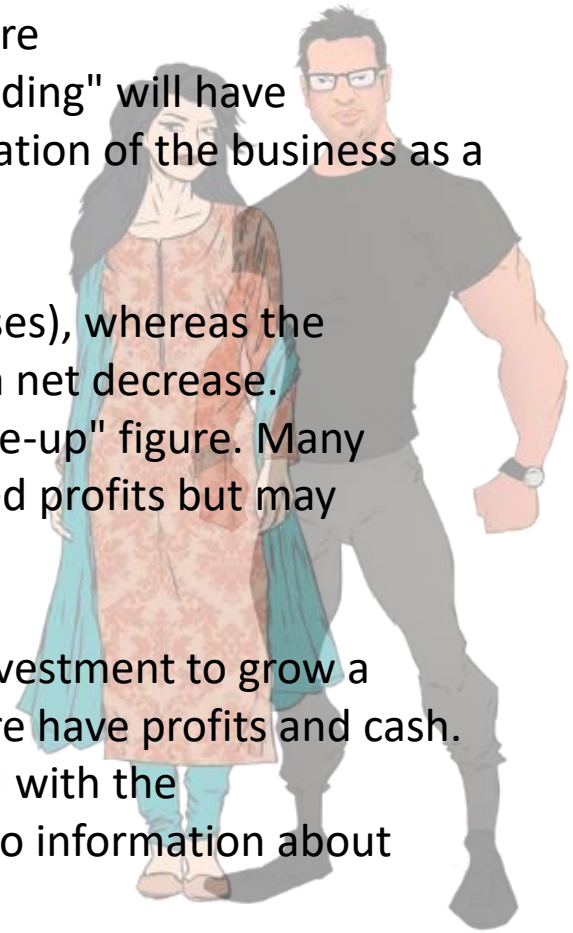
Profits can be manipulated and different accounting policies may lead to different outcomes. It is more difficult, although not impossible, to manipulate cash. A company generating high profit but "overtrading" will have low or negative cash balances; profits exist currently but there is insufficient cash to support continuation of the business as a going concern.

Profit or loss does not show whether a company is suffering from a lack of cash (unless it reports losses), whereas the cash flow statement clearly shows whether the change in the level of cash (and cash equivalents) is a net decrease.

Cash is more credible than profit because it has a tangible (physical) aspect, whereas profit is a "made-up" figure. Many users of financial statements who have been affected by company collapses have lost faith in reported profits but may still trust cash as a factual amount.

Profits do not provide funds for investment; cash is needed to finance asset replacement and new investment to grow a business. Business survival depends on profitability and liquidity. A successful business must therefore have profits and cash.

Cash is more relevant to creditors and providers of loan finance than profits. Creditors are concerned with the availability of cash to meet the debt and interest payments.The statement of profit or loss provides no information about the availability of cash.

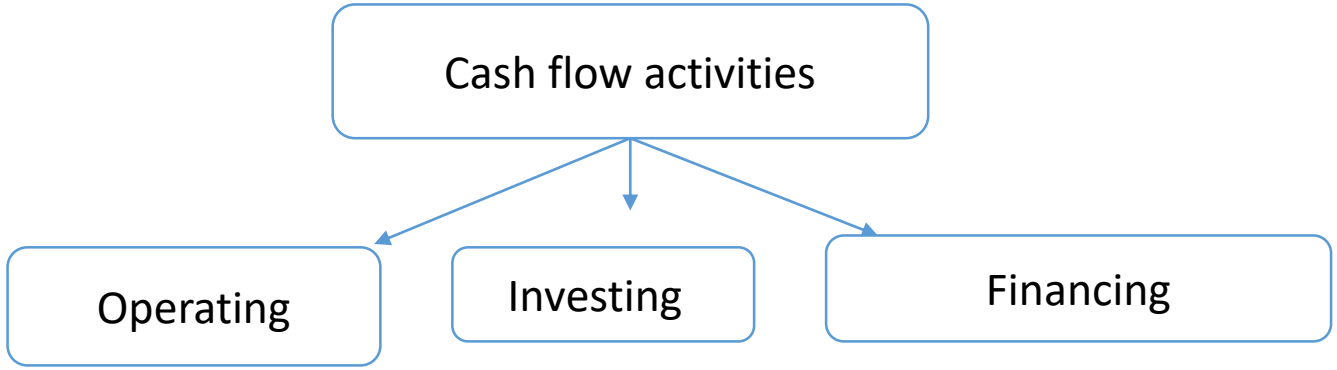


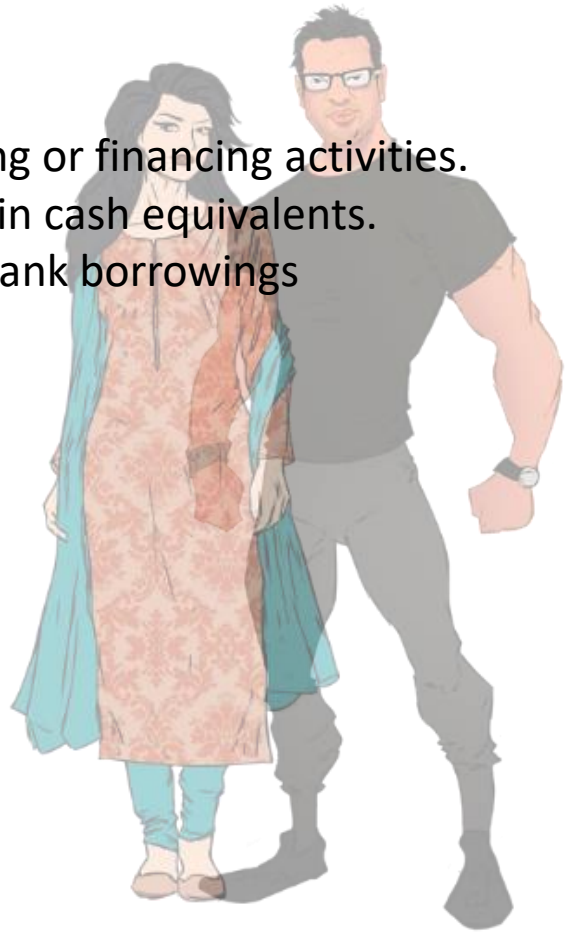
Definitions:

Cash: cash on hand and demand deposits.
Cash equivalents: short-term, highly liquid investments:
- readily convertible to known amounts of cash;
- subject to an insignificant risk of changes in value;
- excluding equity investments unless they are, in substance, cash equivalents (e.g. preferred shares acquired within a short period of their maturity and a specified redemption date).

Cash flows: inflows and outflows of cash and cash equivalents.
Operating activities: principal revenue-producing activities and other activities which are not investing or financing activities.
Investing activities: acquisition and disposal of long-term assets and other investments not included in cash equivalents.
Financing activities: result in changes in the size and composition of equity capital and borrowings. Bank borrowings generally included.

Classification:
IAS 7 requires cash inflows and outflows to be analysed across three activities.





1. Operating Activities or Cash Flow From Operations (CFO)

CFO, without recourse to external sources of finance, is a key indicator of the sufficiency of cash flows to:

- repay loans;
- maintain operating capability;
- pay dividends; and
- make new investments.

It is useful in forecasting future operating cash flows. Since it is primarily derived from principal revenue-producing activities, it generally results from transactions and events that generate profit or loss.

2. Investing Activities or Cash Flow From Investing (CFI)

Separate disclosure is important—as investing cash flows represent the amount spent on resources that are intended to generate future income and cash flows.

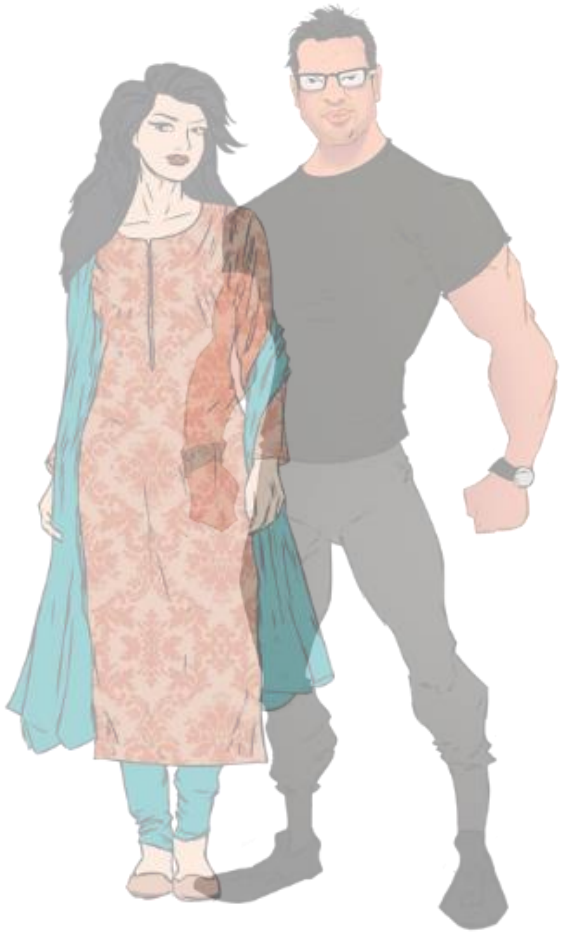
3. Financing Activities or Cash Flow From Financing (CFF)

Separate disclosure is useful in predicting the claims which providers of capital and long-term finance may make on future cash flows.

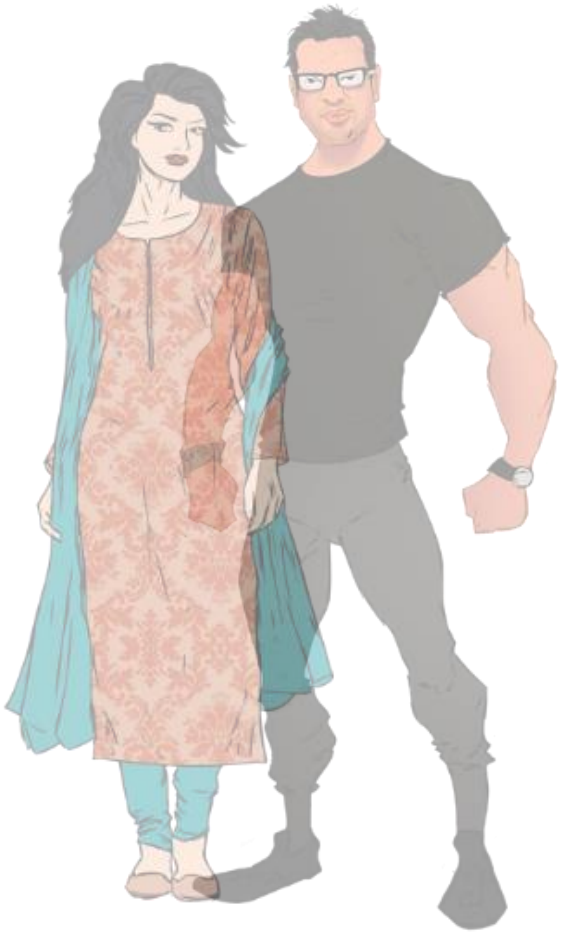
Examples

Examples of cash inflows and outflows across the three activities are depicted in the table below.

TRANSACTIONS	CFO	CFI	CFF
Cash Flows From Operations			
1. Cash receipts from sale of goods/rendering services	**x**		
2. Cash receipts from royalties, fees and commissions	**x**		
3. Cash payments to suppliers for goods/services	**x**		
4. Cash payments to and on behalf of employees (e.g. pension contributions)	**x**		
Non-current Asset Transaction			
5. Payments to acquire/receipts from sales of property, plant and equipment, Intangibles		**x**	
6. Payments to acquire/receipts from sales of shares, loan notes, etc of other Entities		**x**	
7. Cash advances and loans made to other parties and repayments thereof		**x**	
Non-current Liabilities and Equity Transactions			
8. Cash proceeds from issuing shares/equity instruments			**x**



TRANSACTIONS	CFO	CFI	CFF
9. Cash proceeds from debentures, loans, notes, bonds, mortgages, other shortterm or long-term borrowings			x
10. Cash payments to owners to acquire or redeem own (i.e. the entity's) shares			x
11. Cash repayments of borrowings			x
Dividends and Interest			
12. Interest paid			
• when recognised as an expense or capitalised (e.g. in the cost of constructing an asset)	x		
• when it is a cost of obtaining financial resources			x
13. Interest and dividends received			
• when taken into account of in the determination of profit or loss	x		
• when they are returns on investments		x	
14. Dividends paid			
• when they are a cost of obtaining financial resources			x
• when they assist users in determining the company's ability to pay dividends out of operating cash flow	x		



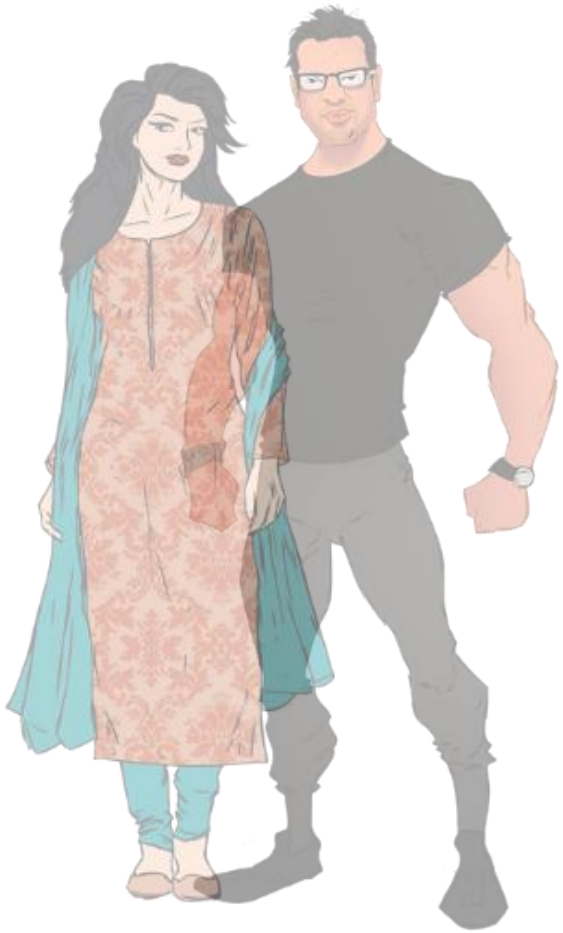
Operating Activities:

Operating activities can be determined using the indirect or direct method.

Direct Method:

- Discloses major classes of gross cash receipts and gross cash payments.
- Information is obtained either from accounting records or by adjusting sales, cost of sales for:
- changes in inventories, operating receivables and payables during the period;
- other non-cash items; and
- other items for which cash effects are investing or financing cash flows.

Technique	**Formula**
1. Cash receipts from customers.	Cash receipts from customers
2. Deduct cash paid to suppliers and employees.	
	– cash paid to suppliers
	– cash paid to employees
- Cash generated from operations	- Cash generated from operations
3. Payments for interest and income taxes.	
	– payments for interest
	– income taxes paid
- Net cash from operating activities	- Net cash from operating activities

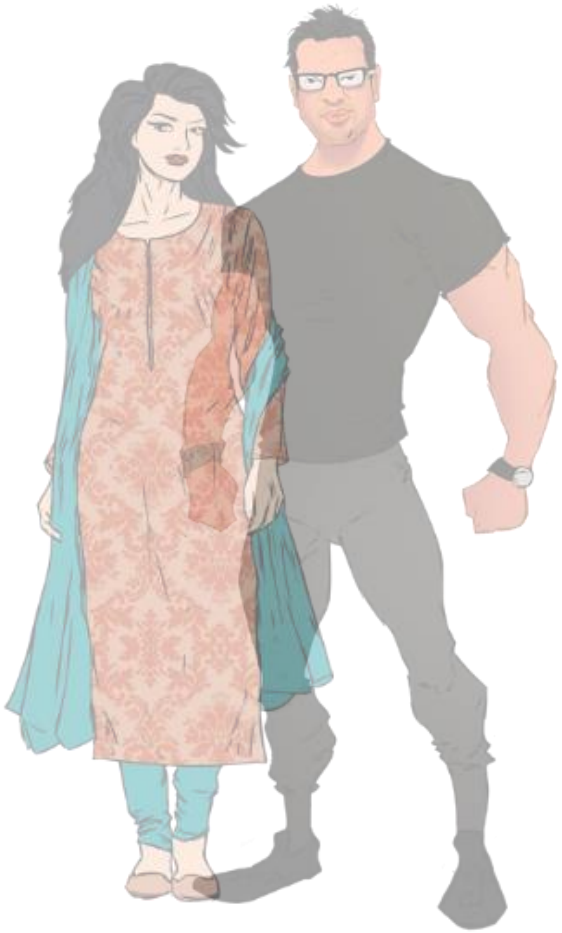


Indirect Method

Adjusts profit or loss for effects of:

- non-cash transactions (e.g. depreciation);
- any deferrals or accruals of past or future operating cash receipts or payments; and
- items of income or expense associated with investing or financing cash flows.

Technique	**Formula**
1. Start with profit before tax.	Profit before tax
2. Adjust for non-cash items, investing items, and financing items accounted for on the accruals basis (e.g. interest).	+ non-cash expenses/losses – non-cash income/gains
- Operating profit before working capital changes	- Operating profit before working capital changes
3. Make working capital changes.	+ increases (decreases) in operating liabilities (assets) – increases (decreases) in operating assets (liabilities)
- Cash generated from operations	-Cash generated from operations



Pro Formas:
Direct Method

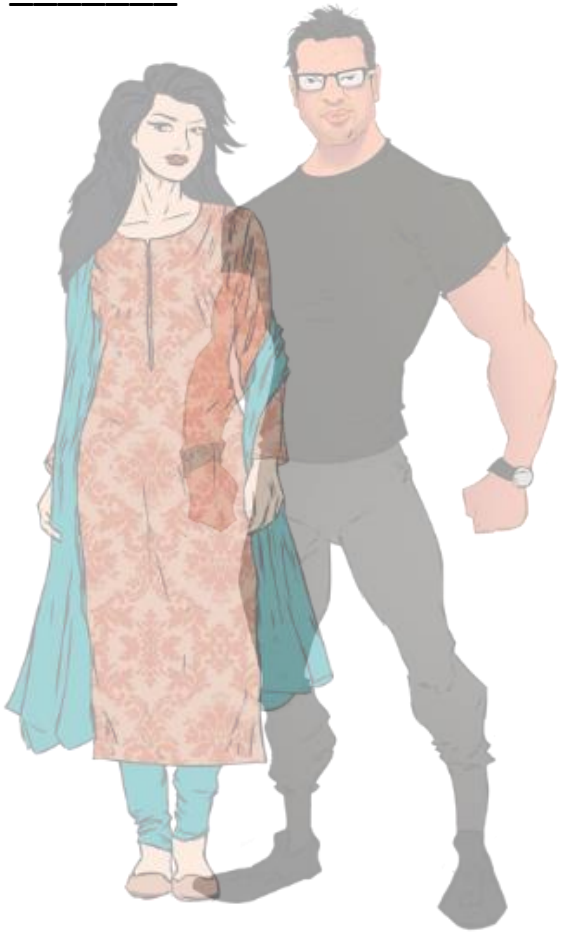
	$	$
operating cash flow.		
Cash flows from operating activities		
Cash receipts from customers	x	
Cash paid to suppliers and employees	(x)	
Cash generated from operations (see next for alternative)	x	
Interest paid	(x)	
Income taxes paid	(x)	
Net cash from operating activities		x
Cash flows from investing activities		
Purchase of property, plant and equipment	(x)	
Proceeds from sale of equipment	x	
Interest received	x	
Dividends received	x	
Net cash used in investing activities		x
Cash flows from financing activities		
Proceeds from issuance of share capital	x	
Proceeds from long-term borrowings	x	
Dividends paid	(x)	
Net cash used in financing activities		x

	$	$
Net increase in cash and cash equivalents		x
Cash and cash equivalents at beginning of period		x
Cash and cash equivalents at end of period		x

Indirect Method

	$
Cash flows from operating activities	
Profit before taxation	x
Adjustments for	
Depreciation	x
Investment income	(x)
Interest expense	x
Operating profit before working capital changes	x
Increase in trade and other receivables	(x)
Decrease in inventories	x
Decrease in trade payables	(x)
Cash generated from operations	x

Everything else is same as direct Method



Advantages of the Direct Method:

-Reporting the major classes of operating cash receipts and payments better reveals an entity's ability to generate sufficient cash from operations to pay debts, reinvest in operations and make distributions to owners. Thus, it better fulfils information needs for decision-making purposes.

- The format is simpler to understand.

Disadvantages of the Direct Method:

-Many entities do not collect information which would allow them to determine the information necessary to prepare the direct method.

-It effectively presents profit or loss information on a cash rather than an accrual basis. This may suggest, incorrectly, that net cash flow from operations is a better measure of performance than profit per the statement of profit or loss.

-It requires supplemental disclosure of a reconciliation of net income and net cash. (However, the incremental cost of providing the additional information disclosed in the direct method is not significant.)

Advantages of the Indirect Method

-It focuses on the difference between profit per the statement of profit or loss and net cash flow from operations.

-It provides a useful link between cash flows, the statement of profit or loss and the statement of financial position.

Investing and Financing Activities:

Separate Reporting

- Major classes of gross cash receipts and gross cash payments arising from investing and financing activities should be reported separately.

Investing Activities

-Purchase of property, plant and equipment this must represent actual amounts *paid.*

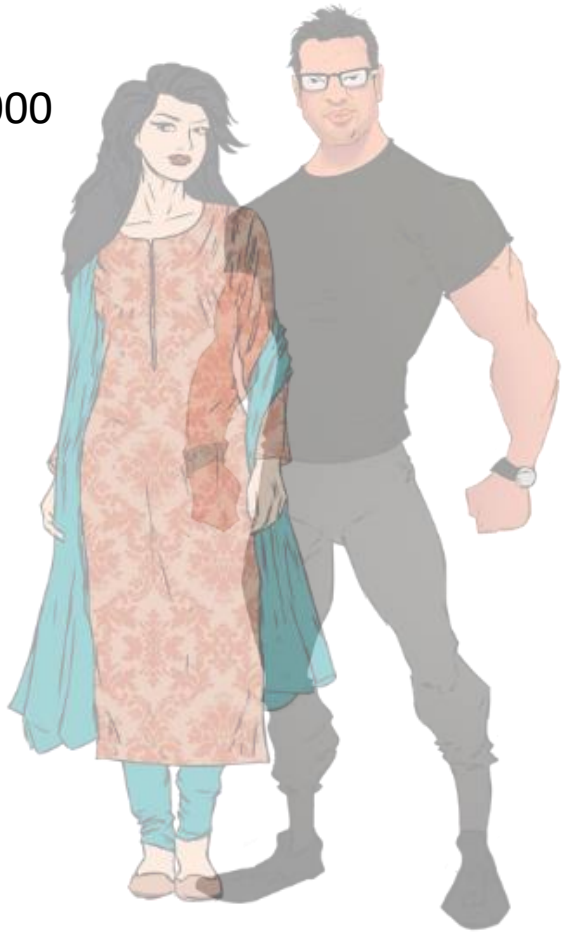
- Proceeds from sales of tangible assets.

Example:

	2015	2014
$m $m		
Statement of financial position extracts		
Non-current assets	10,000	9,000
Further information		
Depreciation during the year	1,000	
Carrying amount of assets disposed of	100	

Required:

Calculate purchases of non-current assets in the period.



Solution:

$m	
Balance b/f	9,000
Depreciation	(1,000)
Disposals	(100)
Additions (Balancing figure)	2,100
	_____
Balance c/f	10,000
	_____

Financing Activities:

-Again, the approach is to reconcile the statement of financial position movements to identify the cash element.

Example

Example:

	2015 $m	2014 $m
Statement of financial position extracts		
Share capital	150	100
Share premium	48	40

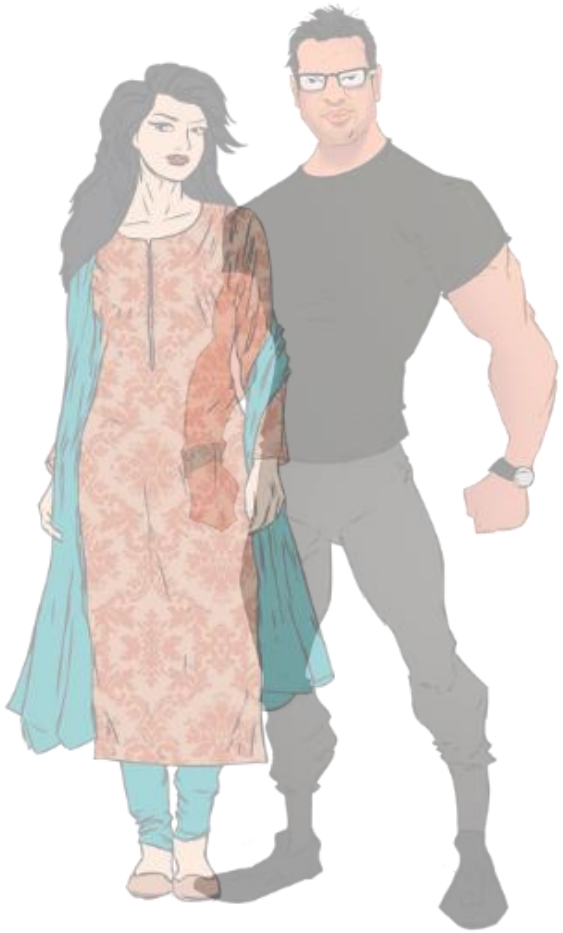
During the period the following transactions affected share capital:

1. The entity issued shares with a nominal value of $10m (share premium $2m) to acquire an interest in a subsidiary

2. The entity issued shares for cash. The expense of the issue was $1m. This has been debited to the share premium account.

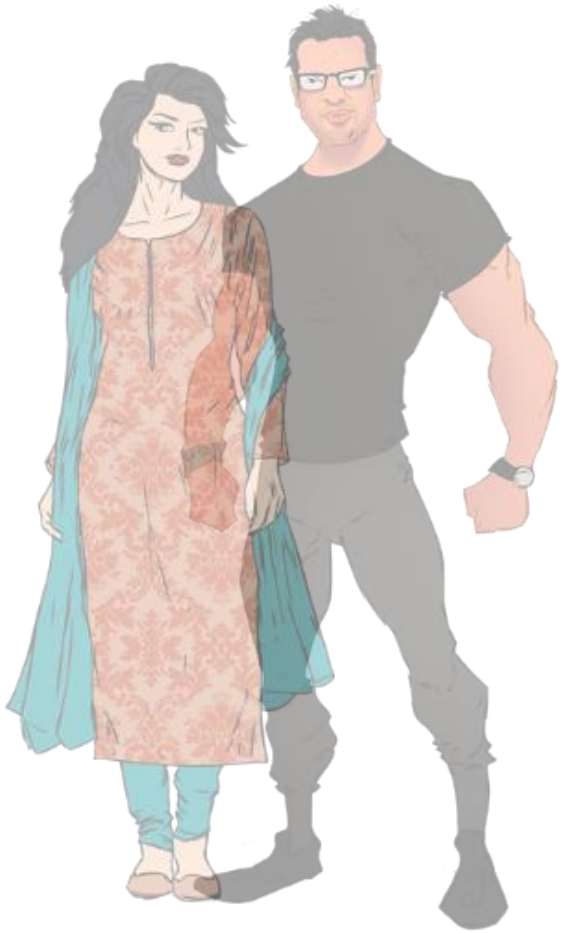
Required:

Calculate the cash raised from the share issue.



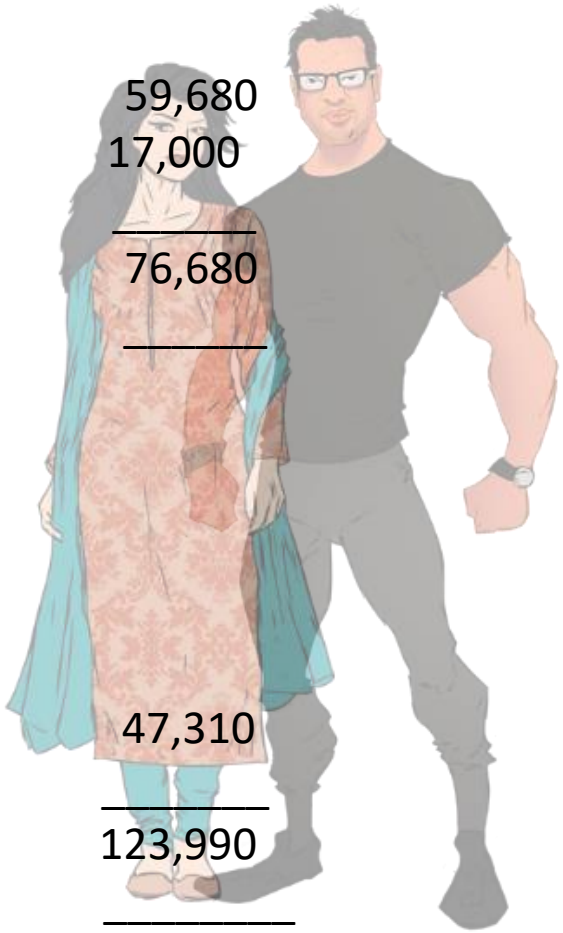
Solution:

	Share capital	Share premium
Balances at the year end	150	48
Add: Expenses of the share issue	0	1
	150	49
Less: Non-cash transaction	(10)	(2)
	140	47
Less: Balances at the start of the year	(100)	(40)
	40	7
Cash raised		47

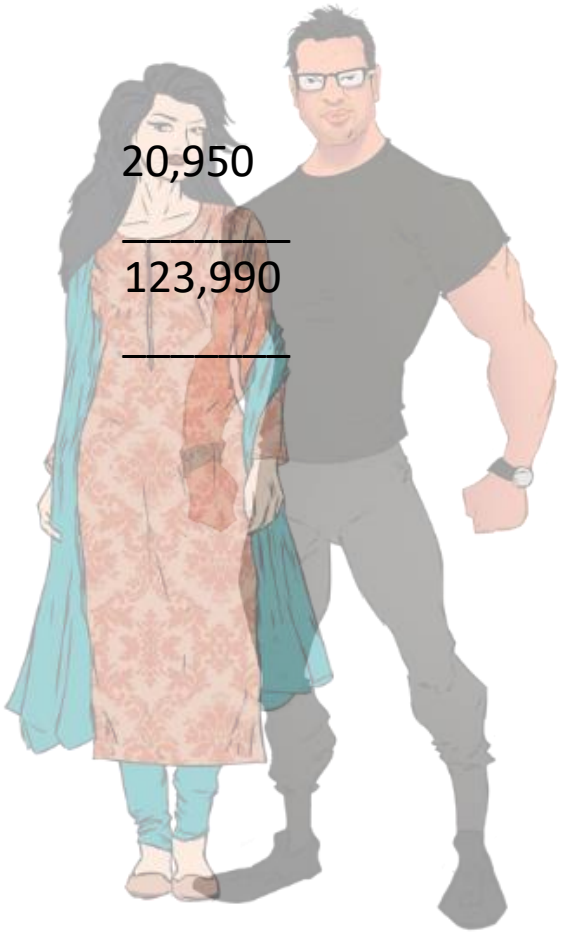


Example:

	2015		2014	
	$	$	$	$
Non-current assets				
(at carrying amount)				
Premises	37,000		38,000	
Equipment	45,800		17,600	
Motor vehicles	18,930		4,080	
		101,730		59,680
Investments		25,000		17,000
		126,730		76,680
Current assets				
Inventories	19,670		27,500	
Trade receivables	11,960		14,410	
Short-term investments	4,800		3,600	
Cash and bank balances	700		1,800	
		37,130		47,310
Total assets		163,860		123,990



	2015		2014	
	$	$	$	$
Capital and reserves				
Capital		78,610		75,040
Non-current liabilities				
Interest-bearing borrowings		25,000		28,000
Current liabilities				
Trade payables	32,050		20,950	
Bank overdraft	28,200		–	
		60,250		20,950
		163,860		123,990



Profit for the year ended 31 December 2016 ($25,200) is after accounting for:

Depreciation	$
Premises	1,000
Equipment	3,000
Motor vehicles	3,000
Profit on disposal of equipment	430
Loss on disposal of motor vehicle	740
Interest expense	3,000

The carrying amount of the assets at date of disposal was:

Equipment	5,200
Motor vehicles	2,010
Interest accrued at 31 December 2016 is	$400.

The company paid a dividend of $21,630 during the year.

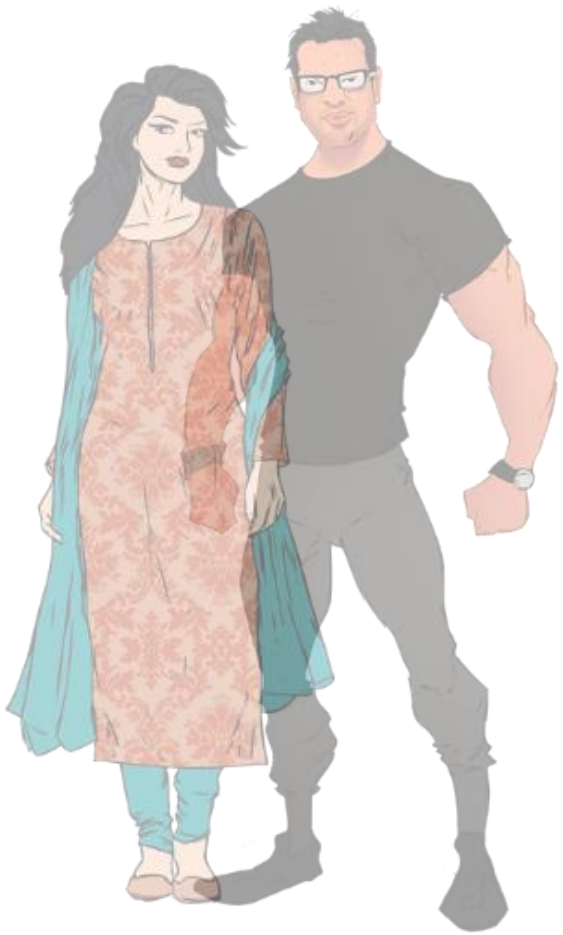
Required:

Prepare a statement of cash flows for the year ended 31 December 2016 in accordance with IAS 7 *Statement of Cash Flows.*

Solution:

Equipment

$000		$000	
Bal b/d	17,600	Disposal	5,200
		Depreciation	3,000
Additions (β)	36,400	Bal c/d	45,800
	54,000		54,000

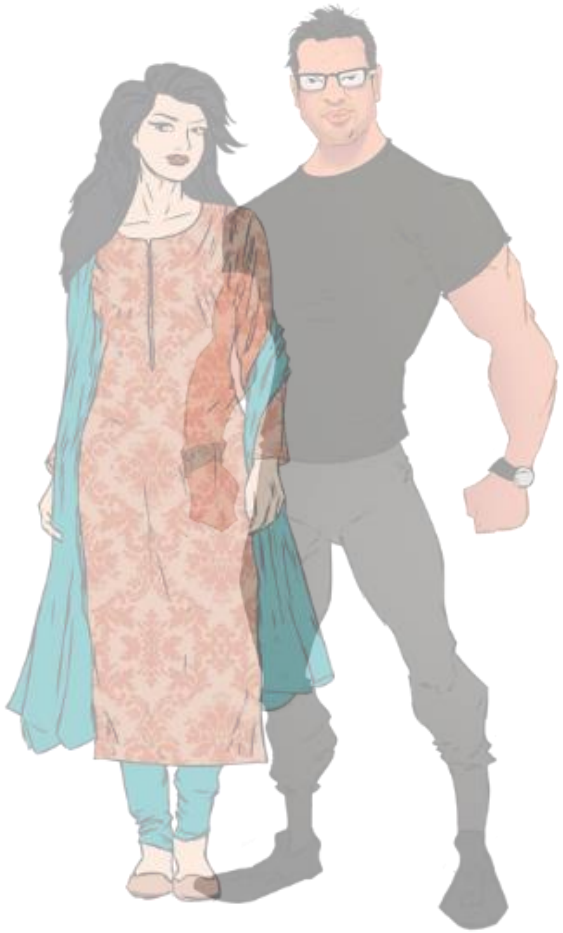


Motor Vehicles

$000		$000
Bal b/d	4,080	Disposal 2,010
		Depreciation 3,000
Additions (β)	19,860	Bal c/d 18,930
	23,940	23,940

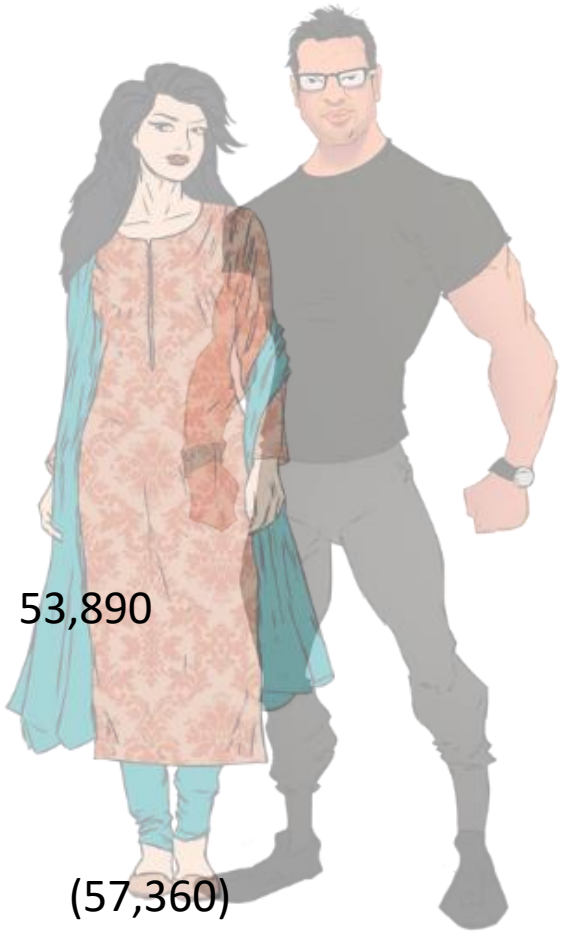
Disposals

	$000	$000	
Equipment	5,200		
Motor Vehicle	2,010		Loss on disposal (vehicles) 740
Profit on disposal (equipment)		430	Proceeds (β) 6,900
	7,640		7,640

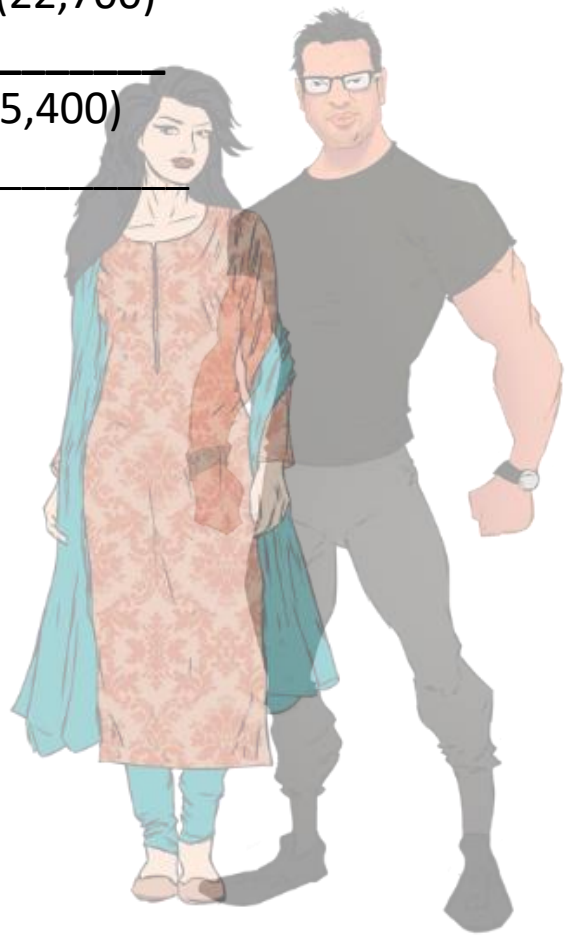


Cash Flow Statement

	$	$
Cash flows from operating activities		
Profit before taxation	25,200	
Adjustments for		
Depreciation	7,000	
Net loss on disposals	310	
Interest expense	3,000	
Operating profit before working capital changes	35,510	
Decrease in trade receivables	2,450	
Decrease in inventories	7,830	
Increase in trade payables $((32,050 – 400) – 20,950)	10,700	
Cash generated from operations	56,490	
Interest paid $(3,000 – 400)	(2,600)	
Net cash from operating activities		53,890
Cash flows from investing activities		
Purchase of long-term investments $(25,000 – 17,000)	(8,000)	
Purchase of equipment and cars $(36,400 (W1) + 19,860 (W2))	(56,260)	
Proceeds from sale of equipment and cars (W3)	6,900	
Net cash used in investing activities		(57,360)



	$	$
Cash flows from financing activities		
Capital repayment	(21,630)	
Borrowings repayment	(3,000)	
Net cash used in financing activities		(24,630)
Net decrease in cash and cash equivalents*		(28,100)
Cash and cash equivalents at beginning of period		(22,700)
Cash and cash equivalents at end of period		**(**5,400)



Amla has prepared the following financial statements for the year ended 31 December 2016:

Statement of profit or loss	**$000**
Revenue	2,880
Cost of sales	(2,016)
Gross profit	864
Expenses	(288)
Profit 576	

	2015	*2014*
Statement of financial position (extracts) $000 $000		
Current assets		
Inventory	384	336
Trade receivables	622	564
Current liabilities		
Trade payables	403	331

You are given the following information:

(1) Expenses include depreciation of $86,000, irrecoverable debts written off of $34,000 and employment costs of $101,000.

(2) During the year, Alma disposed of plant equipment for $58,000 which had a carrying amount of $43,000, the profit being netted off against expenses.

Required:

(a) Show how the net cash flows from operating activities would be presented in the statement of cash flows using the direct method.

(b) Prepare the note reconciling the operating profit to net cash flows from operating activities.

Solution:

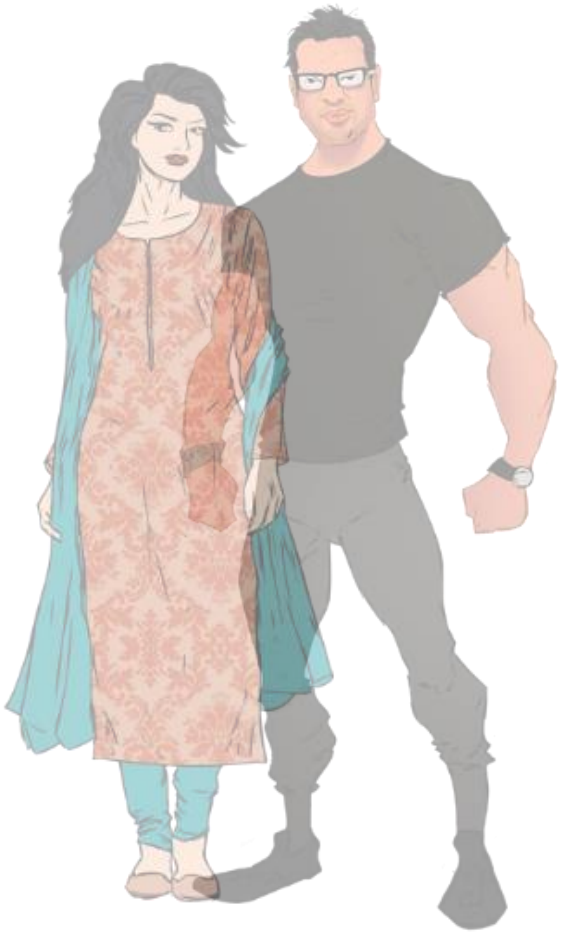
$000 $000

Trade Receivables

Bal b/d	564	Bad debt	34
Revenue	2,880	Cash received β	2,788β
		Bal c/d	622
	3,444		3,444

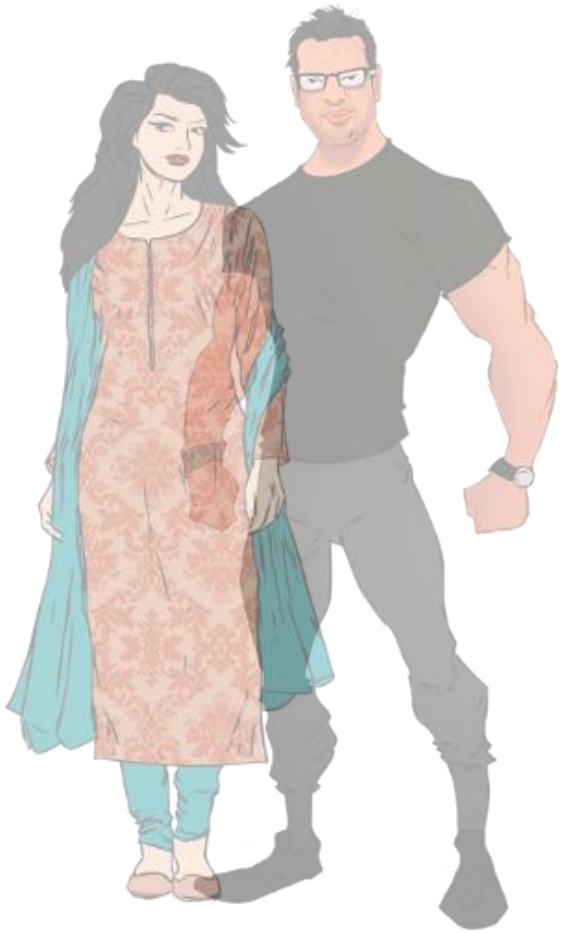
Trade Payables

$000		$000	
Cash β	1,992β	Bal b/d	331
Bal c/d	403	Purchases (W3)	2,064
	2,395		2,395



W3)	**$000**
Opening inventory	336
Purchases	2,064β
Closing inventory	(384)
Cost of sales	2,016

(W4)	**$000**
Other cash expenses (from profit or loss)	288
Depreciation	(86)
Bad debts	(34)
Profit on disposal	15
Employee costs	(101)
Other cash paid to suppliers	82



W3)	**$000**
Opening inventory	336
Purchases	2,064β
Closing inventory	(384)
Cost of sales	2,016

(W4)	**$000**
Other cash expenses (from profit or loss)	288
Depreciation	(86)
Bad debts	(34)
Profit on disposal	15
Employee costs	(101)
Other cash paid to suppliers	82

Reconciliation of operating profit to net cash flows from operating activities

	$000
Profit before tax	576
Depreciation	86
Profit on disposal	(15)
Increase in inventory	(48)
Increase in receivables	(58)
Increase in payables	72
Cash from operating activities	613

Cash Flow Analysis:

- The statement of cash flows provides additional information which can be used to help analyse the position and performance of a company.
- Look at the bottom line. Have cash and cash equivalents increased or decreased during the year? A company cannot maintain a negative cash flow forever. Do consider cash flows of previous years and what was expected from any budgeted cash flows.

Operating Cash Flows:

- Comparison of the cash flow from operating activities and operating profit will give some indication as to whether the company is overtrading. Indicators of this overtrading would be if there were high profits but low levels of cash generation or if there were large increases in inventory, receivables and payables.
- How does the interest expense compare with the interest paid? If interest paid is much higher, this could indicate a capitalisation of interest and possible over-valuation problems in future years.
- Compare the movement on provisions, from the statement of financial position, with any non-cash adjustments made in the operating cash flow calculation. If there is a major difference then this could indicate a manipulation of the profit figure.

Investing Cash Flows:

- Compare the depreciation expense with the purchase of noncurrent assets. If the cash flow is greater than the expense then this is an indication of growth, whereas if the cash flow is less than the depreciation expense then this could mean that the company is not replacing assets when they are taken out of commission.
- Is the cash to acquire new assets coming from operating activities or financing? Ideally, growth should be financed internally from a company's operations rather than having to raise new finance for new investments.
- Is the company selling non-current assets at a loss? If so, this could indicate that the annual depreciation charge is insufficient leading to an overstatement of profits.

Financing Cash Flows

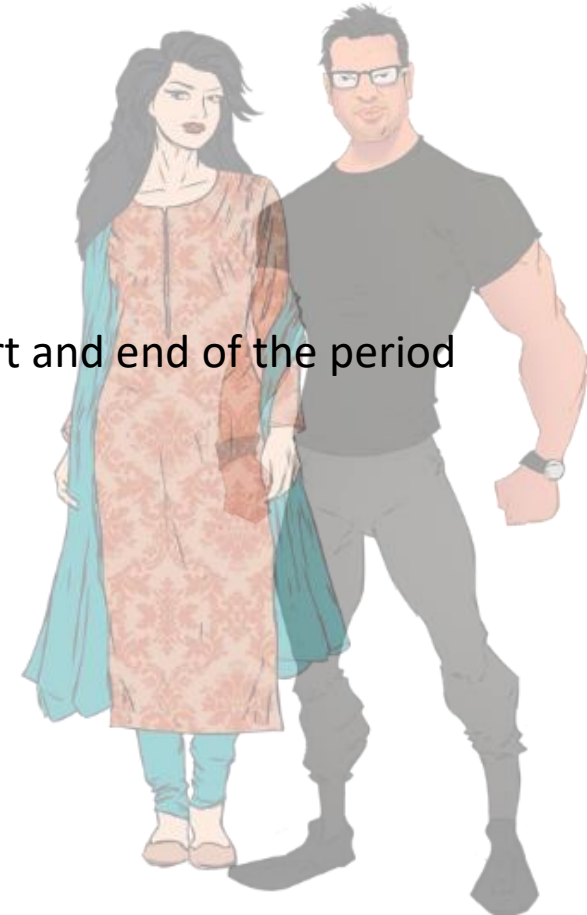
- How is new capital being raised? If in the form of debt, then this will lead to a higher level of gearing and, therefore, risk in the future.
- Compare any dividend paid with the raising of new capital. It is pointless to pay a dividend if the company has to go back to its shareholders and raise additional finance.

Disclosures:

- A number of extra disclosures should be made in most cases to support the main statement of cash flows:
- analysis of cash and cash equivalents;
- major non-cash transactions;
- cash and cash equivalents held by the group;
- reporting futures, options and swaps; and
- voluntary disclosures.

Analysis of Cash and Cash Equivalents:

- A note should be presented which reconciles amounts held as cash and cash equivalents at the start and end of the period (direct and indirect methods).



Basic Principal of Groups

Definitions:

Business combinations:

A transaction or other events in which the acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals are also business combinations as that term used in this standard.

Acquisition Date:

The date the acquirer obtains control of the acquire

Control of an Investee:

Arises when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power to the investee

Subsidiary: An entity controlled by the another entity known as Parent

Parent: An entity which controls one or more than one entities

Group: A parent and its subsidiaries

Consolidated Financial statements:

The financial statements of a group in which the assets, liabilities, equity, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Non controlling Interest:

The equity in a subsidiary which is not directly or indirectly attributable to parent company

Goodwill:

The asset represent the future economic benefits arising from other assets acquired in business combination which are not individually identified and separately recognised.

Parent and Control:

Inclusions:

A parent which issues consolidated financial statements must consolidate financial statements must consolidate all subsidiaries, foreign and domestic, other than those exclude for the reasons specified in IFRS 10 consolidated financial statements

IFRS Defines the meaning of control as:

Control exists when the investor is exposed or has rights to variable return from its involvement with the investee and has the ability to affect those returns through its power over the investee.

The standard considers the substance of the transaction, being the ability to control, rather than the legal ownership of shares as the driving force when considering whether control exists

Power:

- The investor has power over the investee if the investor has rights giving it the ability to direct activities which which significantly affect returns from the investee
- In many situations power is gained by holding more than 50% of the voting rights in the investee
- But power is not always that straightforward and can result from one or more contractual arrangements without holding majority of voting rights
- An investor can have power over an investee even if other entities have rights allowing them to participate in the activities of the investee for example another investor has significant influence.
- The right could be in form of voting rights or right to appoint, remove key management personal of the investee
- The assessment of right should taken into account any potential voting rights it holds in the investee for example share option or convertible instruments

Variable returns:

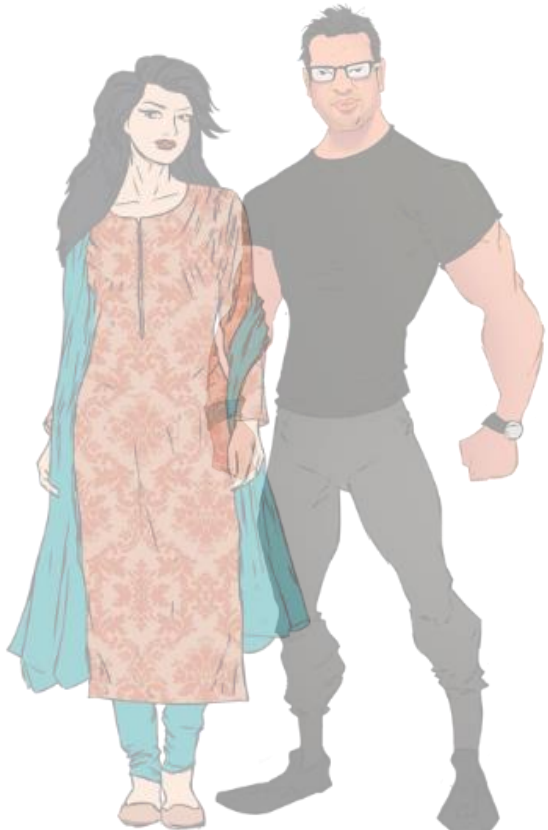
- An investor is exposed to variable returns from the investee when there is potential for variable performance from the investee
- In other words, the returns, dividends and profits from the investee will depend on the performance of the subsidiary

There will be no fixed right to a specific return.

Link between Power and Return:

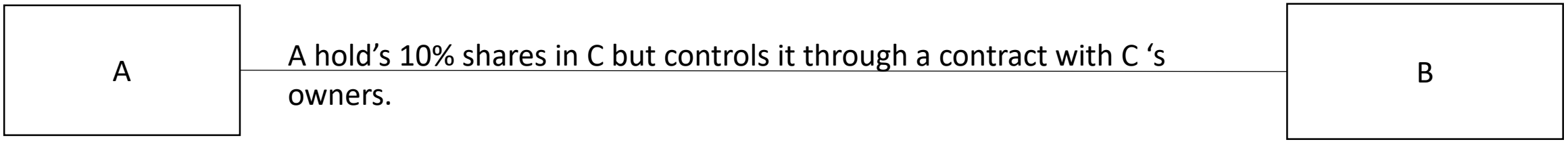
To have control over the investee, the investor will have power and exposure to variable returns but must have also the ability to use that power to affect the returns from the investee

So an investor with decision making rights determines if it is acting either a principal or agent. The investor will only control its investee if it is acting either as principal or agent. The investor will only control its investee if it is acting as principal. An agent would need powers delegated to it by its controlling body.

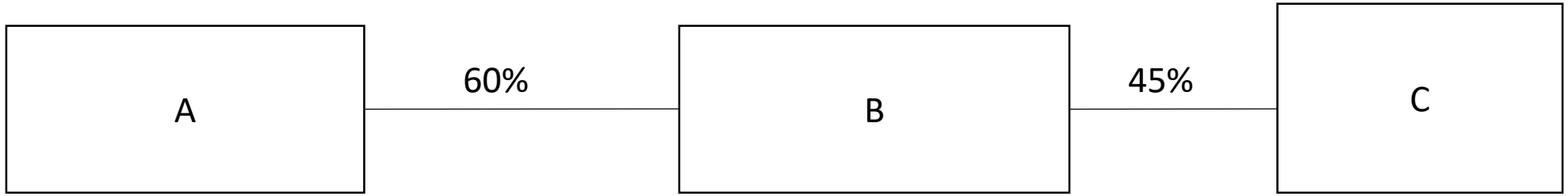


Identify the entities to be included in the group as defined by IFRS 10 in each of the following situations:

a)

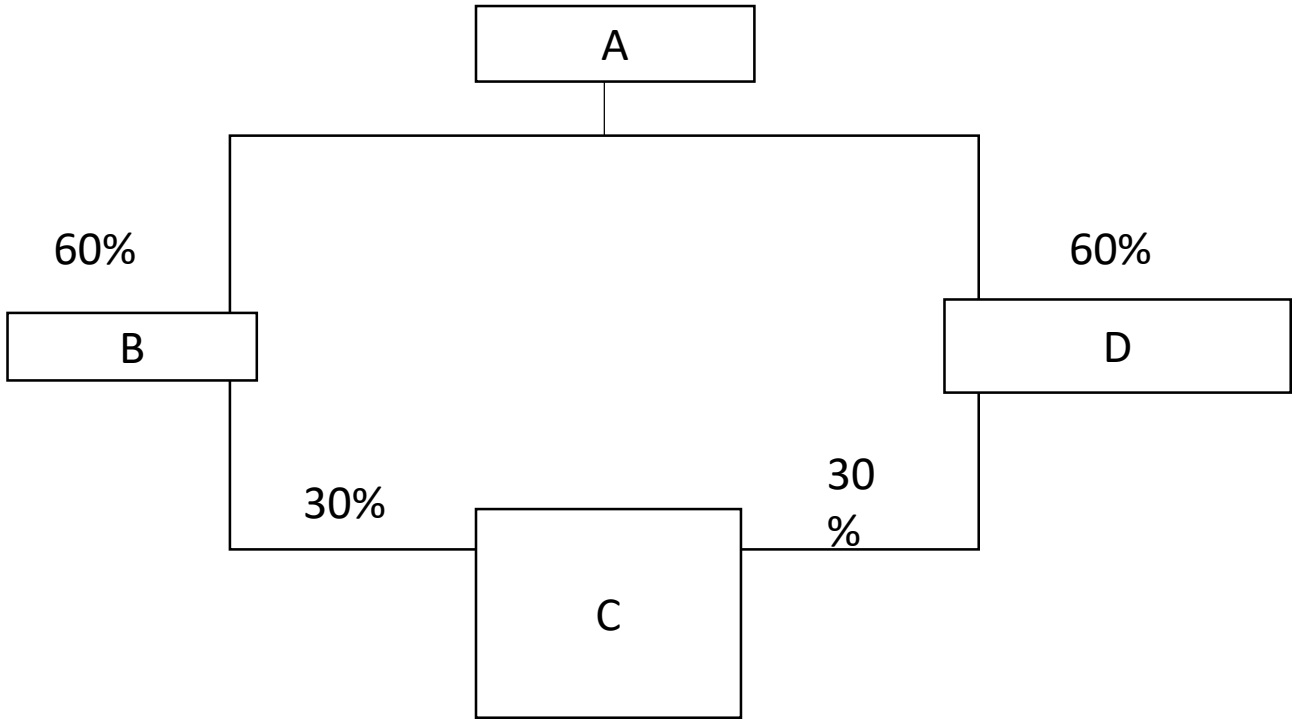


b)

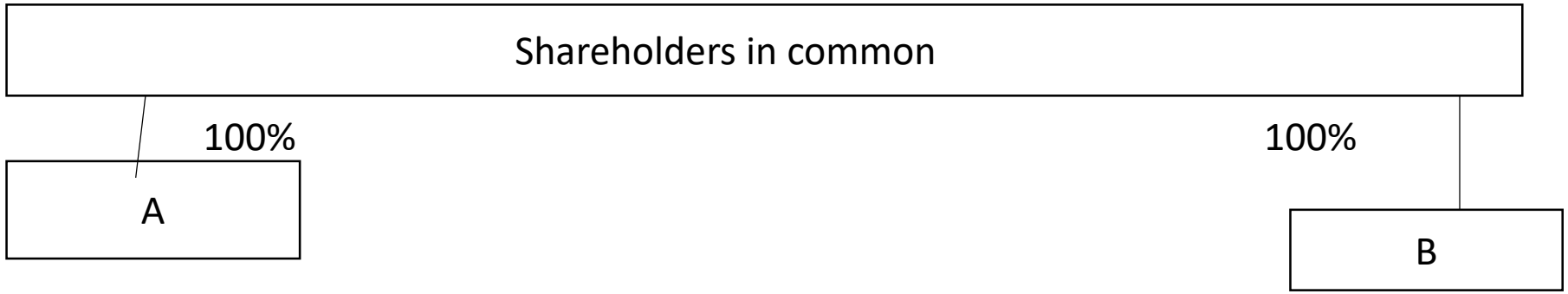


The holders of another 30% of the equity in C have a contract under which they vote according to B's direction.

c)



d)



Solution:

a) Even though A only holds 10% of the equity in C, it is highly likely that C will be a subsidiary because A has contractual arrangements with the owners of C to control the entity.
b) A is parent of B. A is also the parent of C as it has control of 75% of the voting rights of C
c) A is the parent of B and D. A may therefore to control C through a 60% Indirect shareholding, in which case A would be the parent. However, A effectively owns only a 36% interest in C. the substance of this relationship would therefore require scruitney
d) There is no group in this situation, as A and B are shareholders in common. Which are scoped out of consolidation.

Exclusions:

A subsidiary which has been acquired eclusively with the intention to resell it is not consolidated provided that it meets the IFRS 5 criteria of a disposal group on acquisition. In this case it is carried at fair value less cost to sell and disclosed separately.

- Previously, and still in some countries, grounds for excluding individual subsidiaries from consolidation have included:

- Long term restrictions over the parent's rights to control a subsidiary
- A subsidiary sufficiently have different activities from the parent
- Temporary control of subsidiary
- Subsidiaries being immaterial
- Dis appropriate expense or undue time and effort in obtaining information required

- Clearly, management might want to exclude any subsidiary which reflects poorly on the economic performance and financial position of the group

- Under IFRS 10 there are no exclusions from the consolidation of individual subsidiaries which meet the control criteria.

Exemption:

A parent company do not need to present consolidated financial statements if:

- It is a wholly owned or partially owned subsidiary in this case non controlling shareholders must give their concern
- The parent's debt or equity instruments are not traded on a public market
- The parent has not filed its financial statements with a recognised stock market.
- The ultimate or intermediate parent presents consolidated financials in accordance with IFRSs

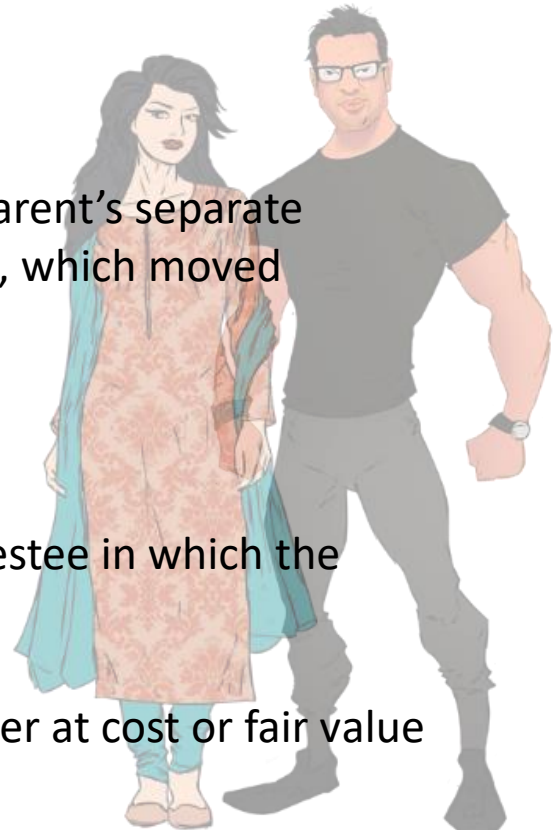
Accounting for Subsidiaries in Separate financial statements:

When the IASB issued IFRS 10 it amended IAS 27 to deal only with accounting for subsidiaries in the parent's separate financial statements. At the same time The IASB issued IFRS 12 Disclosure of interests in other Entities, which moved disclosure requirement from IAS 27 to IFRS 12

Separate Financial statements:

Statements presented by a parent or an investor with joint control or significant influence over an investee in which the investments are accounted for at cost or in accordance with IFRS 9

IAS 27 therefore required that investments in subsidiaries, associates or joint ventures are carried either at cost or fair value in separate financial statements.



- If the investment is carried at cost and subsequently the investment is classified as held for sale then IFRS 5 held for sale becomes the relevant standard. If the investment is carried at fair value and subsequently classified as held for sale then it will be accounted for under IFRS 9

Any dividends received from the investment will be included in profit or loss once the investor's right to receive the dividend is established.

Acquisition Method:

IFRS 3 requires that all business combinations be accounted for using the acquisition method of accounting

This Involves:

- Identifying an acquirer
- Determing acquisition date
- Recognising and measuring the identifiable assets acquired, the liabilities assumed and any NCI in the acquire
- Recognising and measuring goodwill or a gain from a bargain purchase

Provisions of IFRS 10:

Results of Intra group Trading:

Intra group balances and Intra group transactions and resulting un reaslised profits must be eliminated in full on the consolidation of subsidiary

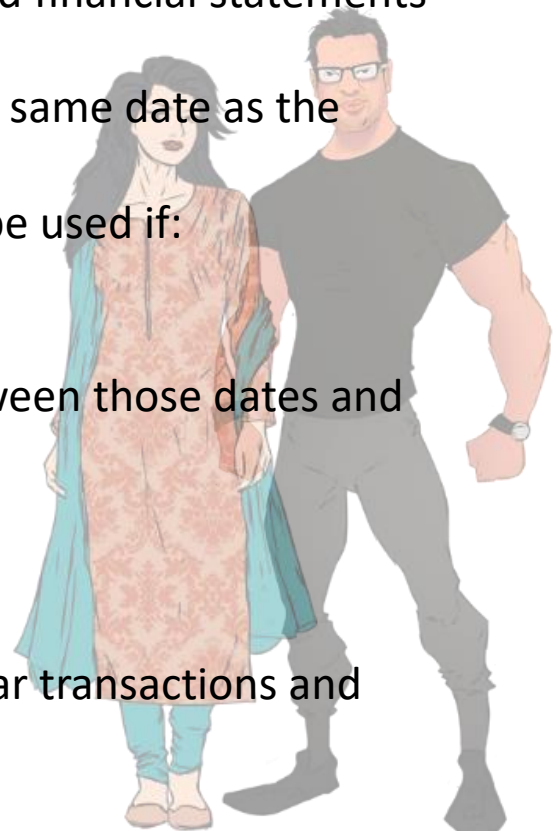
Accounting year ends

- The financial statements of the parent and its subsidiaries used in the preparation of consolidated financial statements are usually drawn up to the same date
- If there is different reporting date either the subsidiary must prepare special statements as at the same date as the group
- Or if it is impractibale to do this, financial statements drawn up to different reporting dates may be used if:

- If the difference is not more than 3 months
- Adjustments are made for the effects of significant transactions or other events which occur between those dates and the date of parent financial statements

Accounting Policies:

- ❑ Consolidated financial statements should be prepared using uniform accounting policies for similar transactions and events



- If a member of a group uses different accounting policies in its individual financial statements, perhaps it is a foreign subsidiary using a different GAAP- than the results must be adjusted to reflect the group policy before incorporating the subsidiary's results into the group.

Date of Acquisition or Disposal:

- The results of operations of subsidiary are included in the consolidated financial statements as from the date the parent gains control of the subsidiary
- The date of acquisition and the date of disposal are based on when control passes, not necessarily the legal date of acquisition or date of disposal.
- The results of operation of subsidiary disposed of are included in the consolidated statement of profit or loss and other comprehensive income until the date of disposal, which is the date on which parent ceases to have control of the subsidiary.

Consolidated Statement of Financial Position

Many companies carry on part of their businesses through the ownership of other companies they control. Such companies are known as subsidiaries.

Controlling interest in subsidiaries generally appear at cost in the statement of financial position of the investing company.

Such interests may result in the control of assets of a very different value to the cost of investment.

Separate financial statements can not provide the shareholders of the parent with a true and fair view of what their investment actually represents

Illustration

	Parent	**subsidiary**
Investment in 80% of subsidiary	$100	
Other net assets i.e. Assets less liabilities	900	1800
	1000	1800

- The investment of $100 in parents account is in substance, the cost of owning assets of 80% of $1800 in subsidiary i.e.$1140
- Parents shareholders can not see this from looking at the accounts

- The solution is prepare the group accounts to show the substance of the transaction.
- The type of group accounts required by the IFRS is called Consolidated financial statements

Rules:

A company with a subsidiary on the last day of its reporting period i.e. a parent must prepare consolidated financial statements in addition to its own individual accounts

❑ In practice parent usually prepare and publish:
- Its own statement of financial position with relevant notes and
- Consolidated version of financial statements, statement of profit or loss and other comprehensive income and statement of cash flows, all with relevant notes

Substance:

- Consolidation involves the replacement of cost of investment in the parents accounts by what its actually represents, namely:
- The net assets of the subsidiary at the end of the reporting period and
- The carring value of goodwill for which parent paid at the date of acquisition.
- This amount is than adjusted for the net assets that are not owned by the parent i.e. the non controlling interest
- In addition, the consolidated reserves must be credited with the parent's share of subsidiary's post acquisition reserves representing the portion of profit or loss accuring to parent since acquisition.

Overview of technique for consolidation:

- The approach broadly may be represented as follows:

Individual Company accounts

	Parent		Subsidiary		Consolidated statement of financial position
Net assets	xxx	+	xxx	=	xxx
Issued capital	xxx		xxx		Parent only
Reserves	xxx		xxx		To be calculated
	xxx		xxx		xxx

Individual Company Accounts:

- There is no such thing as separate set of consolidated accounts; the group does not maintain double entry accounting system
- The individual member of the group maintain their own financial statements and at the period end, after year end adjustments, the individual members of the group are merged to form the basis of consolidated financial statements
- It is important that the financial statements of the individual companies are finalised in accordance with IFRS before the consolidation financial adjustments are made.

Adjustments of Consolidation:

Two types

Major adjustments: Those which drive the double entry
- Goodwill
- Consolidated reserves
- Non controlling interest

Intra group Adjustments

- Intra group balances
- Unrealised profit
- Inventory
- Non current Asset transfers
- Non controlling Interest

Consolidated statement of Financial Position:

Now in this section will build a understanding of consolidations through series of examples with increase in complexity in each case it is assumed that individual company adjustments has already been made.

Example 1:

As at 31 December 2015

	Parent	Subsidiary
Non current Assets:		
Tangibles	2000	500
Investment in Subsidiary	1000	
Net current Assets	2000	500
	5000	1000
Issued Capital	500	1000
Retain Earning	4500	
	5000	1000

More Information:

Picacho bought 100% of subsidiary on 31st December 2015

Notes:

1. The issued capital of the group is the issued capital of Picacho. This is always the case
2. The cost of investment is to disappear. It is replaced
3. The assets and liabilities of the group are simply a line by line cross cast of Picachoo and subsidiary. Picacho controls 100% of subsidiary net assets

Required:

Prepare the consolidated financial statements.

Solution:

Workings:

Subsidiary's net Assets

	Reporting date	Acquisation
Issued capital	$1000	$1000
Retained earning	0	0
	1000	1000

Goodwill

	$
Cost of investment	1000
Non controlling Interest	-
Less: Net Assets of subsidiary (w1)	(1000)
Goodwill	-

Retained Earning:

	$
Picacho	4500
Subsidiary	0
	4500

Consolidated Statement of Financial Position

Non Current Assets	
Tangible Asset (2000 + 500)	2500
Net current Assets (2000 + 500)	2500
	5000
Issued Capital	500 ← Parent only
Retain earning	4500
	5000

Goodwill:

An asset representing the future economic benefits arising from other assets acquired in business combination which are not individually identified and separately recognised

Goodwill is the difference between the value of business taken as a whole and the fair value of its separate net assets.
It can be calculated as:

Cost of Investment	xxx
Add: Value of Non controlling Interest	xxx
Less: Fair value of Net assets of Subsidiary	(xxx)
Goodwill	xxx

Goodwill once recognised must be tested annualy for the impairement annualy and if there is any fall in value it must be recognised as an expense in Statement of profit or loss

Example:

At 31 December 2015

	Pasta	**Subsidiary**
Non current assets:		
Tangibles	1000	800
Investment in subsidiary	1200	
Net current Assets	400	200
	2600	1000
Issued capital	100	900
Retain earning	2500	100
	2600	1000

More Points:

1. Pasta bought 100% of subsidiary on 31st December 2015
2. Subsidiary reserves are $100 at the date of acquisition

3. Part of the cost is goodwill. This must be separately identified as debit to help replace the cost of asset
4.Pasta share of post acquisition profit of subsidiary is included in consolidated retain earning. In this case it is Zero

Required:
Prepare consolidated statement of Financial Position.

Solution:

Workings

Subsidiary's net assets

	Reporting date	Acquisation date
Issued Capital	900	900
Retained earning	100	100
	1000	1000

Goodwill

Cost of investment	1200
Add f.v of NCI	-
Less: F.v of Net assets of subsidiary	(1000)
Goodwill	200

Retain earning:	
Pasta (given)	2500
Share of subsidiary	
100% x (100-100)	0
	2500

Consolidated statement of financial position

Non Current Assets	
Goodwill (w2)	200
Tangibles	1800
Net current assets	600
	2600
Issued capital	100
Retain earning	2500
	2600

Post Acquisition Growth In reserves:

- In the period after acquisition i.e. in post acquisition the subsidiary will either make profit or losses
- The group will include its share of those post acquisition profit or losses in the consolidated retain earnings also known as known as consolidated reserves
- It is therefore necessary for the parent company to identify the profit or losses of the subsidiary in the post acquisition period. Which can be achieved used subsidiary net assets schedule

Example:

As at December

	PK	**Subsidiary**
	$	$
Non current Assets		
Tangible	1400	1000
Investment in subsidiary	1200	
Net current assets	700	600
	3300	1600
Issued capital	100	900
Retained earning	3200	700
	3300	1600

More Points:

1. PK bought subsidiary two years ago
2. Subsidiary reserves were $100 at the date of acquisition
3. Goodwill has been impaired by $80 since the date of acquisition
4. As before part of the cost is goodwill. This must be separately identified as an asset to help replace cost of investment
5. PK share of post acquisition profit of subsidiary in included in consolidated retain earnings.

Required:
Prepare consolidated statement of financial position.

Solution:

Working:

Subsidiary net assets:

	Reporting date	**Acquisition**
	$	$
Issued capital	900	900
Retain earning	700	100
	1600	1000

Goodwill:

	$	$
Cost of Investment		1200
NCI		-
Less: F.v of Net assets of subsidiary company		(1000)
		200

Impaired 80
As an Asset 120

Retain earning

	$
Pk	3200
Share of subsidiary (Gw1)	
100%(700-100)	600
Goodwill written off (w2)	(80)
	3720

Consolidated statement of financial position:

	$
Non current Assets:	
Goodwill (w2)	120
Tangibles	2400
Net current assets	1300
	3820
Issued capital	100
Retain earning (w3)	3720
	3820

Non controlling Interest:

Non controlling interest represent the portion of subsidiary net assets which are not owned by the parent company. IFRS 3 allows to value NCI at the date of acquisition in one of following two ways:

1. Proportionate method
2. Fair value method

- Valuing Net controlling interest at the proportionate share of the subsidiary identifiable net assets means that is not credited with any goodwill, valuing at fair value on acquisition means non controlling interest is credited with its share of goodwill
- The amount of goodwill credited to non controlling interest is not necessarily in the same proportion as the shareholding
- The increase in value of NCI will be debited to goodwill

Example:

	Pakii	**Subsidiary**
	$	$
Non current Assets		
Tangible	1000	600
Investment in subsidiary	1200	
Net current assets	500	600
	2700	1200
Issued capital	100	50
Retained earning	2600	1150
	2700	1200

More Points:

1. Pakii bought 80% of subsidiary two years ago
2. Subsidiary reserves are $150 at date of acquisition
3. Goodwill has been impaired by $200 since date of acquisition
4. Non controlling interest is valued at the proportionate share of subsidiary identifiable net assets, it is not credited with its

Share of goodwill.

5. The assets and liabilities of the group are simply a cross cast of those of Pakii and Subsidiary. Pakii share of subsdiary net assets is 100% on line by line basis

The part which does not belong to Pakii(parent) is known as NCI. It is shown as credit balance in equity in sofp. This examples values NCI without including any value for goodwill.

6. This time goodwill is impaired by $200

7.Pakii's share of post acquisition profit of subsidiary is included in the consolidated reserves.

Required:

Prepare consolidated statement of financial position.

Workings:

Subsidiary's net Assets

	Reporting date	Acquisation date
Issued Capital	50	50
Retain earning	1150	150
	1200	200

Goodwill:

	$
Cost of investment	1200
Share of net assets (80% x 200)	(160)
	1040

Impairment to retain earnings	200
Asset to recognised	840

Non controlling Interest:

Share of net assets (20% x 1200) (w1)	240

Consolidated reserve:

Pakii (given)	2600
Share of subsidiary	
(1150-150) x 80% w1	800
Goodwill impairment	(200)
	3200

Consolidates Statement of financial Position

	$
Non current Assets	
Goodwill	840
Tangibles	1600
Net current assets	1100
	3540
Issued capital	100
Retain earning w4	3200
NCI w3	240
	3540

Example:

	Picassa	Subsidiary
	$	$
Non current Assets		
Tangibles	1000	600
Investment in subsidiary	1200	-
Net current Assets	500	600
	2700	1200
Issued capital	100	50
Retained earning	2600	1150
	2700	1200

More Points:

1. Picassa bought 80% of subsidiary two years a go
2. Subsidiary reserves are $150 at date of acquisition
3. Goodwill has been impaired by $200 since the date of acquisition
4. NCI is value at fair value on acquisition. It is credited it with share of its share of goodwill. The market price of a share in the subsidiary at the date of acquisition was 29.60
5. Assets and liabilities of the group are simply a cross cast of those of parent and subsidiary. Parent's share of subsidiary net

Net assets is 100% on a line by line basis. This example measures NCI at fair value and so includes its share of goodwill. The fair value of NCI is calculated by applying market value of share to the number of shares hold by NCI.

4.NCI is valued based on the fair value on acquisition. Plus its share of any post acquisation profits less its share of goodwill written off.

5. Picassa share of post acquisation profit of subsidiary is included in consolidated retained earnings.

Required:

Prepare Consolidated Financial statements:

Subsidiary's net Assets:

Workings

1.

	Reporting date	Acquisation date
	$	$
Issued capital	50	50
Retained earning	1150	150
	1200	200

Goodwill:

	$
Cost of investment	1200
F.V of NCI (10 x 29.6)	296
Less: Net assets on Acquisition (100%)	(200)
	1296

Impairment 200
Goodwill recognised 1096

Non controlling Interest:

Fair value on acquisition (w2)	296
Share of post acquisition profit (1000 x 20%)	200
Less: share of goodwill impaired (200 x 20%)	(40)
	456

Retained Earning:

	$
Picassa (given)	2600
Share of subsidiary (80% x (1150-150) (w1)	800
Goodwill impairment (200 x 80%)	(160)
	3240

Consolidated statement of financial position

Non current Assets:	$
Tangibles	1600
Goodwill (w2)	1096
Net Current Assets	1100
	3796
Issued capital	100
Retained earning (w4)	3240
NCI (w3)	456
	3796

Intra group transactions:

- Consolidation represents the position and performance of a group of companies as if they were a single entity
- If the group members trade with each other the recivables of one will be cancel out with the payables of other
- Intra group balances are recorded in ledger accounts described as current accounts and included in recievables/payables of individual accounts (sofp). For individual company's financial statements it is correct to record those transactions which will be paid or received to separate entities.

Parent owns 80% of Subsidiary. Parent sells goods to Subsidiary. At the year end the accounts of the two entities include the following balances:

	Parent	Subsidiary
Receivables		
Amount receivable from Subsidiary	1,000	
Payables		
Amount payable to Parent		1,000

Usually, the assets and the liabilities of the group are a straightforward summation of the individual items in the accounts of the parent and its subsidiaries. If these include intra-group balances, the financial statements of the group would show owed from and to itself. This would clearly be misleading.

To avoid this, the intra-group amounts are cancelled on consolidation.

	Parent	Subsidiary	Consolidation adjustment Dr	Consolidated Statement of financial position Cr
Receivables				
Amount receivable from Subsidiary	1,000			1,000
Payables				
Amount payable to Parent		1,000	1,000	

- All intra group transactions in sofp i.e. recievables and payables and statement of profit or loss and other comprehensive income i.e. income and expenses are cancelled on consolidation.
- At the end of the reporting period intra group trading. Intra group trading may result in group company owning inventory which it purchased from another group company.

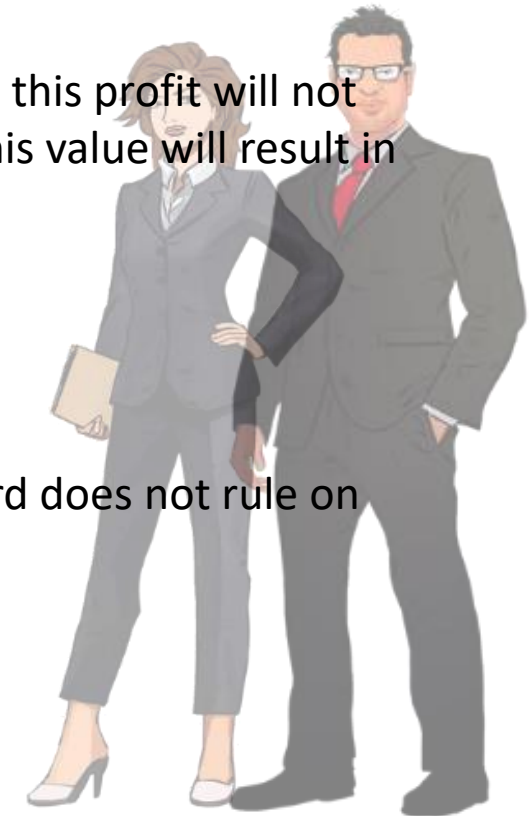
Intra group trading:

Intra-group Trading

- The main reason for intra-group balances arising is intra-group trading.
- If a member of a group sells inventory, at a profit, to another member of the group and that inventory is still held by the buying company at the year end, the company which made:
- the seller will show profit in its own accounts; and
- the purchaser will record the inventory at cost to itself. Intra-group Trading

Both of these points are correct from the individual company view. With respect to the sale, however, this profit will not have been realised from the group's perspective and with respect to the purchase, consolidation of this value will result in the inclusion in the financial statements of a figure which is not at cost to the group.

resulting unrealised profits shall be eliminated in full.



- This implies that the unrealised profit is eliminated from the inventory value. However, the standard does not rule on the

other side of the entry. There are two possibilities:

1. The **entire** profit adjustment against the parent's shareholders.

2. Apportion between parent's shareholders and non controlling interest.

Inventory:

Inventory Sold at a Profit Between Group Companies

- Inventories in the statement of financial position are valued at lower of cost and net realisable value. In the consolidated statement of financial position, where the group is reflected as a single entity, inventories must be at lower of cost and net realisable value t*o the group*.

- The group needs to eliminate profit made by the selling company if inventory is still held by the group at the year end, as the group has not yet realised this profit.

Applying the single entity concept, the group has bought and is holding inventory.

Inventory Adjustment

Adjustments from *seller* perspective:

- Inventory in the statement of financial position.
- Closing inventory in the statement of profit or loss/retained earnings of the selling company.

In the consolidated financial statements adjust inventory to reflect cost to the *group* by eliminating any profit that has not yet been realised to the group.

- Reduce (credit) inventory in the consolidated statement of financial position.
- As each entity's inventory amounts are totalled, it does not matter which amount is reduced.
- In the statement of profit or loss reduce the closing inventory of the selling company, thereby increasing its cost of sales.

Example:
Panda owns 80% of Subsidiary. During the current accounting period, Panda transferred goods to Subsidiary for $4,000, which gave Parent a profit of $1,000. These goods were included in the inventory of Subsidiary at the end of the reporting period.
Required:
Calculate the adjustment in the consolidated statement of financial position.

Solution:

Retain earning Dr 1000
Inventory Cr 1000

Example:

Parent owns 80% of Subsidiary. During the current accounting period, Subsidiary sold goods to Parent for $18,000, which gave Subsidiary a profit of $6,000. At the end of the reporting period, half of these goods are included in Parent's inventory.
At the end of the reporting period, Parent's accounts showed retained profits of $100,000, and Subsidiary's accounts showed net assets of $75,000, including retained profits of $65,000. Subsidiary had retained profits of $20,000 at acquisition.
Ignore goodwill

Required:
Show the adjustment to eliminate unrealised profits in the consolidation workings for Parent.

Solution:

Unrealised profit

(6000 x ½) = 3000

Retained earning Dr 3000
Inventory Cr 3000

Subsidiary Net Asset

		Reporting Date	Acquisation Date
Issued capital		10000	10000
Retain earning given	65000		20000
Unrealised profit	(3000)	62000	
		72000	30000

Non controlling Interest:
Share of net assets including
Unrealised profit (72000 x 20%) = 14400

Solution:

Consolidated Retained earning:

	$
Parent	100000
Share of subsidiary (including URP)	
(62000-20000) x 80%	33600
	133600

- If the subsidiary has sold the goods, the adjustment is made in the *subsidiary's net asset* schedule working.
- If the parent has sold the goods, the adjustment is made in the consolidated retained earnings working.
- The examiner requires that the adjustment be made against the *selling company*

Non current Asset Intra group Transfers:

- In some situations the asset being acquired may be treated as a non-current asset by the purchasing company; it is for use in the entity rather than being sold onwards
- In accordance with the single entity concept, the consolidated financial statements should reflect the non-current assets at the amount at which they would have been stated had the transfer not been made

-On an intra-group transfer, a profit/loss may have been recognised by the selling company. This must be removed on Consolidation

- The buying company will include the asset at cost (which is different from cost to the group) and will depreciate the asset. The expense for the year will be different from what it would have been had no transfer occurred.

Summary of adjustments needed:

- eliminate profit; and
- adjust the depreciation charge.

- Again, the adjustments may be carried out in the consolidated accounts *or* as individual company adjustments. Note that if they are processed as individual company adjustments:

- the unrealised profit will be in the accounts of the *selling* company; and
- the depreciation adjustment will be in the accounts of the buying company.
- *Approach*—Construct a working which shows the figures in the accounts ("with transfer") and shows what would have been in the accounts if no transfer had been made ("without transfer").

Example:

Parent owns 80% of Subsidiary. Parent transferred an asset to Subsidiary at a value of $15,000 on 1 January 2016. The original cost to Parent was $20,000 and the accumulated depreciation at the date of transfer was $8,000. The asset had a useful life of five years when originally acquired, with a residual value of zero. The useful life at the date of transfer remains at three years. Full allowance is made for depreciation in the year of purchase and none in the year of sale.

Required:

Calculate the adjustments for the consolidated financial statements at 31 December 2016.

	Amounts in Accounts	no transfer had occurred	Adjustments
	$	$	$
Cost	15000	20000	
Accumulated depreciation (15000/3yrs)	(5000)	(12000)	
	15000	8000	2000
Charge for the year	5000	4000	1000

Profit on disposal

Proceeds	15000		
NBX(20-8)	(12000)		
Profit on disposal		3000	3000

Dr profit on disposal 3000
Cr Non current Asset 3000
And
Non current asset Dr 1000
P&L- depreciation Cr 1000

Accumulated depreciation of $12,000 is calculated as 3 years @ 20% per annum based on the original cost of $20,000.

Dividends

- An exam question may present *draft* statements of financial position of group companies and a note that dividends have been declared before the year end but have not yet been recognised in the financial statements.
- The final statements of financial position of individual companies need to be consolidated *after* closing adjustments. Process adjustments to finalise the individual statement of financial position before consolidating

- In the books of the company declaring the dividend:

Dr Equity (in statement of changes in equity) x
Cr Curent liabilities (dividendes payable) x

- If the subsidiary is declaring the dividend, the parent will receive its share. This dividend now represents reservesin-transit. The parent *must* record its share of the dividend receivable:

Dr Dividend receivable x
Cr Profit or loss x

- The dividend receivable and liability are intra-group balances and must be cancelled.
- Consolidated statement of financial position will reflect in liabilities:
- the parent's dividends payable; and
- the non-controlling interest's share of the subsidiary's dividends payable.

Consolidated Statement of Comprehensive Income

The statement of profit or loss and other comprehensive income shows the income generated by resources
- The parent's own statement of profit or loss and other comprehensive income includes dividend income from its subsidiary.
- The consolidated statement of profit or loss and other comprehensive income shows the income generated by the group's resources

The consolidated statement of profit or loss and other comprehensive income is prepared on a basis *consistent* with that used in the preparation of the consolidated statement of financial position

Control and Ownership
Consolidated Statement of Profit or Loss

	$
Revenue	x
[Parent + Subsidiary (100%) – intra-group items]	
Profit after tax *(CONTROL)*	x
Ownership	
Equity shareholders of the parent	x
Non-controlling interests	
(% × subsidiary's profit after tax)	x
Profit for the period	x

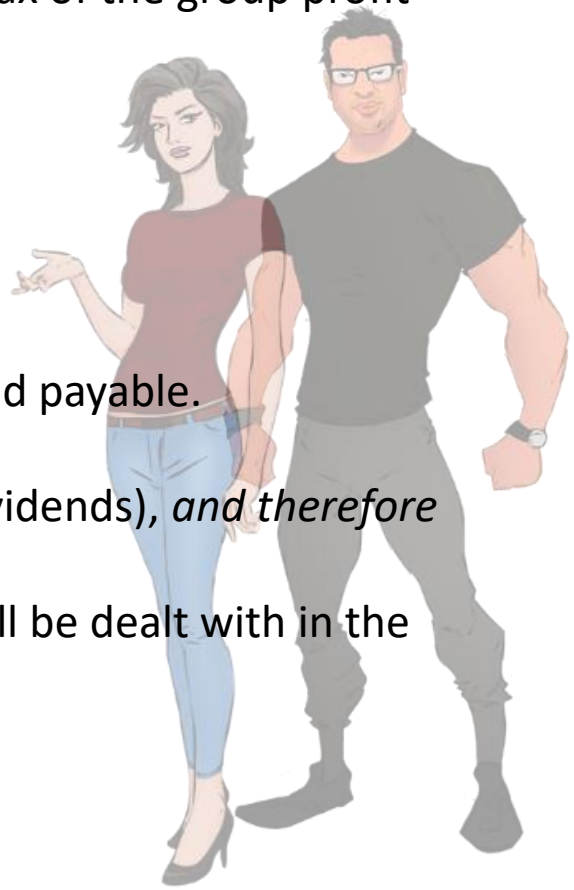
-This reflects the profit or loss section of the statement of profit or loss and other comprehensive income; any other gains or losses for the period will be included within other comprehensive income. This session focuses on the profit or loss component of the statement of profit or loss and other comprehensive income.

- The profit or loss shows the income generated from the net assets under the parent's control.

In the profit or loss, dividends from the subsidiary are replaced by the parent's share of the subsidiary's income and expenses (100%) line by line, as far as profit after tax.

Reflect *ownership* by identifying the non-controlling interest's share of the subsidiary's profit after tax of the group profit after tax in profit or loss, leaving profit attributable to the parent's shareholders.

-Eliminate the effects of transactions between group members (*single-entity concept*).



Dividends

- Dividends from a subsidiary to its parent are intra-group items:
- Cancel the parent's dividend income from the subsidiary against the subsidiary's dividends paid and payable.

-This "leaves" the non-controlling interest's share of the subsidiary's dividends.

-Non-controlling interest in the subsidiary in profit or loss is calculated on profit after tax (before dividends), *and therefore includes the non-controlling interest's share of the subsidiary's dividends and* retained *profits.*

- In profit or loss, dividend income is from trade investments **only**. Any dividends paid or payable will be dealt with in the statement of changes in equity.

Other Items

Trading:

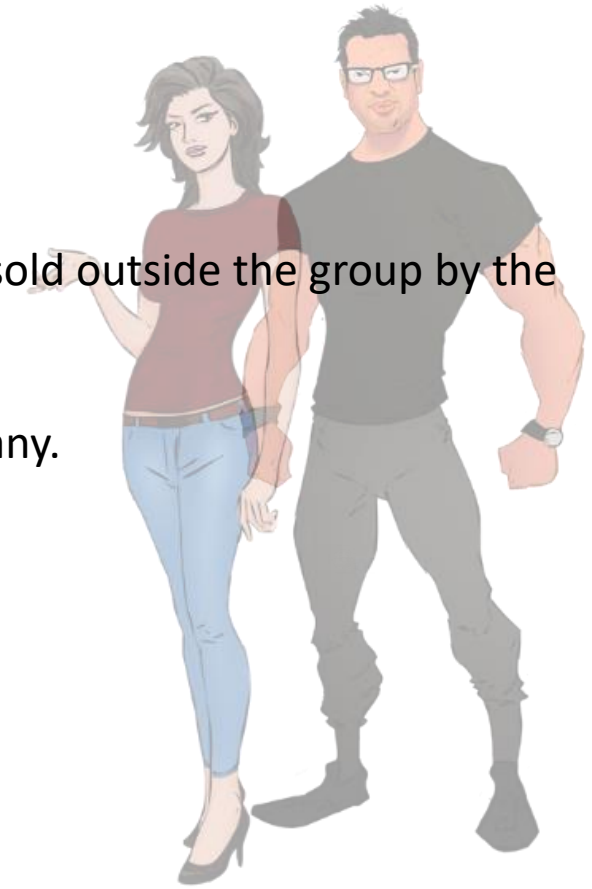
- Intra-group trading will be included in the revenue of one group company and the purchases of another. Such intercompany items must be cancelled on consolidation (single entity concept) by taking the following steps:
- add across parent and subsidiary revenue and cost of sales; and
- deduct the value of intra-group sales from revenue and cost of sales.

Unrealised Profits in Closing Inventory:

If any items sold by one group company to another are included in inventories (i.e. have not been sold outside the group by the year end), their value must be adjusted to the lower of cost and net realisable value to the group.

The adjustment will be made as a consolidation adjustment against the profits of the selling company.

- Steps to set up the provision for unrealised profit:
- Calculate the amount of inventory remaining at the year end.
- Calculate the intra-group profit included in it.
- Make an adjustment against the inventory to reduce it to cost to the group (or net realisable value if lower).



Zem owns 75% of Tisha. The trading account for each company for the year ended 31 March is as follows:

	Zem	Tisha
	$	$
Revenue	120,000	70,000
Cost of sales	(80,000)	(50,000)
Gross profit	40,000	20,000

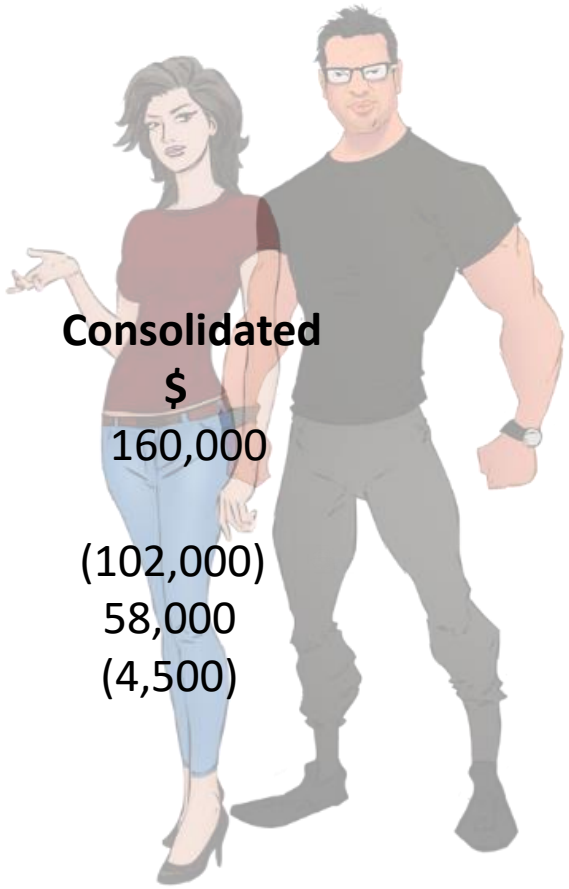
During the year, Porpoise made sales to Whales amounting to $30,000. Of these sales, $15,000 was in inventory at the year end. Profit made on the year-end inventory items amounted to $2,000.

Required:

Calculate group revenue, cost of sales and gross profit.

Solution:

	Zem	Tisha	Adjustment	Consolidated
	$	$	$	$
Revenue	120,000	70,000	(30,000)	160,000
Cost of sales — per question	(80,000)	(50,000)	30,000	
— unrealised profit			(2,000)	(102,000)
Gross profit	40,000	18,000		58,000
Non-controlling interest (25% × 18,000)				(4,500)



Unrealised Profit in Opening Inventory:

- Last year's closing inventory will become this year's opening inventory, so any adjustments made in the previous year in terms of the unrealised profit will be reversed in the current year on the presumption that the inventory has been sold in the current period.

Any unrealised profit in the opening inventory will be deducted from the costs of the original selling company, thereby increasing the profits for the current year

All we are doing with unrealised profit is shifting the period in which the profit is recognised, delaying the recognition of the profit by the group until the goods have been sold outside of the group.

-This adjustment only ever affects the gross profit calculation, never the statement of financial position.

Illustration:

In year 1, Parent sells goods to Subsidiary for $100; the cost of these goods was $80. At the end of the year, the goods are still held by the Subsidiary. In year 2, the Subsidiary sells the goods for $110.

	P	**S**	**Group**
Year 1 Profit	$20		0
Year 2 Profit		$10	$30

The profit recognised by the Parent and the Subsidiary over the two years is $30 and the group also recognises profit of $30. The adjustment for unrealised profit merely changes the period of recognition of profit, in this example slipping by one year the recognition of the initial $20 profit.

Non-current Asset Transfers:

- The consolidated profit or loss should include depreciation of non-current assets based on cost to the group and should exclude profit/loss on non-current asset transfers between group members. This is consistent with treatment in the consolidated statement of financial position.

-Eliminate profit or loss on transfer and adjust depreciation in full (control).

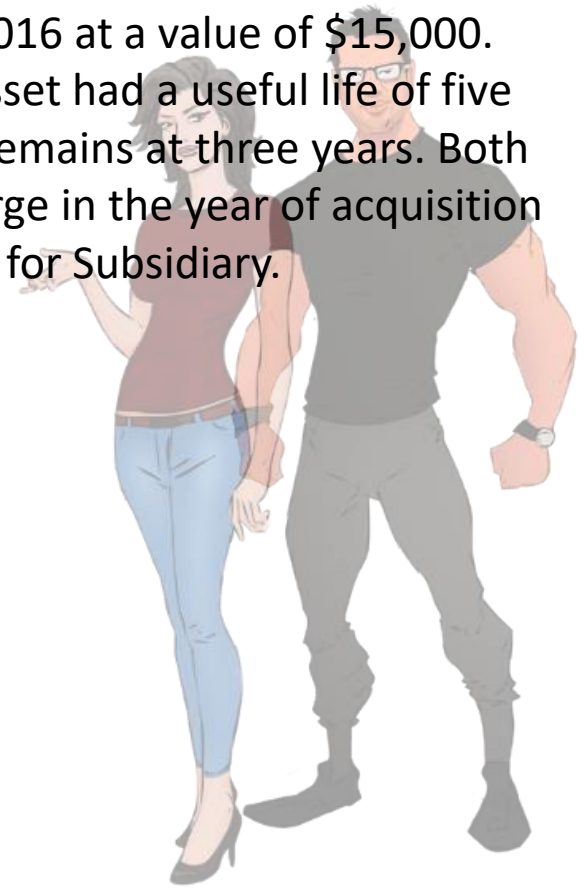
- These adjustments are made in full against the consolidated figures.

Illustration:

Parent owns 80% of Subsidiary. Parent transferred a non-current asset to Subsidiary on 1 January 2016 at a value of $15,000. The asset originally cost Parent $20,000 and depreciation to the date of transfer was $8,000. The asset had a useful life of five years when originally acquired, with a residual value of zero. The useful life at the date of transfer remains at three years. Both companies depreciate their assets at 20% per annum on cost, making a full year's depreciation charge in the year of acquisition and none in the year of disposal. Total depreciation for 2016 was $700,000 for Parent and$500,000 for Subsidiary.

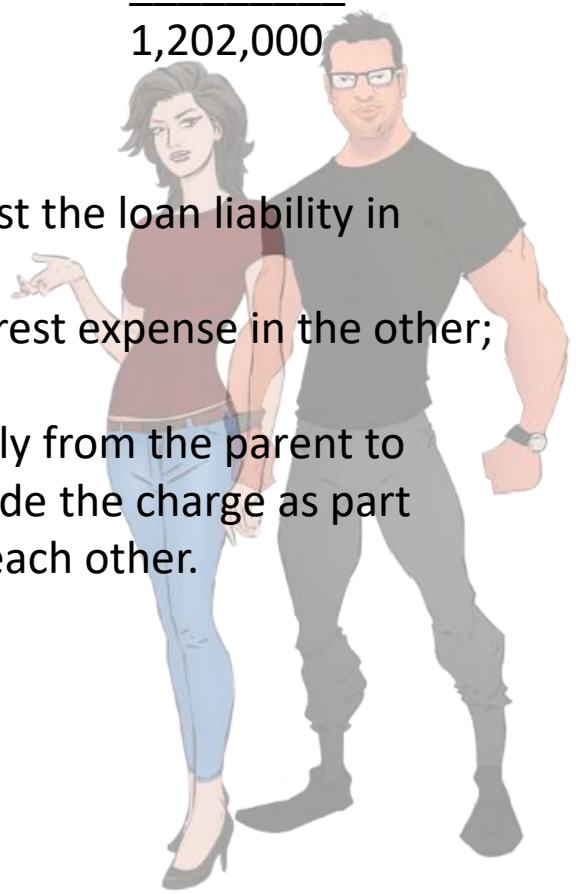
Required:

Show the adjustments required for the above transaction in the consolidated statement of profit or loss for the year ended 31 December 2016.



Solution

	Parent	Subsidiary	Adjustment	Consolidated
	$	$	$	
Per question	700,000	500,000		1,200,000
Asset unrealised profit [15,000 – (20,000 – 8,000)]	3,000			3,000
Depreciation adjustment (15,000 ÷ 3 years) – 4,000	(1,000)			(1,000)
				1,202,000



Interest and Other Charges:

- Where a group company lends money to another group company the loan asset is cancelled against the loan liability in the consolidated statement of financial position.
- Where the loan carries interest payments there will be interest income in one company and interest expense in the other; this interest will also need to be eliminated.

-Many companies also make a form of **management charge** against other group companies, normally from the parent to the subsidiary. The parent will reflect other income in its profit or loss while the subsidiary will include the charge as part of operating expenses. On consolidation, these intra-group charges must also be cancelled against each other.

Illustration:
A Parent has made an 8% $100,000 loan to its Subsidiary. The Parent's single entity accounts include interest income of $8,000. The Subsidiary's single entity accounts show interest expense of $8,000. These two figures will be cancelled against each other in the consolidated accounts and no interest income or interest expense will be recognised.

Non controlling Interest:

The non-controlling interests' share of subsidiary's profit after tax must be shown, leaving the remaining profit as attributable to shareholders of the parent.

Goodwill Treatment:

If non-controlling interest is valued at fair value (i.e. credited with its share of goodwill) any impairment loss relating to goodwill must be allocated between the parent and non-controlling interest in the proportion of their respective share ownerships.

Any excess of the fair value of the assets and liabilities acquired over the cost of the acquisition is credited to profit or loss immediately.

Peeta owns 75% of Sumaira . Statements of profit or loss for the two companies for the year ending 30 June are as follows:

	Peeta	**Sumaira**
	$	**$**
Revenue	100,000	50,000
Cost of sales	(60,000)	(30,000)
Gross profit	40,000	20,000
Expenses	(20,000)	(10,000)
Profit for the period	20,000	10,000

During the year, Peeta sold goods to Sumaira for $20,000, at a gross profit margin of 40%.
Half of the goods remained in inventory at the year end.
Non-controlling interest is valued at fair value on acquisition. Goodwill has been impaired by $4,000 in the year ended 30 June.

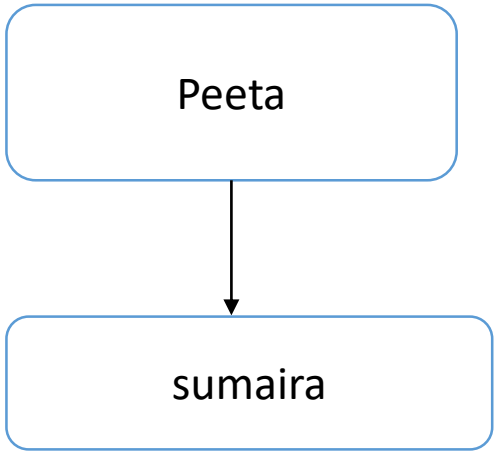
Required:

Prepare the consolidated statement of profit or loss of the group for the year ended 30 June.

Solution:

Workings:

Group structure:



Consolidation schedule

	Peeta	Sumaira	Adjustment	Consolidated
	$	$	$	$
Revenue	100,000	50,000	(20,000)	130,000
Cost of sales per question	(60,000)	(30,000)	20,000	
unrealised profit (W4)			(4,000)	(74,000)
Expenses	(20,000)	(10,000)		(30,000)
Goodwill		(4,000)		(4,000)
Profit				22,000

Non-controlling interest:

	$
Sumaira (W2) 6,000 × 25% =	1,500

Unrealised profit

	%	$	
Selling price	100	20,000	
Cost	(60)	(12,000)	**$**
Gross profit	40	8,000 × ½ = 4,000	

Consolidated statement of comprehensive profit or loss for year ended 30th June

	$
Revenue	130,000
Cost of sales	(74,000)
Gross profit	56,000
Expenses	(30,000)
Goodwill	(4,000)
Profit	22,000
Non-controlling interest (W3)	(1,500)
Profit for the period	20,500

Mid year Acquisition:

A parent may not acquire a subsidiary only at the start or end of a year. If a subsidiary is acquired mid-year, it is necessary to calculate the net assets at date of acquisition.

Inclusion of Subsidiary results:

Consolidated financial statements only include the results of the subsidiary from the date of acquisition, (i.e. when control is gained). If the subsidiary is acquired mid-year:
- consolidate subsidiary from the date of acquisition;
- identify net assets at the date of acquisition—opening net assets (equity) plus profit to date of acquisition (see consolidated statement of financial position notes); and
- assume revenue and expenses accrue evenly over the year (unless the contrary is indicated). Therefore time-apportion totals for revenue and costs, only including the postacquisition share, then deduct intra-group items.

Example:

Pakeeza acquired 80% of Subor on 31 May 2016 for $20,000. Subsidiary's net assets at 31 December 2015 were:

	$
Issued capital	1,000
Retained earnings:	15,000
16,000	

During the year to 31 December 2016, Subsidiary made a profit after tax of $600.

Non-controlling interest is valued at the proportionate share of the identifiable net assets; it is not credited with goodwill.

Required:

(1) Calculate Subsidiary's net assets at acquisition.

(2) Calculate goodwill on acquisition.

(3) Show the profits from Subsidiary to be included in the consolidated retained earnings.

Solution:

(1) Net assets of Subsidiary at acquisition

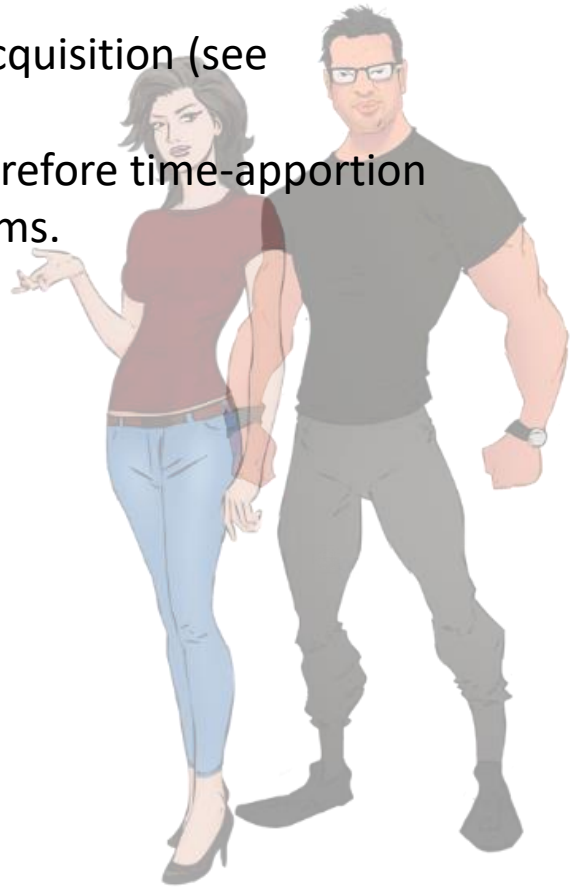
	At acquisition	
	$	**$**
Issued capital		1,000
Retained earnings:		
At 31 December 2015	15,000	
1 January – May 2016 (600 × 5/12)	250	15,250
		16,250

Goodwill:

	$
Cost of investment	20,000
Less: Share of net assets acquired	
80% × 16,250 (W1)	(13,000)
	7,000

Profit from Subsidiary included in consolidation retained earnings
$
Share of post-acquisition reserve of Subsidiary
80% (15,600 - 15,250) 280
Inclusion of subsidiary results:

Consolidated financial statements only include the results of the subsidiary from the date of acquisition, (i.e. when control is gained). If the subsidiary is acquired mid-year:
- consolidate subsidiary from the date of acquisition;
- identify net assets at the date of acquisition—opening net assets (equity) plus profit to date of acquisition (see consolidated statement of financial position notes); and
- assume revenue and expenses accrue evenly over the year (unless the contrary is indicated). Therefore time-apportion totals for revenue and costs, only including the post acquisition share, then deduct intra-group items.



Polka acquired 75% of Sufii during the year on 1 April. Extracts from the companies' statements of profit or loss for the year ended 31 December are:

	Polka	Sunny
	$	$
Revenue	100,000	75,000
Cost of sales	(70,000)	(60,000)
Gross profit	30,000	15,000

Since acquisition, the Polka has made sales to the Sunny of $15,000. None of these goods remain in inventories at the year end.

Required:

Calculate revenue, cost of sales and gross profit for the group for the year ending 31 December.

Solution:

Consolidated statement of profit or loss for the year ending 31 December 9/12

	Polka	Sunny	Adjustment	Consolidated
	$	$	$	$
Revenue	100,000	56,250	(15,000)	141,250
Cost of sales	(70,000)	(45,000)	15,000	(100,000)
Gross Profit	30,000	11,250	0	41,250

Disposal:

When a group disposes of all or part of its interest in a subsidiary, the disposal needs to be reflected in the parent's books and, more importantly, in the consolidated financial statements.

- Consolidated financial statements reflect:
- inclusion of results and cash flows of the entity disposed of;
- calculation and presentation of profit or loss on disposal;

and

- any remaining interest in the company after a part-disposal.
- In dealing with these matters in consolidated financial statements, the single entity concept is applied and the effect on the group as a whole is considered.

-Disposal may be:

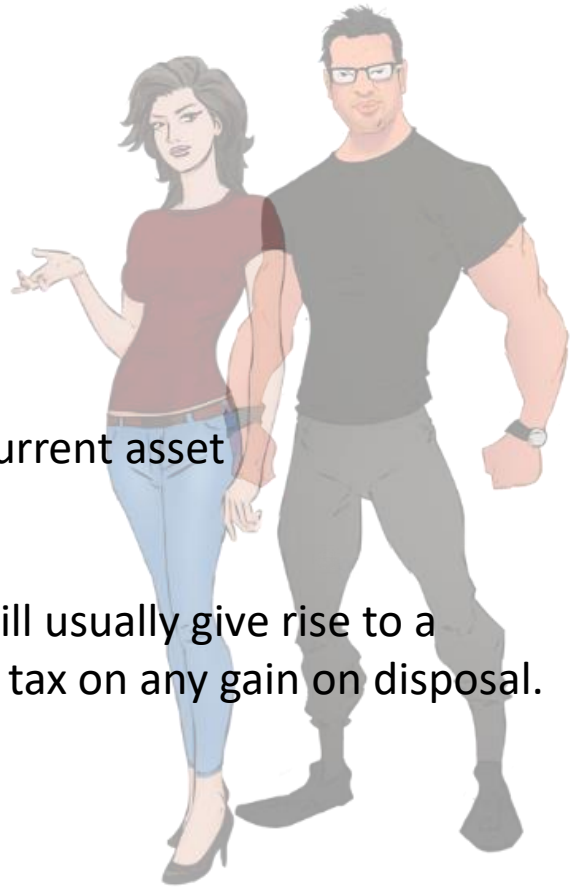
-full disposal (i.e. sell entire holding);* or

-part disposal, retaining some interest in the undertaking.

Treatment in Parent's Own Accounts:

- Parent will carry its investment in a subsidiary in its own statement of financial position as a non-current asset investment, usually at cost.

The sale of all or part of an investment is recorded as a disposal in the parent's own accounts and will usually give rise to a profit or loss on disposal (i.e. proceeds less cost of investment sold). An accrual may be required for tax on any gain on disposal.



How to recognise disposal:

	$	$
Dr Cash/receivables (proceeds)	X	
Cr Investment in S (cost of investment sold)		X
Dr P or L loss on disposal *(or* Cr profit on disposal)	X	X

If required

	$	$
Dr P or L tax charge (tax on gain on disposal)	X	
Cr Tax payable		X

Treatment in Consolidated Accounts:
Consolidated Statement of Financial Position

The consolidated statement of financial position should simply reflect the closing position.
- If at year end the parent has sold its shares in the subsidiary, there will be no reference to the subsidiary in the statement of financial position (even if the subsidiary was sold on the last day of the year).

Consolidated Statement of Profit or Loss and Other Comprehensive Income

The consolidated statement of profit or loss and other comprehensive income must reflect the pattern of ownership in the period.

- Profit or loss on disposal must be calculated from the group's perspective. This will be different to that recognised by the parent because:

-The group recognises 100% of subsidiary profit (or loss) during the term of ownership whereas the parent recognises only dividends received from the subsidiary; and

-The group will recognise impairment of goodwill (the parent does not).

Pattern of Ownership Before Disposal After disposal	Treatment in statement of Profit or loss and other Comprehensive Income	Treatment in statement of Financial Position
For example its subsidiary 90% to O%	Consolidate until the date of disposal	Nothing need to do

Group Profit or Loss on Disposal

Any disposal of a shareholding that results in the loss of control will give rise to profit or loss on disposal being recognised in profit or loss.

On the date that control is lost the following adjustments must be made:

- Derecognise the carrying amount of assets, including goodwill, liabilities and non-controlling interest from the consolidated statement of financial position.
- Recognise the fair value of the consideration received on the disposal of the shareholding.
- Reclassify to profit or loss any amounts that relate to the subsidiary's net assets previously recognised in other comprehensive income, where required.
- Recognise any resulting difference as a gain or loss in profit or loss attributable to the parent.

Example:

Plum purchased 80% of the shares in Sink a number of years ago for $125 million. On the acquisition date, the non-controlling interest was valued at a fair value of $25 million, the fair value of System's net assets was $140 million, and goodwill of $10 million was recognised.Since the acquisition, Sink has made profits of $20 million and goodwillhas been impaired by $4 million. Today, Plum sells all of its shares in System for $160 million.

Parent and group profit or loss on disposal are calculated as follows:

Parent

	$ million
Proceeds on disposal	160
Cost of investment	(125)
Profit on disposal	35

This profit would be included in Plumber's profit or loss in the year of disposal. Tax would be applied to this figure where relevant.

Group

	$ million
Proceeds on disposal	160
System net assets on disposal (140 + 20)	(160)
Goodwill remaining (10 – 4)	(6)
Non-controlling interest on disposal (25 + ((20 – 4) x 20%))	(28.2)
Profit on disposal	22.2

This profit would be included in the consolidated profit or loss in the year of disposal.

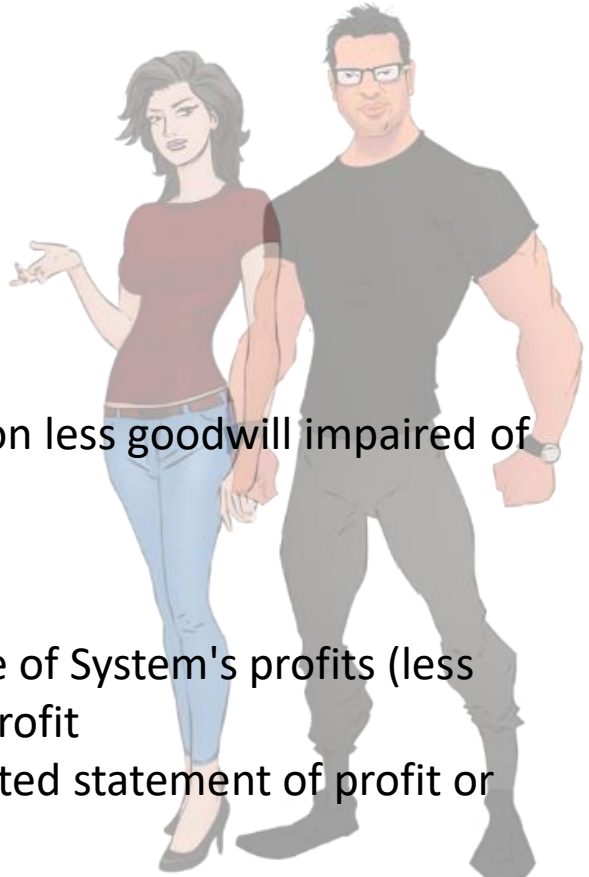
Difference in profit

The $12.8-million difference in the two profit figures is System's post acquisition profit of $20 million less goodwill impaired of $4 million times

Plum's percentage holding of 80%:

($20 – $4) x 80% = $12.8 million

This difference exists because the consolidated statement of profit or loss included Plumber's share of System's profits (less goodwill impaired) during the period of control, while Plumber's own (single entity) statement of profit or loss only included dividends received from System. The higher profit recognised in the consolidated statement of profit or loss during the term of ownership results in less profit recognised on disposal



Discontinued Operations

- It is highly likely that the disposal of a subsidiary will be classified as a discontinued operation.

In this case, the results for the subsidiary to the date of disposal will be presented separately from the results of the continuing operations.

IFRS 5 requires that the revenue and costs to the date of disposal and any profit or loss on the actual disposal of the operation are presented as a single item in the profit or loss, and then analysed further either in the profit or loss or in the disclosure notes.

More Aspects of Consolidation

Consolidation problems are usually tackled in two stages:
Stage 1 Process any individual company adjustments.
Stage 2 Do the consolidation

Accounting Policy adjustments:

Group Policy

IFRS 10 requires that the accounts of subsidiaries be drawn up according to the same accounting policies as the parent. If this is not the case, then the accounts of the subsidiary may have to be restated in line with the group policy.

- Such a requirement is rare in practice because a situation which required it would, by definition, be contrary to IFRS.
- It might be needed in the cases of:
- mid-year acquisition where the parent has not yet imposed its policies on the subsidiary; or
- foreign subsidiaries following local GAAP.

Investment property:
A property that is owned by a parent but occupied by a subsidiary, or vice versa, will be treated as investment property (under IAS 40) in the financial statements of the single entity but as property (under IAS 16) in the consolidated financial statements as the asset is owner occupied from a group perspective

Goodwill on Acquisition:

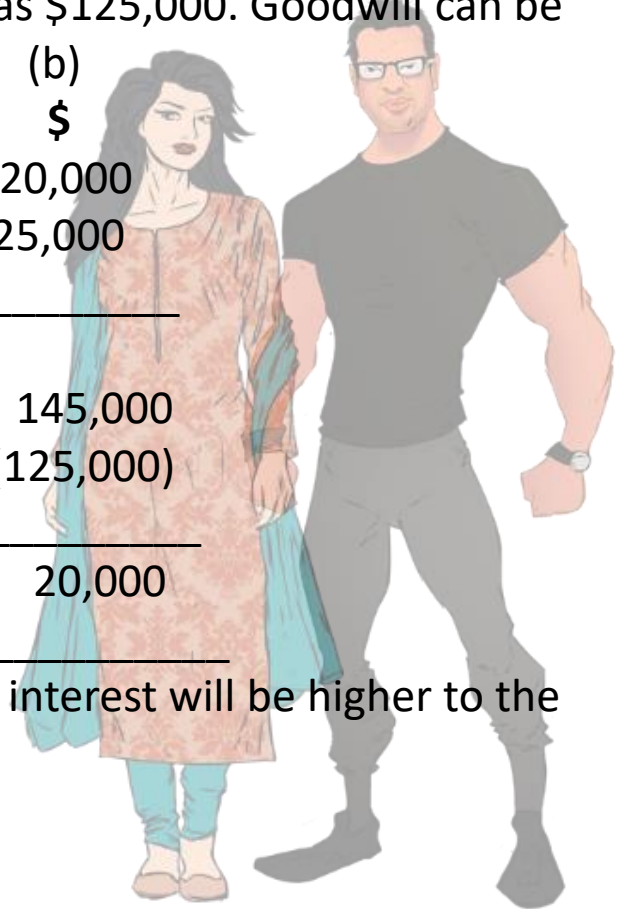
Valuation of NCI: The non-controlling interest's share of goodwill may be recognised as part of the acquisition process. The option to measure non-controlling interest is allowed on a transactionby- transaction basis.

Example:

Parent acquires 80% of Subsidiary for $120,000. The fair value of the non-controlling interest's share in Subsidiary is $28,000, while the value of non-controlling interest based on the proportionate share of identifiable net assets acquired would give a value of $25,000. The fair value of the subsidiary's net assets on acquisition has been determined as $125,000. Goodwill can be calculated as either:

	(a)	(b)
	$	**$**
Cost of investment	120,000	120,000
Non-controlling interests	28,000	25,000
	148,000	145,000
Fair value of net assets acquired	(125,000)	(125,000)
Goodwill	23,000	20,000

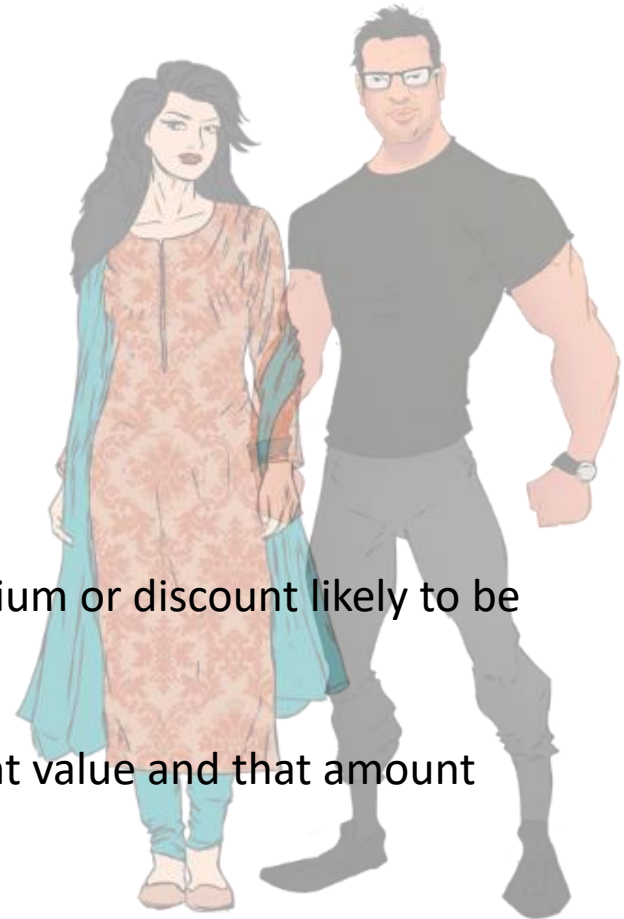
If non-controlling interest is valued at fair value (a), then the value of goodwill and non-controlling interest will be higher to the extent of the non-controlling interest's share of the fair value of the subsidiary.



There are several issues to address:
- What is included in cost of acquisition?
- The meaning of the term "identifiability".
- Calculation of the fair value.
- Accounting for the revaluation in the accounts of the subsidiary.
- Accounting for the goodwill arising on consolidation.

Fair value of purchase consideration:

An acquisition is accounted for at its cost. Cost is:
- the amount of cash or cash equivalents paid; or
- the fair value of the other purchase consideration given.
-Any costs directly associated with the acquisition of the subsidiary must be expensed to profit or loss as a period cost.



Deferred Consideration:
The cost of the acquisition is the present value of the consideration, taking into account any premium or discount likely to be incurred in settlement (and not the nominal value of the payable).

If cash is to be paid sometime in the future, then the amount will need to be discounted to present value and that amount included as the fair value in the cost calculation.

The increase in present value, through the passage of time, will be a finance cost charged to profit or loss.

Example:

Parent acquired 60% of Subsidiary on 1 January for $100,000 cash payable immediately and a further $121,000 after two years. The fair value of Subsidiary's net assets at acquisition amounted to $300,000. Parent's cost of capital is 10%. Non-controlling interest is not credited with goodwill.

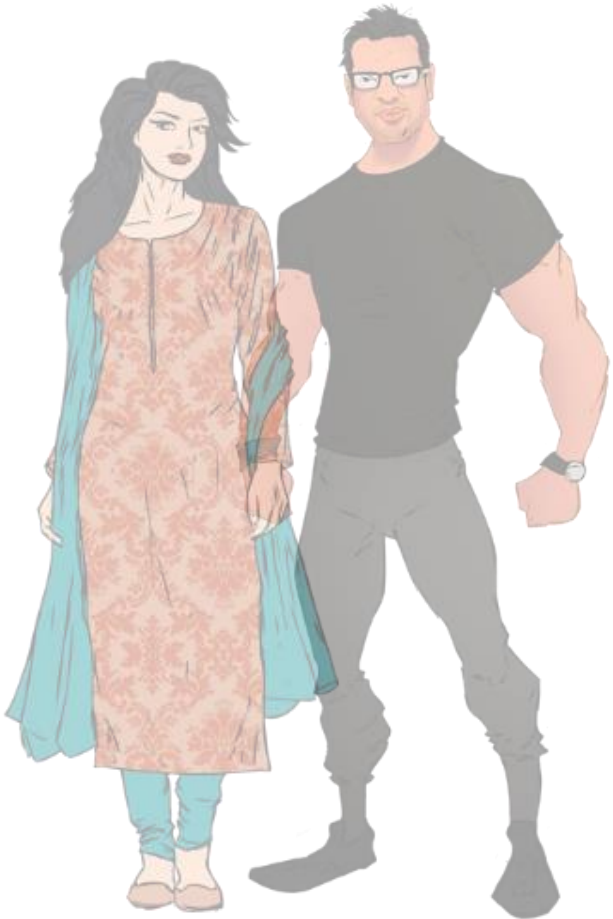
Required:

Calculate the goodwill arising on acquisition and show how the deferred consideration should be accounted for in Parent's consolidated financial statements.

Solution:

Cost of investment in Subsidiary at acquisition: $100,000 + $121,000/1.21 = $200,000

Goodwill	**$000**
Cost of investment	200
Non-controlling interest (40% x 300,000)	120
Share of net assets acquired	(300)
	20



Deferred consideration
Double entry at 1 January:

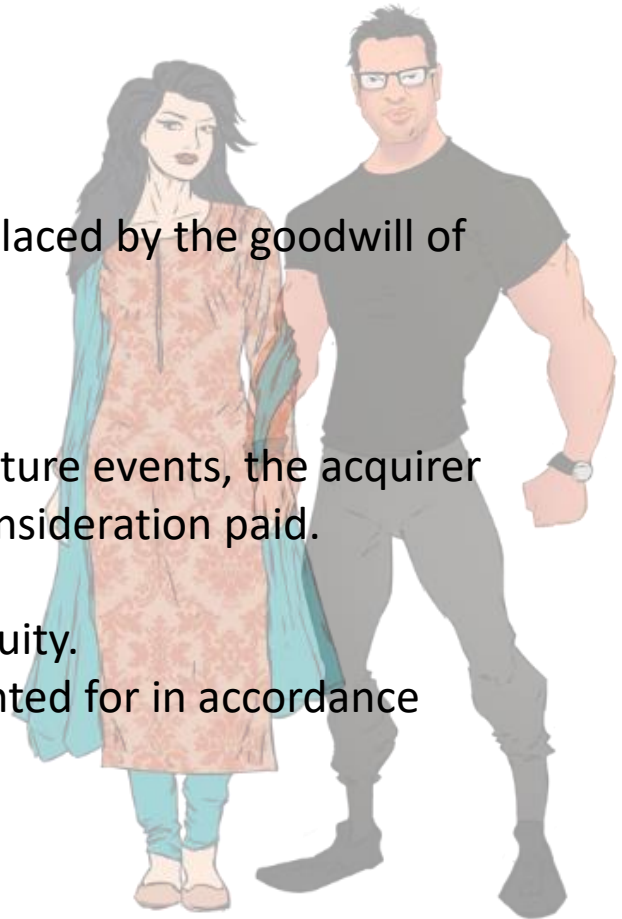
Dr Cost of Investment in Subsidiary $100,000
Cr Deferred consideration $100,000

On 31 December, due to unwinding of discount, the deferred consideration will equal
$121,000/1.1 = 110,000

Dr Parent retained earnings $10,000
Cr Deferred consideration $10,000

In the consolidated statement of financial position, the cost of investment in Subsidiary will be replaced by the goodwill of $20,000, and the deferred consideration will be $110,000.

Contingent Consideration:
When a business combination agreement provides for an adjustment to the cost, contingent on future events, the acquirer includes the acquisition date fair value of the contingent consideration in the calculation of the consideration paid.
- If the contingent settlement is to be in cash, then a liability will be recognised.
- If settlement is to be through the issue of further equity instrument the credit entry will be to equity.
- Any non-measurement period changes to the contingent consideration recognised will be accounted for in accordance with the relevant IFRS and will not affect the original calculation of goodwill.



Share Exchange:

- It is quite common for a parent to acquire shares in the subsidiary by issuing its own shares to the previous shareholders in a share exchange.
- The cost of acquisition is determined multiplying the number of shares issued by the parent by the market price of the parent's shares at the date of acquisition.

Example:
Parent acquired 80% of Subsidiary's 100,000 shares in a three-forfive exchange. The market price of one share in P on acquisition was $4.00 and that of S was $2.20.
Cost of investment = 100,000 × 80% × 3⁄5 × $4.00 = $192,000
The value of S's share is irrelevant.

Recognition:

-The identifiable assets and liabilities acquired are recognised separately as at the date of acquisition (and therefore feature in the calculation of goodwill).
-Any future costs which the acquirer expects to incur in respect of plans to restructure the subsidiary must not be recognised as a provision at the acquisition date. They will be treated as a post-acquisition cost.

Measurement:

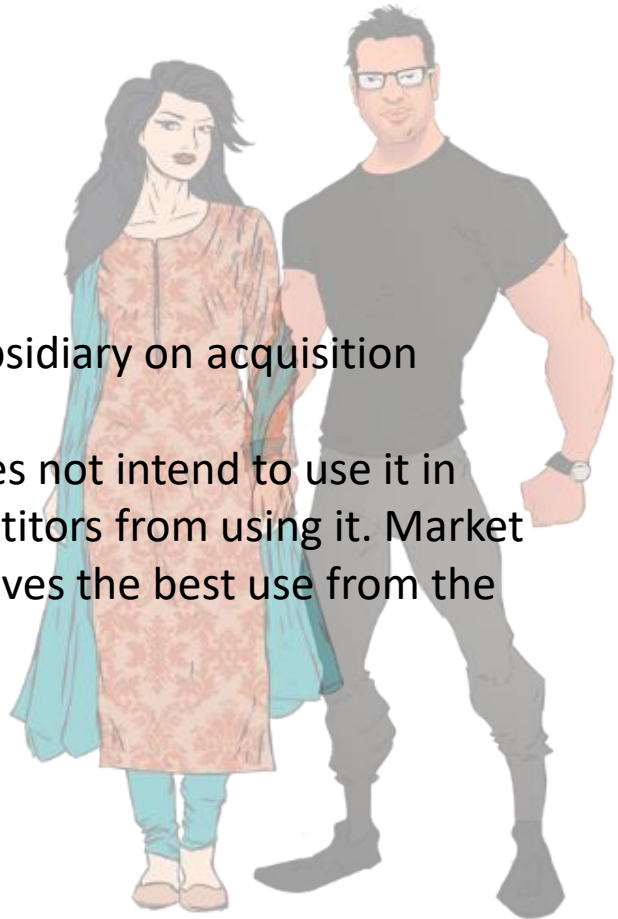
All assets and liabilities of the subsidiary which are recognised in the consolidated statement of financial position are measured at their acquisition date fair values.

This reflects the amount which would have been paid toacquire the individual assets and liabilities at the acquisition date and correctly identify the value of goodwill acquired.
- The non-controlling interest of the subsidiary is measured
at either:
- fair value; or
- the non-controlling interest's proportionate share of the

Fair Values:

An entity should apply IFRS 13 *Fair Value Measurement* when measuring the net assets of the subsidiary on acquisition

The fair value must reflect the highest and best use for a nonfinancial asset even if the parent does not intend to use it in this manner. The parent may be planning to use the asset in a "defensive" manner, to stop competitors from using it. Market participants, though, would not be using it in this manner; they would use it in a manner which gives the best use from the asset and it is this value which should be applied to the asset.

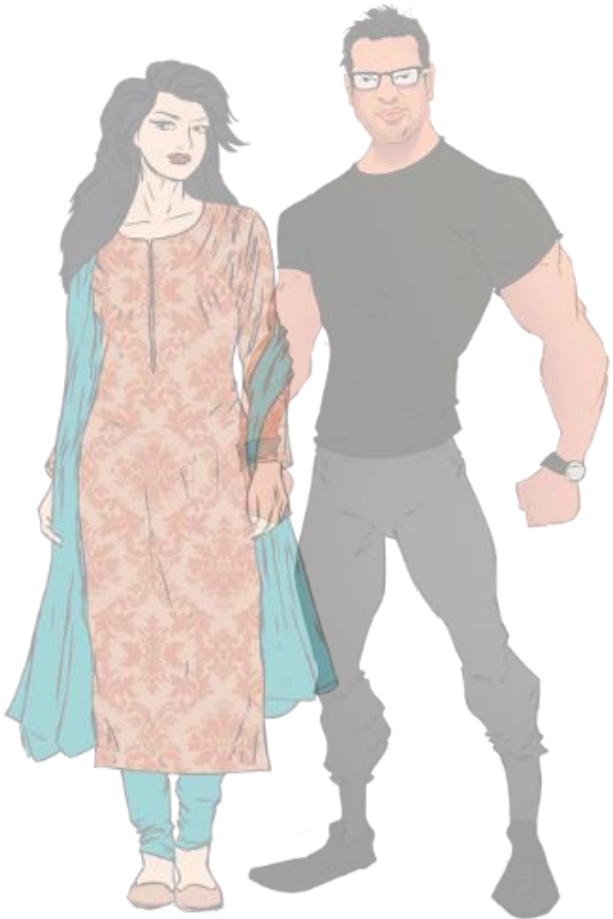


Bargain Purchase:

If, on initial measurement, the fair value of the acquiree's net assets exceeds the cost of acquisition (excess), then the acquirer reassesses:
- the value of net assets acquired;
- that all relevant assets and liabilities have been identified;
and
- that the cost of the combination has been correctly measured.

If an excess still remains after the reassessment, then that excess is recognised immediately in profit or loss.

-This excess (gain) could have arisen as a result of:
- future costs not being reflected in the acquisition process;
- measurement of items not at fair value, if required by another standard, such as deferred tax being undiscounted; or
- bargain purchase.



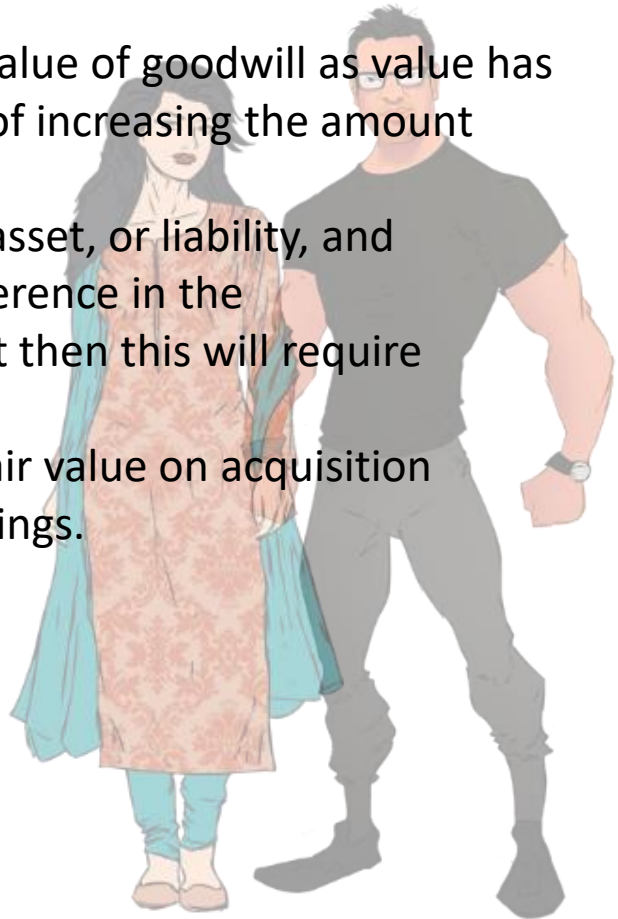
Fair Value Adjustment Accounting:

✓ The fair value adjustment will not normally have been reflected in the financial statements of the subsidiary at the date of acquisition.

✓ If the subsidiary has not reflected fair values in its accounts, this must be done before consolidating.

This is not a revaluation exercise under IAS 16 but a fair value exercise in accordance with IFRS 3.

- An increase from carrying amount to fair value of an asset will have the effect of reducing the value of goodwill as value has now been attached to an identifiable asset. A decrease from carrying amount will have the effect of increasing the amount of goodwill.
- At the acquisition date, identify the difference between fair value and carrying amount of the asset, or liability, and include this difference in the schedule of net assets. Next, consider the effect of this fair value difference in the post-acquisition period; if the fair value is greater than the carrying amount of a depreciating asset then this will require an adjustment to depreciation in the post-acquisition period.
- In summary, all assets and liabilities, be they monetary or non-monetary, should be valued at fair value on acquisition and any changes to that value in the post-acquisition period will be adjusted against retained earnings.



Depreciating Asset:

Allow for any additional (or reduced) depreciation based onvthe fair value difference and then show the reporting date figure as a balancing item.

Example:

On acquisition of a subsidiary, the carrying amount of its buildings was $25 million and their fair value $30 million. The buildings had a remaining useful life at the date of acquisition of 20 years. Two years have passed since the acquisition took place. The fair value difference on the acquisition date is $5 million. The post-acquisition adjustment for depreciation is $500,000 ($5 million × 2/20 years). The fair value difference remaining at the reporting date is $4.5 million.

Extract from net assets' schedule:

	Reporting date	Acquisition date	Post Acquisition
Fair value difference	**4.5**	**5**	**(0.5)**

Non Depreciating Asset:

Because there will be no depreciation in the post-acquisition period, the fair value difference at the reporting date will be the same as at the acquisition date.

Example:
As for *example 4* with an asset of land (rather than buildings). The fair value difference remaining at the reporting date is $5 million.

Extract from net assets' schedule:

	Reporting Date	Acquisition date	Post Acquisition
Fair Value difference	**5**	**5**	**0**

Inventory:

-If the inventory has been sold, there will be no fair value difference remaining at the reporting date and so the post acquisition amount will be the balancing figure.
- If the inventory has not been sold, then the fair value difference will be the same at the reporting date as it was on acquisition.

Example:

As for *Illustration 4* with an asset of inventory which has now been sold. The fair value difference remaining at the reporting date is $0.
Extract from net assets' schedule:

	Reporting Date	Acquisition date	Post Acquisition
Fair value difference	0	5	(5)

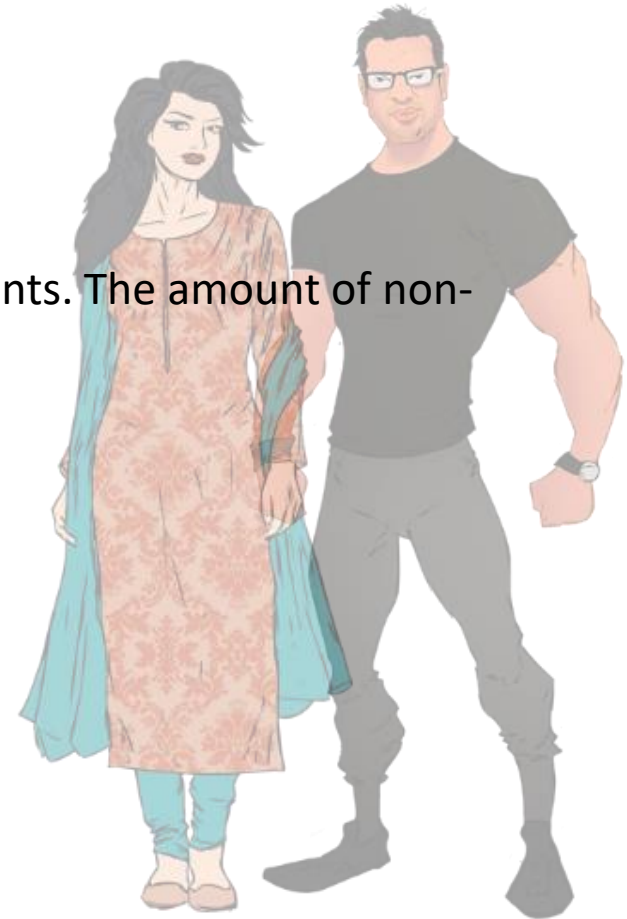
Contingent Liabilities:

- Again, any change in the fair value of the contingent liability between the reporting date and the acquisition date is a post acquisition adjustment to net asset.

How is Adjustment Accounted for ?

IFRS 3 Business combination referred to this as allocation of cost of acquisation.

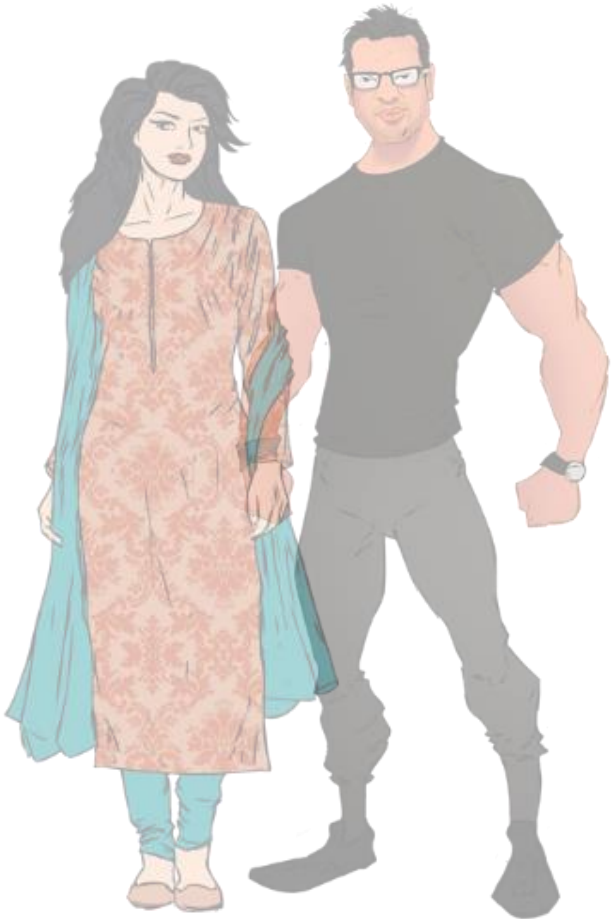
FRS 3 requires the entire fair value difference to be reflected in the consolidated financial statements. The amount of non-controlling interest will reflect its share of the difference.



Example:

Pinga As at 31st December 2015

	Pinga	Subsidiary
	$	$
Non Current Assets:		
Tangibles	1700	1000
Cost of investment in subsidiary	1100	
Current Assets	400	300
	3200	1300
Issued Capital	100	100
Retained earning	2900	1000
Current Liabilities	200	200
	3200	1300

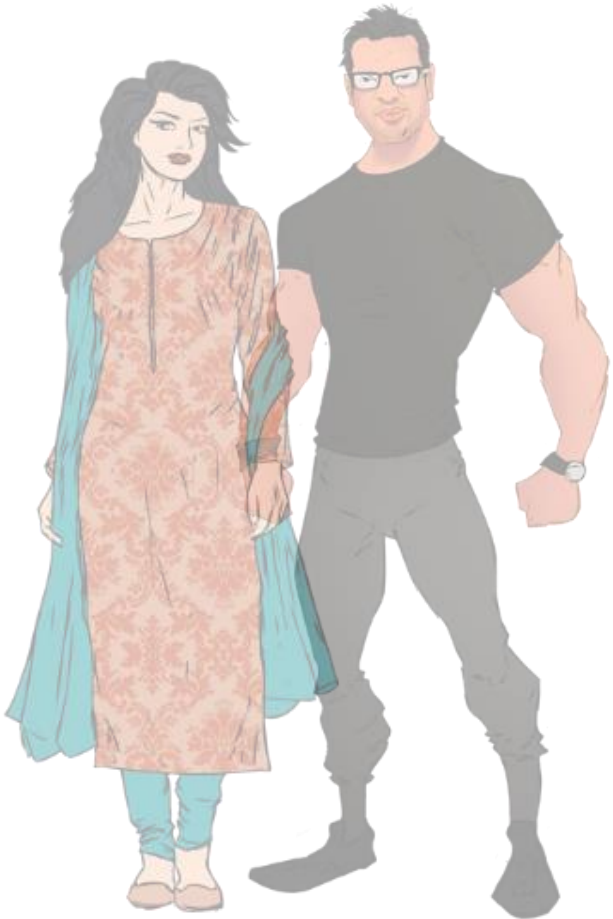


More Information:

Parent bought 80% of Subsidiary two years ago.
At the date of acquisition, Subsidiary's retained earnings stood at $600 and the fair value of its net assets were $1,000. The revaluation was due to an asset which had a remaining useful economic life of 10 years as at the date of acquisition. Goodwill has been impaired by $40 since acquisition. Non-controlling interest is valued at the proportionate share of the identifiable net assets; it is not credited with its share of goodwill.

Required:

Prepare the Consolidated statement of financial position as at 31st December 2015



Solution

Workings:

Net Assets

	At reporting date	**At acquisition date**
	$	$
Issued capital	100	100
Retain earning	1000	600
Fair Value Adjustment (300 x 8/10)	240	300
Net Assets	1340	1000

Goodwill:

	$
Cost of Investment	1100
NCI	200
Less: Net Assets acquired	(1000)
	300

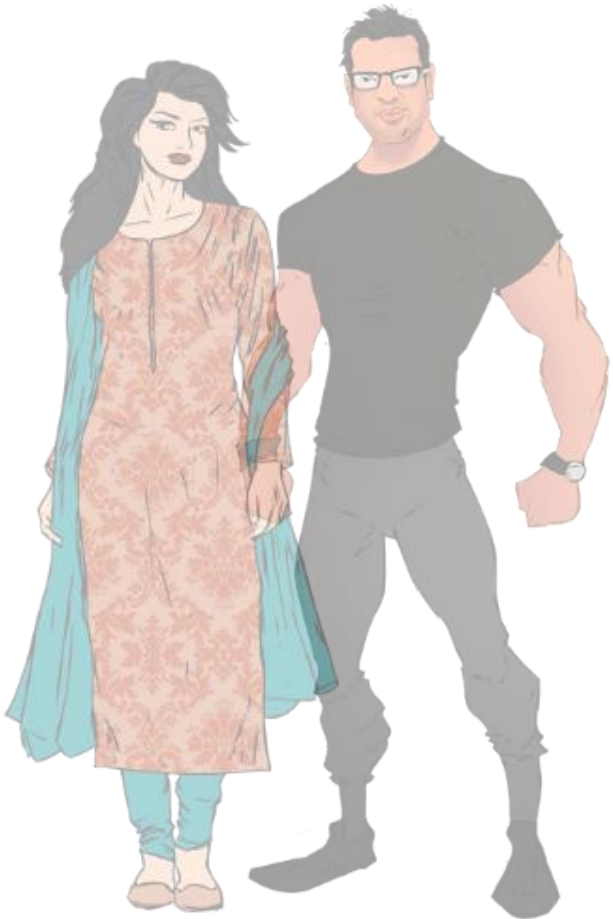
Impairment	40
Recognise as asset	260

Non controlling Interest:

1340 x 20% = $268

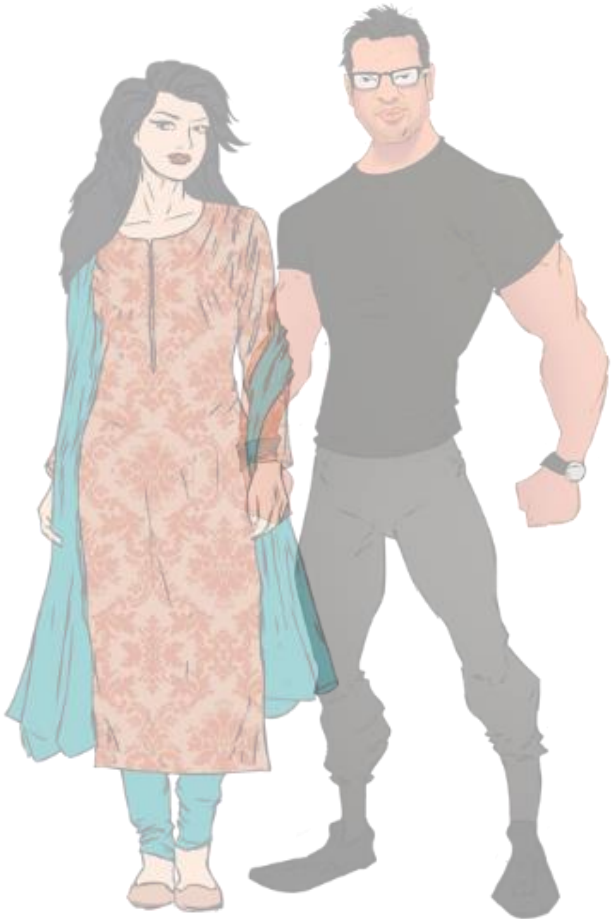
Consolidated Retain Earning:

		$
Pinga		2900
Share of subsidiary (1340-1000)		
	x 80%	272
Impairment		(40)
Goodwill		3132



Pinga consolidated Financial Statements:

	$
Non Current Assets:	
Goodwill	260
Tangibles(1700 + (1000 + 240)	2940
Current Assets (400 + 300)	700
	3900
Issued capital	100
Retained earning	3132
Non controlling Interest	268
Current Liabilities (200 + 200)	400
	3900



Post Acquisition changes in subsidiary reserves:

The parent's share of the subsidiary's post-acquisition retained earnings is included in the consolidated retained earnings.

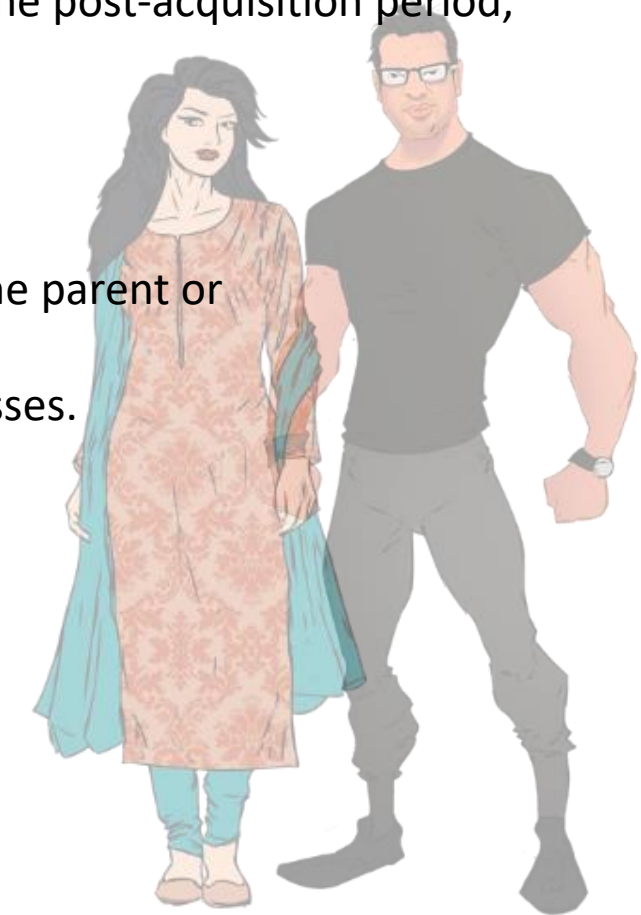
If the group has a policy of regularly revaluing its assets then the parent's share of the subsidiary's post-acquisition change in revaluation will be included in a consolidated revaluation reserve. The non-controlling interest's share will be included in the amount of non-controlling interest in the statement of financial position.

In the unlikely event that there is a change in the subsidiary's share capital or share premium in the post-acquisition period, due to a bonus or rights issue, then simply reverse the issue to get back to the pre-issue position.

Accounting for Goodwill:

Once calculated any positive goodwill is recognised as a consolidated asset; it is not an asset of the parent or subsidiary but an asset of the group.
Subsequent to initial recognition, goodwill is carried at cost less any accumulated impairment losses.

Goodwill is tested annually for impairment; any loss is expensed
to profit



Initial Accounting Determined provisionally:

Provisional Accounting

- If accurate figures cannot be assigned to elements of the business combination then provisional values are assigned to those elements at the date of acquisition.

-Any new information which becomes available, relating to acquisition date assets and liabilities, is retrospectively adjusted against the initial provisional amounts recognised as long as the information is known during the "measurement period".

Measurement Period:

- The measurement period is the period after the acquisition date during which the parent may adjust the provisional amounts recognised in respect of the acquisition of a subsidiary.

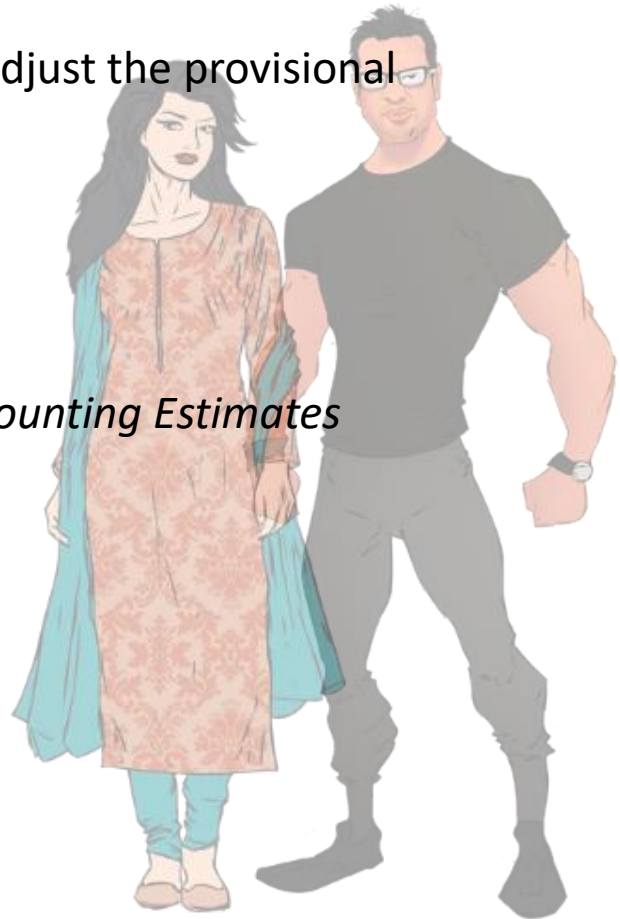
The measurement period cannot exceed one year after the acquisition date.

Subsequent Adjustments

- Any other adjustments are treated in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors:*

-an error in acquisition values is treated *retrospectively*; and

- a change in estimate is treated *prospectively*.



Example:

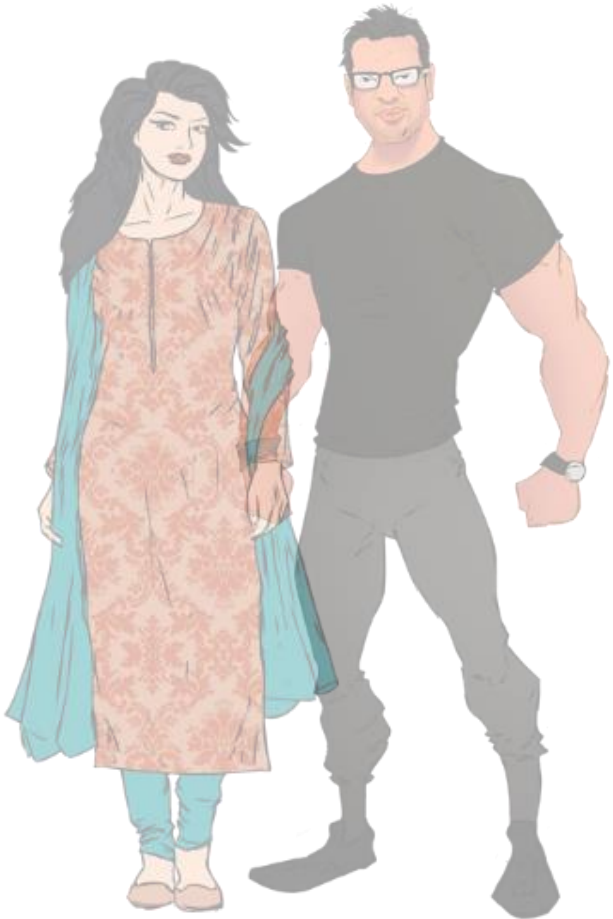
Pari acquires 80% of Subsidiary for $60,000. The subsidiary's net assets at date of acquisition were $62,500. At the end of the first year, goodwill has been impaired by $1,000. In the year following acquisition, but within 12 months of the acquisition date, it was identified that the value of land was $2,500 greater than that recognised on acquisition. The value of goodwill at the end of year 2 was valued at $7,400.

Year 1:

Cost of investment	60,000
Net assets on acquisition (62,500 × 80%)	50,000
Goodwill	10,000
Goodwill charge to profit or loss	1,000

Year 2:

Cost of investment	60,000
Net assets on acquisition (65,000 × 80%)	52,000
Goodwill on acquisition	8,000
Goodwill at year end	7,400
Goodwill charge to profit or loss	600



Journal

Dr Land	2,500	
Dr Profit or loss (goodwill)	600	
Cr Goodwill (9,000 – 7,400)		1,600
Cr Non-controlling interest (2,500 × 20%)		500
Cr Opening retained earnings		1,000
(adjustment for prior year expense)		

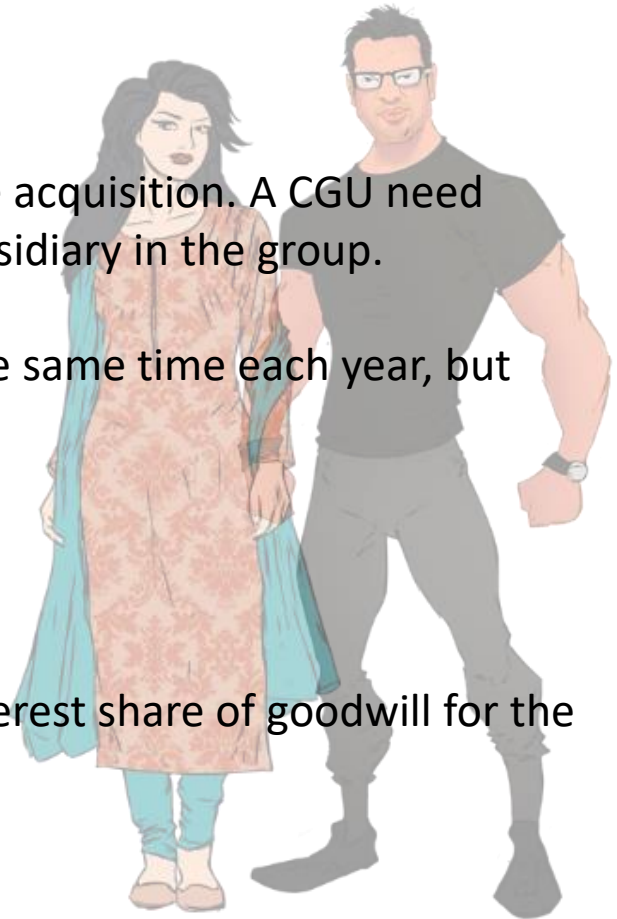
Impairment of Goodwill:

Goodwill on acquisition must be allocated to a cash-generating unit (CGU) which benefits from the acquisition. A CGU need not necessarily be a unit of the subsidiary acquired; it could be a unit of the parent or another subsidiary in the group.

Goodwill for each CGU must be tested annually for impairment. The test must be carried out at the same time each year, but does not have to be carried out at the year end.

Non-controlling Interest Valued at Proportionate Share
of Identifiable Net Assets

Any goodwill in a partially-owned subsidiary must be grossed up to include the non-controlling interest share of goodwill for the purposes of the impairment test.



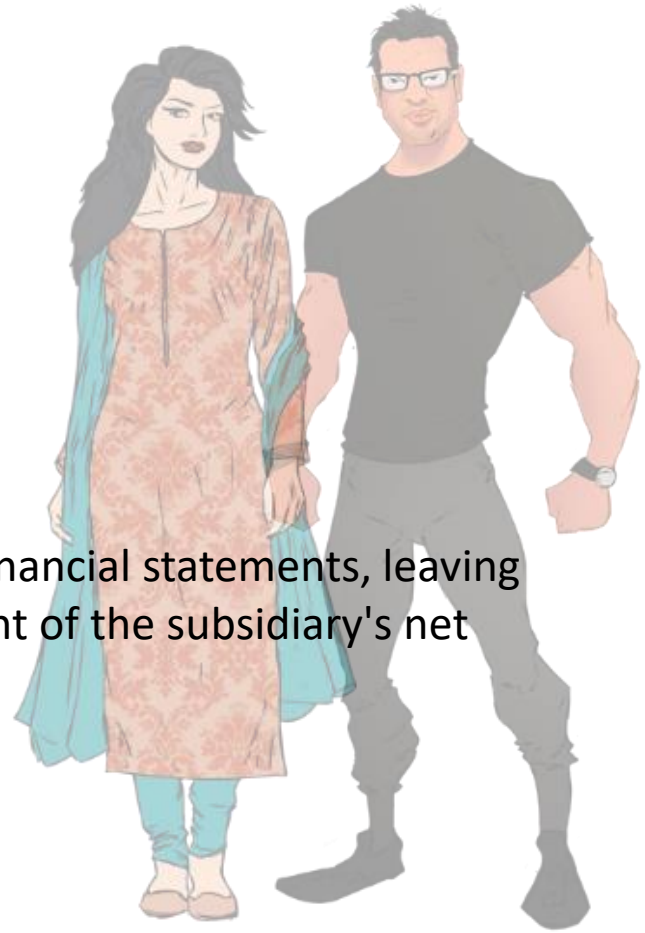
- Any impairment will firstly be allocated against this grossed-up goodwill figure.
-Any impairment in excess of this grossed-up goodwill will then be allocated against the remaining assets of the CGU on a pro rata basis.

Example:

Pasha Co acquires 75% of Subsidiary. The carrying amount of the subsidiary's net assets on 30 June was $1,800; this included $300 of goodwill. The recoverable amount of the subsidiary on the same day was $1,640.

Impairment:

Goodwill grossed up (300 × 100 ÷ 75)	400
Other net assets	1,500
	1,900
Recoverable amount	1,640
Impairment	260

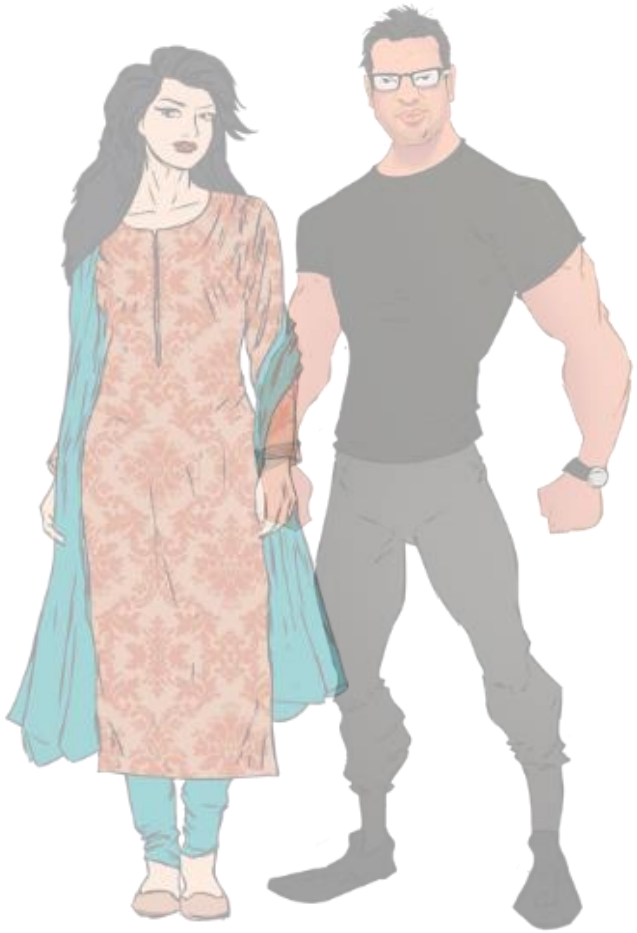


Of this amount, 75% (195) will be allocated against the goodwill recognised in the consolidated financial statements, leaving goodwill included in the consolidated statement of financial position of $105. The carrying amount of the subsidiary's net assets, including goodwill, will now be $1,605.

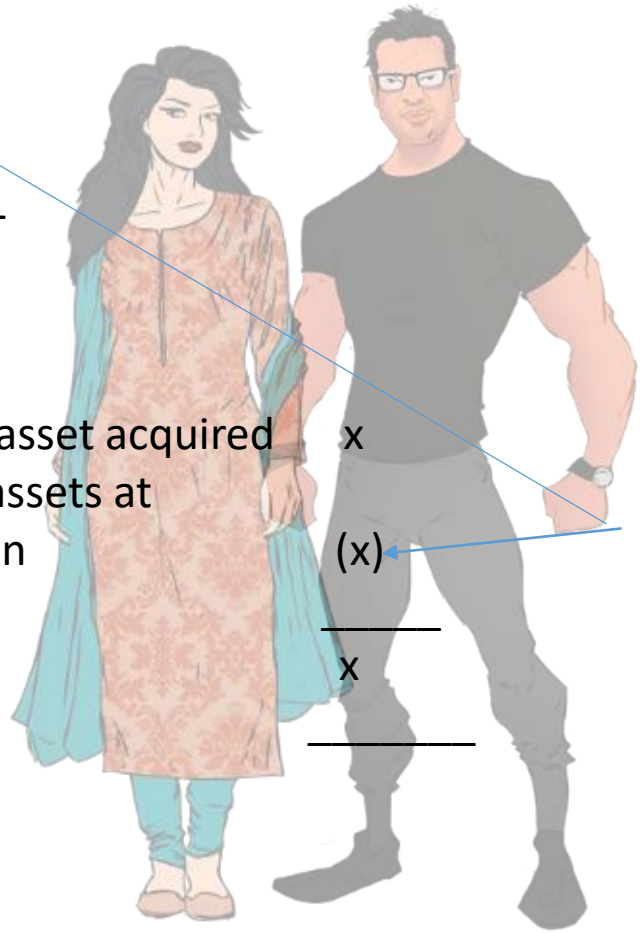
NCI Valued at Fair Value:
There will be no need to gross up goodwill for the impairment test as the non-controlling interest in goodwill has already been recognised and included in the total goodwill figure.
-Any impairment of goodwill is shared among the owners of the subsidiary in the same proportion in which the profits of the subsidiary are shared.

Consolidation workings:

1. Establish group structure **W1**
2. Process individual company adjustments
- do the double entry on the question paper (as far as possible)
3. Net assets summary **W2**
- one for each subsidiary
- aim is to show the net assets position at two points in time.



	At reporting Date	At Acquisation
Issued capital	x	x
Retained earnings	x	x
per Q	(x)	(x)
Adjustments	_____	_____
	x	x
Fair value		
Difference	x	x
NON-CONTROLLING INTEREST	x	GOODWILL
x% x Net asset at reporting date		
		Cost
CONSOLIDATED RETAINED EARNINGS		Share net asset acquired x
		x% x Net assets at acquisition (x)
		_____
		x
All of Parent	x	_____
per Q	x	
Adjustments	(x)	
Subsidiary share of	x X %	
Post acquisation profit	x	
Goodwill Adjustment	(x)	



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The Conceptual and Regulatory Framework for Financial Reporting

GAAP:

Generally Accepted Accounting Principle is a term set for financial reporting standards and reporting guidelines used to prepare accounts in a country/legislation . Though it is a dynamic concept which changes with time time according to the changing business environment.

Sources of GAAP

Regulatory Framework

The body of rules and regulations from which ever source, which an entity must follow when preparing accounts in particular country for example

Statue
Accounting standards

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Statements issued by professional accountancy bodies which lay down rules on accounting for different issues, for example:

- International financaial reporting standards (IFRSs)
- Financial reporting standards (fRAs)
- Financial Accounting standards (FASs)

Role of statue and standards

Some Countries like UK USA has very legalistic approact to draft financial statements. The legal rules are specific and detailed and and system is more geared to the production of a profit figure for taxation purposes
Some countries adopt an approach by which statue provides framework of regulaition

For example in UK statue : companies act and Framework: Financial reporting framework.

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IFRS VS GAAP

Over a decade countries are adopting IFRSs along with local GAAP . Other countries which don not have their own local GAAP they do relay on IFRSs wholly.

There are advantages and disadvantages for countries adopting IFRSs which are as follows:

Advantages:

- ✓ recognised globally
- ✓ One international model for all
- ✓ Reduced training cost, accountants has to learn one model
- ✓ Improved quality and creadibility provides access to global funds

Disadvantages:

- Cost to convert from local GAAP
- Perception of difficulty
- Reluctance to change
- May be requirement for both statutory and IFRSs

IASB

The international accounting standard board was formed to takeover the work of International accounting standard committee (IASC) in 2001. the IASC was an independent private sector body set up by accountancy body in 1973.
The IASC had complete autonomy in the setting of international accounting standards and in the issue of discussion documents on issue of discussion documents on international accounting issues from 1981.

Objectives:

The IASB Mission statement sets out its objectives to develop in the public interest, a single set of high quality, understandable and enforceable global reporting standards that require high quality, transparent and comparable information in financial statements

- To promote and facilitate adoption of IFRSs through the convergence of national accounting standards and IFRSs
- To promote the use of rigorous application application of those standards.
- To take account of need of range of sizes and types of entities in diverse

Economic settings.

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Standard Setting:

IFRSs are developed through involvement of international due process which includes:

- The business communities
- Stock exchanges
- Regulatory and legal authorities
- Accountants
- Financial analysts
- Regulators
- Legal authorities
- Academics

Due process normally involves the following steps

- Identification and review of associated issues and consideration of the application of the framework to issues.
- Study of national accounting requirements and practice and exchange of views with national setters
- Consultation with the IFRSs advisory council about adding the topic to IASB's agenda.
- Formation of an advisory (working) group to to advise the IASB..
- Publishing a discussion document (exposure draft) for public discussion
- Consideration of all coments received within the comment period
- If considered desirable, holding a public hearing and conducting field tests.
- Approval of a standard by atleast 10 votes of the IASB.

The IASB may develop and publish discussion document, usually called discussion papers for public comment

A discussion paper:

- Sets out the problem, the scope of the project and financial reporting issues
- Discusses research findings and relevant lieterature
- Presents alternative solutions to the issue under consideration and the arguments and implications relative to each.
- Following the receipt and review of comments. The IASB develop and publishes an exposure draft, which is also for public comment.

Exposure Draft:

An exposure draft invites comment on any aspect of specific questions and the proposed IFRS. It sets out the proposed stnadard and transitional provison.

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Voting:

The publication of standard, exposure draft or a final IFRIC interpretation requires approval of 10 members out of IASB 16 members in case of less members nine members approval is required

Comment period:

within the IASB constitution, the comment period is for a reasonable period. This period is for 90 to 120 days, the minimmum period for exposure draft is 60 days.

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International financial reporting framework

IFRSs are major Generally accepted accounting principles. They are widely used and accepted for the preparation of financial statements Across many legislations.

GAAP hierarchy:

- IFRS, including and apendencies that form part of the standard
- Interpretations
- Apendices to an IFRS that do not form part of the standard
- Implentation guidance issued by the IASB.

All stnadards and interpretaions issued under previous constitutions (IASs .SICs) continued to applied unless those are amended or withdrawn.

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General purpose Financial statements

- IFRSs apply to publish financial statements of profit oriented organisagtions
- Organisations may be corporate or organised in other forms such as mutual co operatives or partnerships
- IFRSs apply to all general purpose financial statements
- IFRSs apply to both single entity financial statements ans consolidated financial statements
- Any limitation on the applicability of the IFRS is made clear in the scope section of IFRS.
- Some standards allow choice of accounting such as IAS 16 PPE give choice between cost model and revaluation model

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Adaptation:

IFRSs are used

- As national requirements
- As the basis for national requirements
- As an international benchmark for the countries who are developing their own standards
- By regulatory authorities and companies
- By large multinational companies for the purpose of raising finance on international capital markets.

Ratio Analysis and Interpretation

The objective of financial reporting is to provide information about an entity to external users of its financial statements. The users of financial statements and their information needs are the key issue in financial reporting.

Investors:
- The providers of risk capital and their advisers are concerned with risk inherent in, and return provided by, their investment.
They need information:
- to help them determine whether they should buy, hold or sell;
- that enables them to assess the performance of management.

Employees
- Employees and their representative groups are interested in information about:
- the stability and profitability of their employers;
- which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

Lenders
- Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

Suppliers and Other Creditors

- Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due.
- Trade suppliers are likely to be interested in an entity over a shorter period than lenders unless they are dependent on the continuation of the entity as a major customer.

Customers

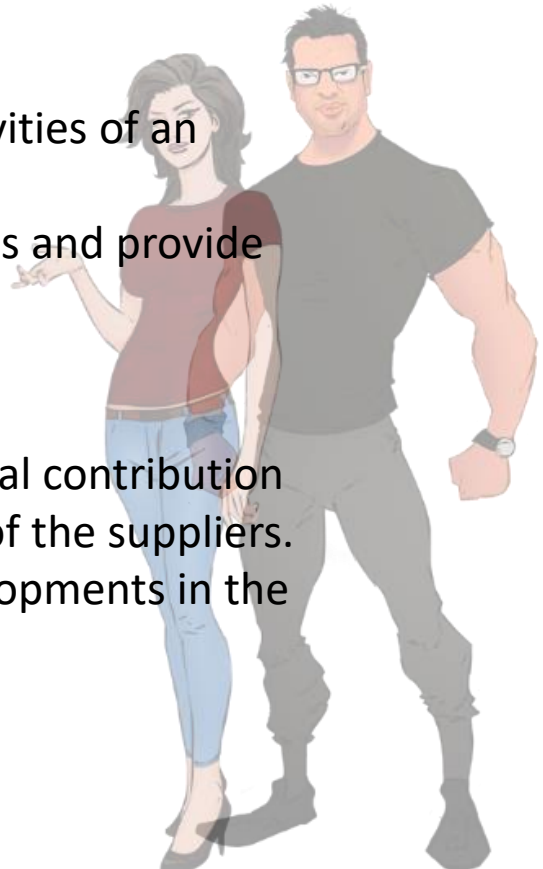
-Customers have an interest in information about the continuation of an entity, especially when they have a longterm involvement with, or are dependent on, the entity.

Governments and Their Agencies

- Governments and their agencies are interested in the allocation of resources and, therefore, the activities of an entity.
- They also require information in order to regulate the activities of entities, determine taxation policies and provide a basis for national income and similar statistics.

Public

- Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of the suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.



Types of Organisation

Commercial

- Commercial organisations (businesses) are generally profitseeking (i.e. they aim to maximise the wealth of their owners/ shareholders).
- Sub-classifications include:

-industrial (e.g. extractive, steel, pharmaceuticals, textiles, clothing, electronics, transport, construction, engineering, service);

- manufacturing (e.g. specific divisions of industrial such as pipes, drugs, fabric, shoes, semiconductors, cars);
- financial, which can also be considered as a service in managing money (e.g. banking, insurance, investment funds); and
- service, where no goods or products are produced (e.g. audit and accountancy, consulting, entertainment, advertising, marketing).
- The primary objectives of businesses are to:

-continue in existence;

- maintain growth (or at least not decline); and
- make a profit.
- Other objectives for commercial organisations may include:

-market standing (e.g. to achieve market share);

- innovation (e.g. to lead new product developments);
- productivity (e.g. optimum allocation of resources);
- managing and sustaining physical and financial resources;
- manager performance and development;
- worker performance and attitude; and
- public responsibility (e.g. waste recycling and local employment).

Not-for-Profit:

- Not-for-profit organisations do not consider profit to be their primary objective. They aim to satisfy particular needs of their members (they do not have shareholders) or of society in general, and usually consider financial objectives as constraints under which they have to operate.
- Examples include:
- government departments, local authorities and agencies (exist to implement policy);
- educational establishments (but note that private education has a profit motive);
- hospitals (note that private hospitals would be classified as profit orientated);
- charities (collect money and effectively distribute according to charity's aims);
- pressure groups which raise money to follow a given agenda (e.g. Greenpeace); and
- clubs and mutual societies that raise money directly from members to be able to provide common services to those members (e.g. golf clubs, tennis clubs, building societies, insurance, trade unions).

Public Sector:

- The public sector is the part of the economy and the services provided which are controlled by governmental organisations. Typical examples include the police, military, fire and ambulance services, public roads, public transport, public utilities (gas, electricity, water, telephone—although in many countries these may have been privatised into commercial organisations with shareholders), primary healthcare, libraries, refuse collection and local authorities.
-Those facilities, businesses and services not controlled by government will be in the private sector.

Non-governmental Organisations (NGOs)

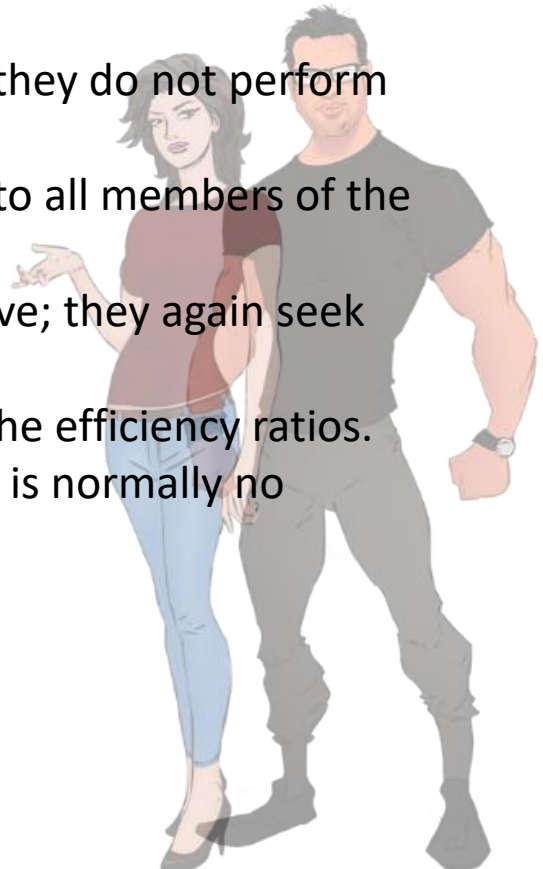
- Originally established by the United Nations in the 1950s, the concept of the NGO spread into general usage during the 1970s. Many diverse types of bodies are now described as NGOs.
- Generally accepted characteristics of an NGO include:
- voluntary formation;
- aim to improve circumstances and prospects of disadvantaged people;
- independence from the direct control of any government;
- not constituted as a political party;
- non-profit-making; and
- not a criminal group (in particular it is non-violent).
- However, some NGOs may be closely identified with a political party; many NGOs generate income from commercial activities (e.g. consultancy contracts or sales of publications); and a small number of NGOs may be associated with politically based protests.

The World Bank classifies NGOs as either operational or advocacy:

- **Operational** NGOs are primarily involved in the design and implementation of development (aid) related projects (both relief-oriented and development-oriented).
- **Advocacy** NGOs defend or promote a specific cause, typically trying to raise awareness, acceptance andknowledge by lobbying, press work and activist events.
- For example, Oxfam, although a charity, is an NGO and establishes NGOs in many countries to enable funds raised to be disbursed to end recipients. Other NGOs may promote acountry's culture and language in other countries or establish health education programmes (e.g. AIDS, birth control).

Aims and Objectives (non-profit organisations)

- Not all organisations are concerned with profitability. Not-forprofit organisations and the public sector are more concerned with providing a service.
- Service users and the general public will want to know how these types of organisations have performed and that they are providing value for money.
- Users are more concerned that the required service is provided as economically, efficiently and effectively as possible. Value for money audits are frequently carried out within public sector organisations to ensure that costs are minimised, outputs are maximised and a level of quality is achieved.
- Management must be seen as the stewards of the organisation's resources and therefore must maintain close control of the resources within their domain.
- The bottom line for many public sector entities, especially local and national governments, is that if they do not perform then they will be voted out by the public to whom they should be providing a service.
- Among their many objectives, national governments seek to provide health, education and policing to all members of the community; they do not seek to make a profit from giving these services.
- Other organisations such as charities and many museums do not have profit as their primary objective; they again seek to provide a service to various groups within the local and international community.
- Most of the non-profitability ratios can be calculated for these specialised organisations, especially the efficiency ratios.
- Management and control of cash is also very important within these types of organisations; as there is normally no profit objective, the management of cash can quite easily be forgotten.



Key Performance Indicators (KPIs)

-The analysis of not-for-profit and public sector organisations should consider indicators other than profit. It should be noted that some of these organisations may actually make a profit, more commonly termed "surplus", as some of their operations will result in profitable transactions.

- KPIs enable users to determine whether the organisation is meeting its aims and objectives.
- KPIs include some of the following:
- For charities—growth in number of donors or a growth in donation per donor;
- For schools—number of pupils attaining at least 3 A grades in their exams;
- For hospitals—the number of patients readmitted after undergoing surgery;
- For golf clubs—the increase in membership; and
-For local councils—number of complaints received from public regarding potholes in roads.

Use of Ratios

- Ratios are of no use in isolation. To be useful, a basis is needed for comparison, for example:
- previous years;
-other companies;
- industry averages; or
- budgeted v actual (for management use).

Influences on Ratios

- The "story" of the performance and position told by a set of financial statements is a function of:
- business factors (including the results of management actions and related party situations)*; and
- accounting policies.

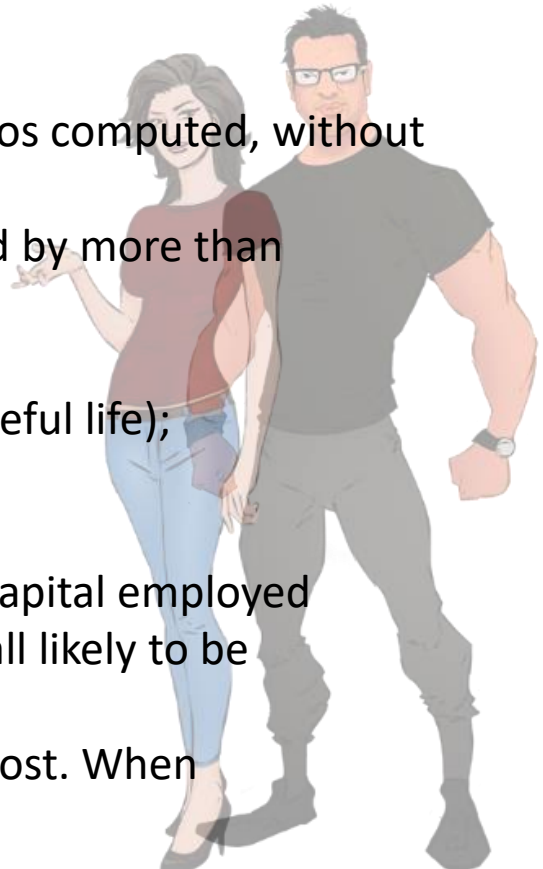
Business Factors

- Type of business (e.g. retailer, manufacturer): This affects the nature of the assets employed and the returns earned; a retailer may have higher asset turnover but lower margins than a manufacturer.
- Quality of management: Better-managed businesses are likely to be more profitable and have better working capital management than businesses in which management is weak.
- State of economy and market conditions: If a market or the economy in general is depressed, this is likely to adversely affect companies and make most or all of their ratios appear worse.
- Management actions: These will be reflected in changes in ratios. For example, price discounting to increase market share is likely to reduce margins but increase asset turnover; withdrawing from unprofitable market sectors is likely to reduce turnover but increase profit margins.
- Changes in the business: If the business diversifies into wholly new areas, this is likely to change the resource structure and thus affect key ratios. A new acquisition near the year end will mean that capital employed will include all the assets acquired but profits generated by the new acquisition will only be included in the statement of profit or loss for a small part of the year, thus tending to depress return on capital employed (ROCE).
- Related party situations: A parent company and its subsidiaries are related parties and transactions between them may not be on non-commercial terms due to the control that is exercised by the parent.
- There is nothing "wrong" with transactions being other than "at arm's length", for example:
- sale of raw materials for a production process or goods for distribution at a transfer price that is not a market price;
- transfer of non-current assets at an undervalue (or overvalue);
- management charges; or
- financial support (e.g. loans) at below-market interest rates (e.g. zero finance cost).

- However, although the effects of these transactions will be eliminated on consolidation in the consolidated financial statements, the single entities' financial statements will be distorted. For example, the profits of one may be boosted and those of another dampened.
- To assess the performance of a single entity though the analysis and interpretation of ratios it is therefore necessary to take account of the existence of related-party relationships and the related transactions.
- Relevant disclosures that should be made in published financial statements include:
- the nature and amounts of transactions;
- any outstanding balances including terms of settlement, security and guarantees; and
- whether any allowance has been made for irrecoverability of outstanding balances and any bad debt expense.

Accounting Policies

- Choice of accounting policies can significantly affect the view presented by the accounts, and the ratios computed, without affecting the business's core ability to generate profits and cash. For example:
- If assets are depreciated for a whole year in the year of acquisition, accounting profit may be reduced by more than the additional income generated if the acquisition is near the end of the accounting period.
- Carrying amounts of non-current assets will be greater:
- if they are depreciated on a reducing balance basis rather than a straight-line basis (over the same useful life);
- the longer the estimated useful life; and
- the higher the estimated residual value (i.e. the depreciable amount will be lower).
- If a business revalues its assets rather than carrying them at historical cost, this will usually increase capital employed and reduce profit before tax (due to higher depreciation). Thus, ROCE, profit margins and gearing are all likely to be lower if a business revalues its assets.
- In times of rising prices, inventory valuation will be higher under FIFO than under weighted average cost. When inventory volumes are increasing, higher profits will be reported under FIFO.



- Where policies have been chosen to reflect the entity in the best possible light, then the entity could be accused of adopting "creative accounting" policies which do not necessarily reflect a fair presentation of the events and transactions which have occurred in the period

Limitations of Ratios

-Ratio analysis is essentially a retrospective examination—not prospective. Ratios use historical data which is unlikely to be predictive as this ignores future actions by management and changes in the business environment. When trying to make forecasts for historical ratios, consideration should be given to the entity's future plans and the impact that these plans will have on the historical data.

-Ratios are based on accounting rather than economic data. Making adjustments to historical costs to reflect current economic values may increase relevance but with a loss of reliability.

-Usefulness is limited by the limitations of financial statements (e.g. "off balance sheet items").

Ratios may be distorted by differences in accounting policies.

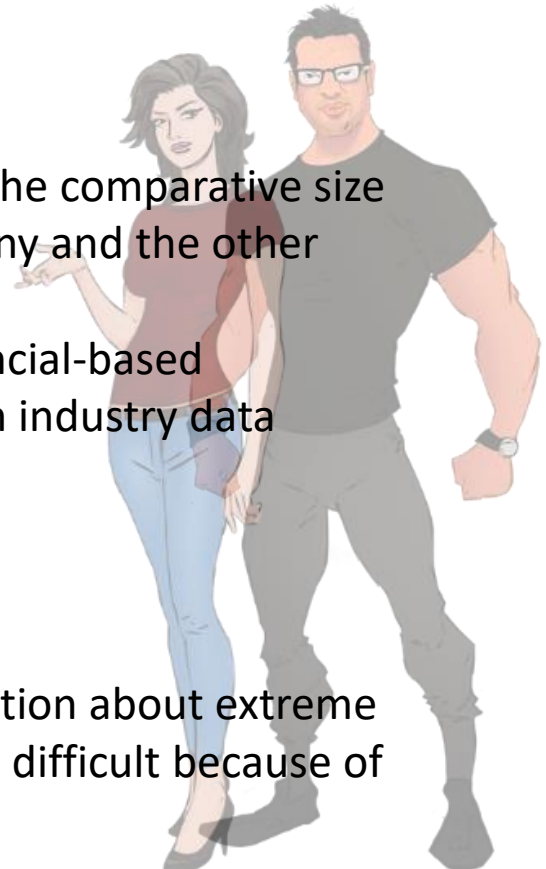
-Comparisons between companies in the same industry sector may not provide reliable information. The comparative size of the companies would need to be considered; also, one company might be a new, expanding company and the other might be an old, stagnating company.

-A wide range of governmental and commercial organisations publish industry statistics including financial-based information. This information may not, however, be reliable. Factors to be considered when using such industry data include whether:

-the information is provided on a voluntary or mandatory basis;

- the collection of the data is sponsored by one specific company;

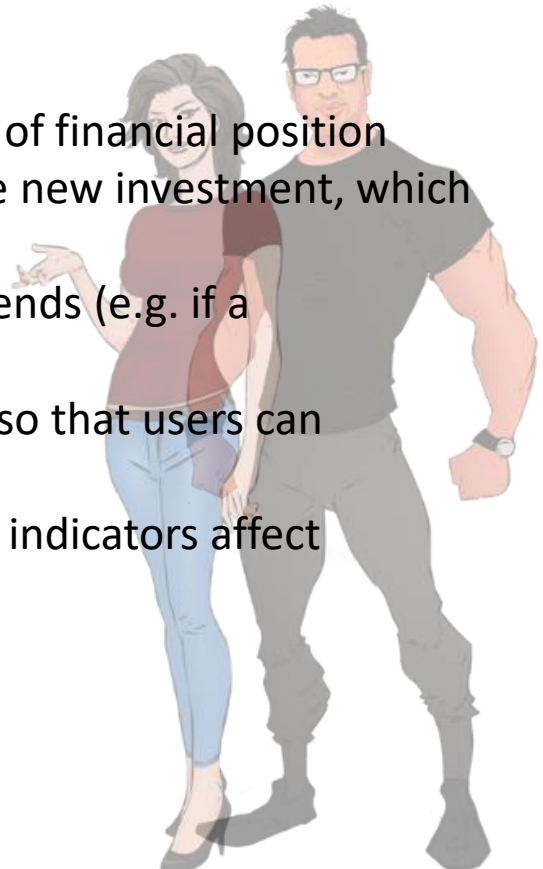
- entities contributing to the statistics have the same year end. Ratios summarise information; information about extreme values and the spread of data is therefore "lost". Comparisons between different types of business are difficult because of representative of how the business operates at other times.



representative of how the business operates at other times. differing resource structures and market characteristics.
-Many ratios use figures from the statement of financial position, these figures represent only one point in time. If an entity has seasonal or cyclical trading cycles then the ratios derived from the statement of financial position may not be

Illustration:
A group has total debt of $100 and equity of $800, giving a gearing ratio of 12.5%. If all of the debt was held by one subsidiary in the group, and that subsidiary had equity of $100, then the gearing ratio for that subsidiary would be 100%. By preparing consolidated financial statements the gearing risk of that subsidiary is hidden in the results of the group as a whole. The same could be said of a loss-making entity within the group; if the group as a whole is profitable then the loss made by an entity of the group may well be hidden from view.

Other Indicators:
- Absolute comparisons can provide information without computing ratios (e.g. comparing statements of financial position between this year and last may show that new shares have been issued to repay borrowings or finance new investment, which may in turn affect gearing and ROCE).
- Background information supplied about the nature of the business may help to explain changes or trends (e.g. if a business has made an acquisition).
- The statement of cash flows provides information as to how a business has generated and used cash so that users can 0btain a fuller picture of liquidity and financial adaptability.
-Not all indicators of performance need to be financial in nature. Many other factors and non-financial indicators affect an assessment of performance. For example:
- employee satisfaction and staff turnover;
- quality or products or services;
- manufacturing capability, productivity and flexibility;
- interaction of the entity within the local community;



- environmental compliance (as many companies now include an environmental report as part of their annual financial statements)

Creative Accounting:

- Over the past 40 years, companies have tried to be creative in the way they account for certain transactions. This has led to abuses of the accounting entries recording these transactions and the financial statements not reflecting the economic reality of the situation. The following are some of the main areas in which management have been creative in their accounting treatment.

Off Balance Sheet Financing:

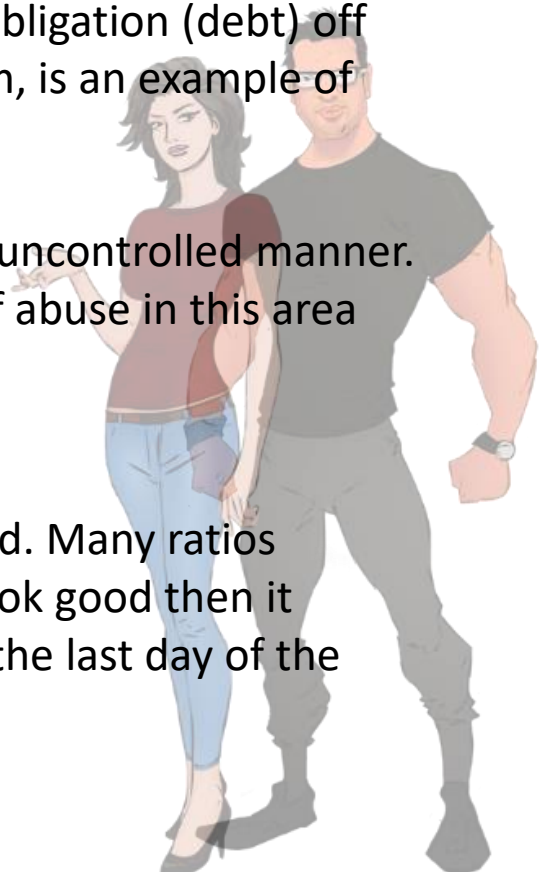
- This is where a company has a present obligation to make a payment but has been able to keep the obligation (debt) off the statement of financial position. A sale and repurchase transaction, if accounted under its legal form, is an example of off balance sheet financing.

Profit Manipulation or Smoothing:

< Management prefer profits to be increasing at a steady rate, not going up and down each year in an uncontrolled manner. Management will change revenue and cost recognition in order to smooth out the profits. Examples of abuse in this area include early recognition of revenue and incorrect recognition of provisions.

Window Dressing:

- This is where the financial statements are made pretty for one moment in time, normally the year end. Many ratios are calculated using figures from the statement of financial position. If these figures can be made to look good then it will improve the related ratios and put the company in a much better light. Settling trade payables on the last day of the year only to reinstate them the next day is an example of such abuse.



Group v. Single Entity:

-When analysing a set of accounts, the analyst needs to consider whether a single entity or a group is being analysed.

- If it is a group the question must be asked, "Has the parent bought or sold a subsidiary during the current period"?
- If so, then it is not possible to simply compare current year with previous year, as the two periods are not the same.
- If a purchase or disposal took place during the year then the analyst will need to strip out the effects of the transaction in order to make meaningful judgement on the performance of the group.
- If a user wishes to analyse a subsidiary within a group then it is no use using the consolidated financial statements, as they may mask the specific performance of a single subsidiary within the group.

Accounting Ratios:

- Accounting ratios help to summarise and present financial information in a more understandable form. They assist in assessing a business's performance by identifying significant relationships between different figures.
- Ratios divide into five main areas:

1. Performance
2. Short-term liquidity
3. Long-term solvency
4. Efficiency
5. Investors' (or stock market) ratios.

Performance/profitability Ratios:

Performance ratios measure the rate of return earned on capital employed, and analyse this into profit margins and use of assets. These ratios are frequently used as the basis for assessing management effectiveness in utilising the resources under their control.

Key Ratios

-Return on (total) capital employed (ROCE):

-

$$\frac{\textbf{Profit before interest and tax}}{\textbf{Share capital + reserves + debt}} \times 100$$

- Measures overall efficiency of company in employing resources available to it.

- Return on shareholders' funds (ROSF): Measures how efficiently a company is employing funds which shareholders have provided.

$$\frac{\textbf{Profit before tax}}{\textbf{Share capital + reserves}}$$

- Measures how efficiently a company is employing funds which shareholders have provided.

When drawing conclusions from ROCE/ROSF consider:
- target return on capital (company or shareholder)
- real interest rates;
- age of plant;
- leased/owned assets;
- revaluation of assets; and
- R&D policy.

Gross profit Margin Percentage:

$$\frac{\textbf{Gross profit}}{\textbf{Sales}} \times 100$$

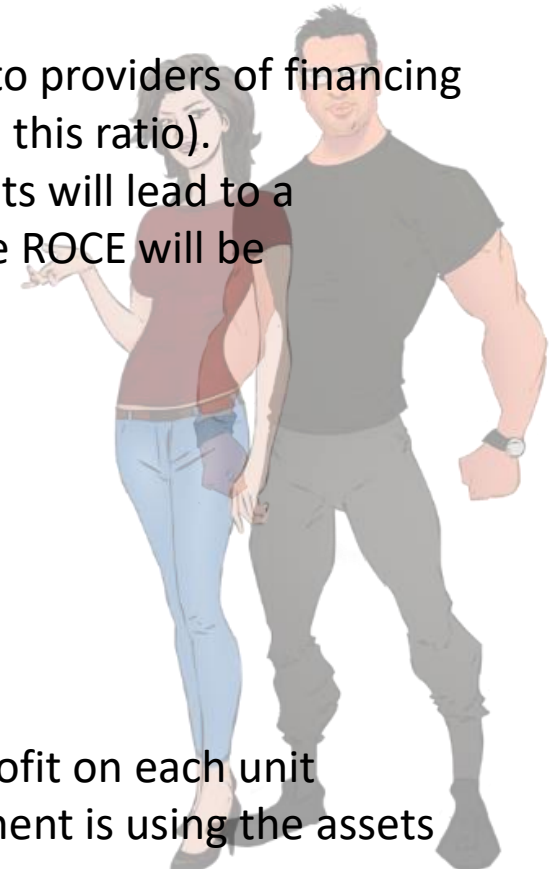
- Measures margin earned by company on sales.

When drawing conclusions from Gross profit margin consider:
- Variations between years may be attributable to:
- change in sales prices;
- change in sales mix;
- change in purchase/production costs; or
- inventory obsolescence.

Profit margin/sales percentage:

$$\frac{\textbf{Profit after tax}}{\textbf{Sales}} \times 100$$

-Profit after tax divided by sales measures the profitability of the organization compare to sales of particular period.
May change because of:
• change in the value of sales—investigate whether it is due to price or to volume changes;
• company relocation to new premises.
Analysis
- ROCE measures return achieved by management from assets which they control, before payments to providers of financing for those assets (i.e. lenders and shareholders. Usually year end capital employed is used to compute this ratio).
- Consideration needs to be given to the age of an entity's assets; old assets with low carrying amounts will lead to a high ROCE, whereas an entity which has just made a major acquisition of new assets will find that the ROCE will be fairly low as the asset will not have reached its optimum performance levels.
- ROCE can be further subdivided into profit margin and asset turnover (use of assets).



$$\textbf{Profit margin} \times \textbf{Asset turnover} = \textbf{ROCE}$$

$$\frac{\textbf{PBIT}}{\textbf{Turnover}} \times \frac{\textbf{Turnover}}{\textbf{Capital Employed}} = \frac{\textbf{PBIT}}{\textbf{Capital employed}}$$

-Profit margin is often seen as a measure of quality of profits. A high profit margin indicates a high profit on each unit sold. Asset turnover is often seen as a quantitative measure, indicating how intensively the management is using the assets

Liquidity:

- Short-term liquidity ratios are used to assess a company's ability to raise cash to meet payments when due. In practice, information contained in the statement of cash flows is often more useful when analysing liquidity.

Key Ratios

Current ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

Usually expressed as :1 ratio

Measures adequacy of current assets to cover current liabilities.

Quick ratio (acid test):

- $$\frac{\text{Current Asset} - \text{Inventory}}{\text{Current Liabilities}}$$

Usually expressed as :1

- Eliminates the slower-moving item, inventory from the calculation, thus measuring real short-term liquidity.

Indicators:

- Low ratio may indicate liquidity problems.
- High ratio may indicate poor use of shareholder/company funds.
- Consider constituent components of ratio inventory obsolescence (in case of current ratio), recoverability of receivables (in case of both ratios).
- Consider manipulation if a company has positive cash balances and a ratio greater than 1:1, payment of payables just prior to the year end will improve the ratio.

Window Dressing:

The illustration below shows how easy it is for an entity to manipulate the ratios simply by writing a cheque to clear some of the payable balance.

Illustration:

Statement of financial position extracts

	$000
Receivables	900
Cash	500
Payables	1,000

Required:

(a) Calculate the quick ratio.

(b) Re-calculate the ratio if $400,000 of cheques are written out of the cash book and posted to suppliers' accounts.

Solution

Solution

(a) Quick ratio:

$$\frac{1{,}400}{1{,}000} = 1.4:1$$

(b) Quick ratio =

$$\frac{1{,}400 - 400}{1{,}000 - 400} = \frac{1000}{600} = 1.7:1$$

Longterm:

Significance:

Gearing ratios examine the financing structure of a business. They indicate to shareholders the degree of risk attached to the company and the sensitivity of profits and dividends to changes in profitability and activity level.

Key Ratios

- Gearing ratio:

$$\frac{\textbf{Fixed return capital, preference shares, debentures, loan stock}}{\textbf{Equity capital and reserves}}$$

OR

$$\frac{\textbf{Debt}}{\textbf{Debt + Equity}}$$

-Measures relationship between company's borrowings and its share capital and reserves.
 A company is highly geared if it has a substantial proportion of its capital in the form of preference shares, debentures or loan stock.

-Interest on fixed return capital (and possibly dividends on preference shares) generally has to be paid irrespective of whether profits are earned—this may cause a liquidity crisis if a company is unable to meet its fixed return capital obligations. High gearing, therefore, should be accompanied by stable profits.
- Asset backing—generally loan capital is secured on assets—these should be suitable for the purpose (not fast depreciating or subject to rapid changes in demand and price).

Interest Cover:

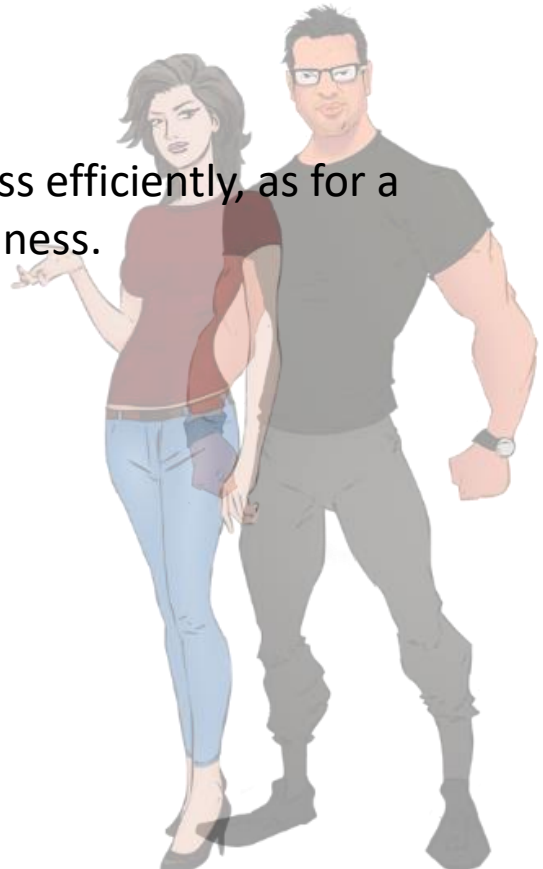
$$\frac{\textbf{Profit before Interest}}{\textbf{Interest}}$$

When drawing conclusions from gearing ratios consider:
- assets in the statement of financial position at historical cost or revalued amount—revaluation of non-current assets increases shareholders' funds and thus decreases gearing;
- use of "off balance sheet finance" to reduce gearing.

Interest cover indicates the ability of a company to pay interest out of profits generated. Interest cover of less than two is usually considered unsatisfactory. This indicates that the company may have difficulty financing its debts if its profits fall and also indicates to shareholders that their dividends are at risk as interest must be paid first, even if profits fall.

Efficiency:

Working capital ratios are an important indicator of management's effectiveness in running the business efficiently, as for a given level of activity it is most profitable to minimise the level of working capital employed in the business.



$$\frac{\textbf{inventory}}{\textbf{Cost of sales}} \times 365$$

(= number of days it takes to turn inventory over once so the lower the better)
-Ideally consider the components of inventory:
- raw material to volume of purchases;
- WIP to cost of production; and
- finished goods to cost of sales.

When dealing inventory turnover days take following into consideration:

- High inventory turnover rate—may be efficient but risk of stock outs increased.
- Low inventory turnover rate—inefficient use of resources and potential obsolescence problems.
- Accurate reflection?
-Does position represent real inventory turnover rate for the year or does year-end inventory holding distort the true picture?

Receivable days:

$$\frac{\textbf{trade receivables}}{\textbf{Credit sales}} \times 365$$

- Measures period of credit taken by company's customers.
- Ideal approximately 30–40 days, depending on the industry.

• A change in the ratio may indicate:
– bad debt/collection problems;
– a change in the customer base (big new receivable—slow payer); or
– a change in settlement terms.
• Accurate reflection?
– Does year-end receivables give a reasonable indication of the receivable profile for the year as a whole?

Payable days:

$$\frac{\textbf{trade payables}}{\textbf{Credit purchases}} \times 365$$

- Measures number of days' credit taken by company from suppliers.
- Should be broadly consistent with receivable days.

• A change in the ratio may indicate:
– liquidity problems with the company if the figure is high;
– potential appointment of receiver by aggrieved suppliers.
• Accurate reflection?
– Do year-end payables give a reasonable indication of payable profile for the year as a whole?

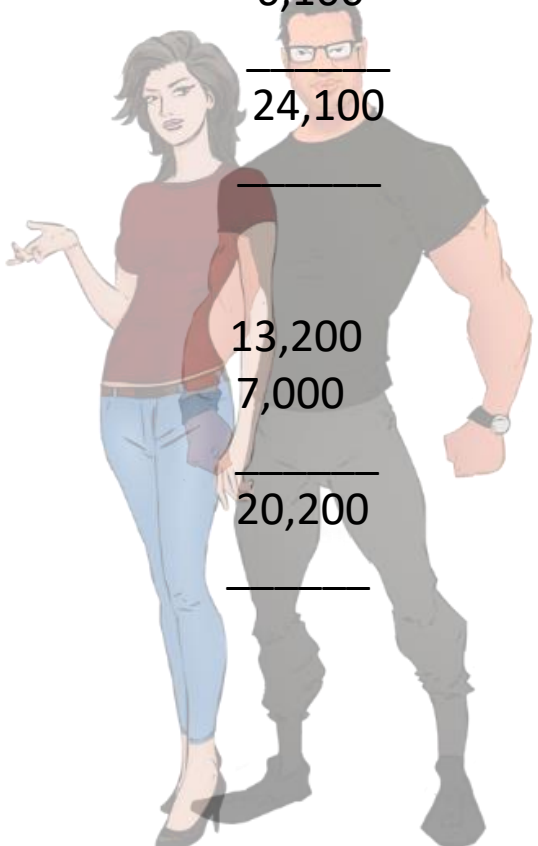
Asfandyar has produced the following financial statements:

Statement of profit or loss for the year ended 30 June

	2015	*2014*
	$000	**$000**
Revenue	28,000	25,000
Cost of sales	(15,700)	(18,300)
Gross profit	12,300	6,700
Distribution costs	(3,100)	(2,200)
Administrative expenses	(3,100)	(2,000)
Profit before tax	6,100	2,500
Income tax expense	(1,000)	(500)
Profit after tax	5,100	2,000

Statement of financial position at 30 June

	2015		*2014*	
	$000	**$000**	**$000**	**$000**
Non-current assets		23,000		18,000
Current assets				
Inventory	4,800		2,300	
Trade receivables	3,200		2,500	
Bank and cash	–		1,300	
		8,000		6,100
Total assets		31,000		24,100
Equity and liabilities				
Capital and reserves				
Ordinary share, $1 each.		14,200		13,200
Retained earnings		12,100		7,000
		26,300		20,200
Current liabilities				
Trade payables	3,600		3,900	
Short-term borrowings	1,100		–	



	2015		2014	
	$000	$000	$000	$000
	4,700		3,900	
Total equity and liabilities		31,000		24,100

Required:
(a) State and calculate THREE profitability and THREE liquidity/efficiency ratios for EACH of the two years.
(b) Using the information provided by the ratios calculated in (a) comment on the financial performance of Virgil.

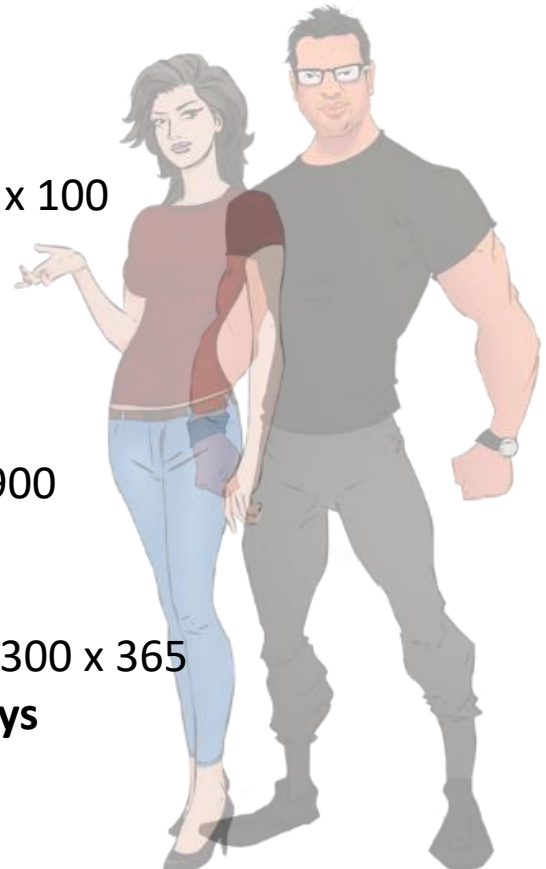
Solution:

(a) Profitability ratios

(1)	*2015*	*2014*
Gross profit %:		
Gross profit/revenue × 100	12,300 /28,000 × 100	6700/25000 X 100
	= 43.9%	**= 26.8%**
(2)		
Net profit %:		
PBIT/revenue × 100	6100/28000 x 100	2500/25000 x 100
	= 21.8%	**= 10%**
(3)		
ROCE:		
PBIT/Capital employed × 100	6100/26300 x 100	2500/20200 x 100
	= 23.2%	**= 12.4%**

Liquidity/efficiency ratios

(1)		
Current ratio:		
Current assets / Current liabilities	8,000/4,700	6,100/3,900
	= 1.7:1	**= 1.6:1**
(2)		
Inventory turnover (days):	4800/15700 x 365	2300/18300 x 365
Inventory/cost of sales × 365	**= 112 days**	**= 46 days**



	2015	2014
(3)		
Average collection period:		
Trade receivables/sales × 365	3200/28000 x 365	2500/25000 x 365
	= 42days	= 37 days

(b) Comment on financial performance

• The major trend revealed by the ratios is the significant increase in profitability over the two years (as demonstrated by each of the profit ratios).

• Revenue has increased, maybe in terms of volume and selling price, and the cost of sales has reduced. The reduction in costs may well be due to a reduction in the quality of the goods purchased. Care must be taken that the quality of goods is not reduced, otherwise customers will go elsewhere for the product in the future.

• Regarding liquidity, the position has worsened slightly over the period. The current ratio has increased. This could signal potential future cash flow problems. Virgil has taken on new short-term borrowings during the last 12 months.

• The efficiency ratios have tended to deteriorate. Inventory is taking more than twice as long to be turned over. However, this could be an indication that a wider range of goods is held. This could explain the increase in sales. The increase in the average amount of credit given to customers also may have encouraged sales.

Investors Ratio:
Significance
-Investors' ratios help to establish characteristics of ordinary shares in different companies. For example:
- Earnings per share (EPS) are important to those investors looking for capital growth.
- Dividend yield, dividend cover and dividends per share are important to those investors seeking income.

- Dividend yield:

$$\frac{\text{Dividend per share}}{\text{Current market price per share}}$$

- Dividend cover:

$$\frac{\text{EPS}}{\text{Dividend per share}}$$

- Price/earnings (PE) ratio:

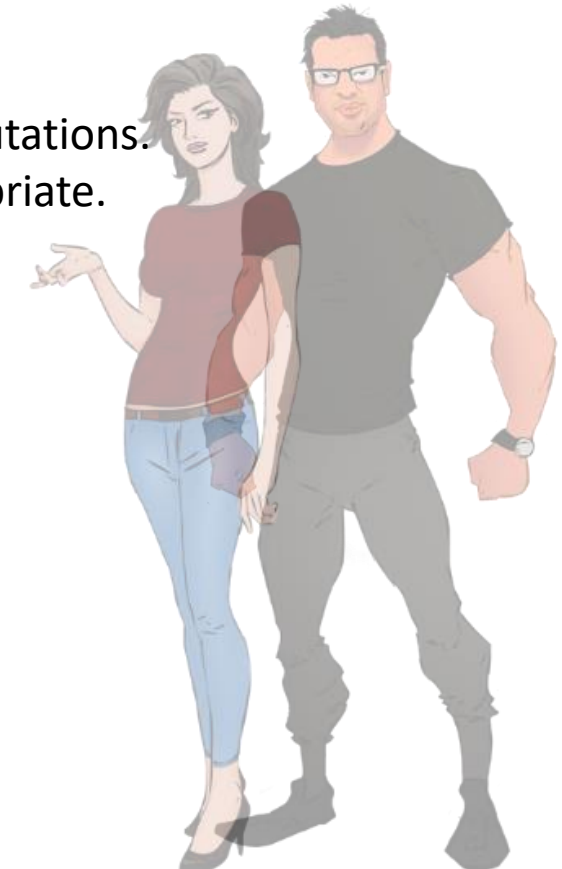
$$\frac{\text{Current market price per share}}{\text{EPS}}$$

Exam Technique:

- If asked to interpret accounts:
- make comments pertinent to the users of accounts;

therefore we need to identify audience from requirement;

- only compute ratios if you can make use of them (and always define ratios calculated), make comparisons and suggest reasons;
- also compare absolute numbers in the accounts to identify differences (e.g. changes year on year);
- look for the influence of business factors and accounting policies;
- be able to link different pieces of information and see what they point towards;
- indicate the need for further information if necessary; and
- be aware of the limitations of ratios.
- Most marks in the exam are likely to be for specific, relevant comments rather than solely for computations.
- If asked to write a report, put a table of ratios in an appendix and refer to them in the text as appropriate.

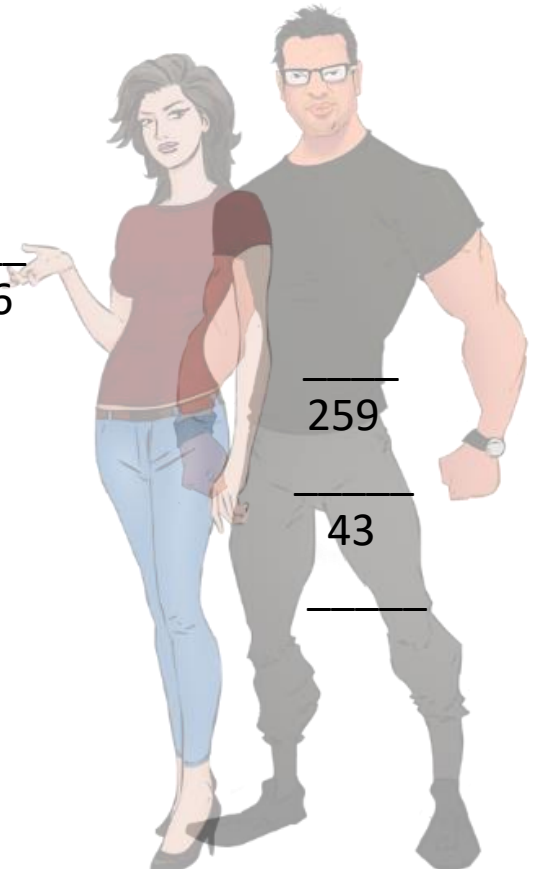


Example:

The management of Tutii is negotiating an overdraft facility to provide working capital for business expansion. The bank manager has been provided with the following extracts from the financial statements for the last three years:

Statement of financial position at 31 December

	2014		*2015*	
	$000	**$000**	**$000**	**$000**
Tangible non-current assets		163		153
Current assets				
Inventory	40		52	
Receivables	45		52	
Bank	15		2	
	100		106	
Total assets		263		259
Current liabilities (including tax)		45		43



Profit or loss

	2013	*2014*	*2015*
	$000	**$000**	**$000**
Revenue	360	375	390
Purchases	230	250	280
Profit before tax	32	46	14

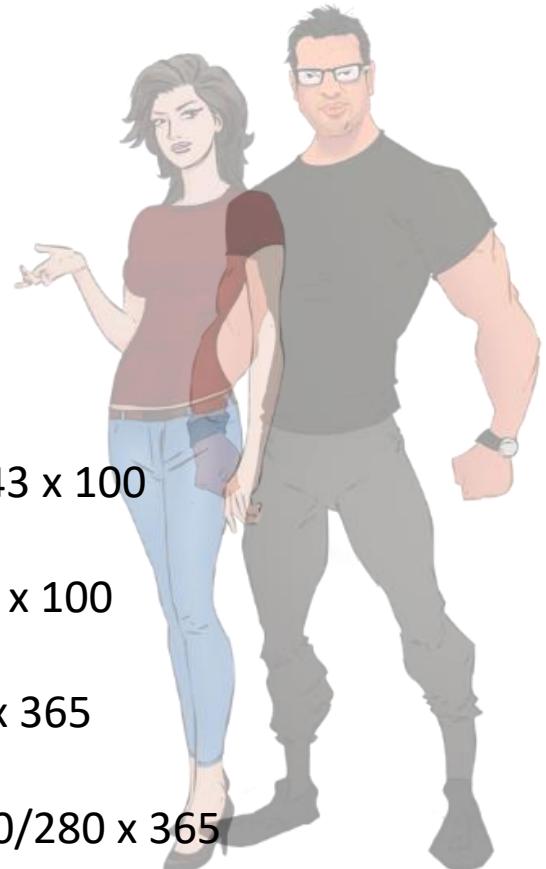
The following information is also available:

(1) All sales and purchases are made on credit terms.

(2) The company commenced trading on 1 January 2014 with capital of 100,000 $1 ordinary shares issued at a premium of 60 cents each.

(3) Income tax amounted to $5,000 in 2015 and $6,000 in 2016. There was no income tax charge for 2014.

(4) Dividends paid amounted to 5 cents per share in 2014, and 10 cents per share in each of 2015 and 2016.



	2014	**2015**
(i) ROCE:		
Profit before tax/ Capital employed × 100	46/263-45 x 100	14/259-43 x 100
(ii) Net profit Margin:		
Profit before tax/ sales x 100	46/375 x 100	14/390 x 100
(iii) Receivable days:		
Receivables/credit sales x 365	45/375 x 365	52/390 x 365
(**iv) Payment period:**		
Payables/Cr. Purchases x 365	45-5-10/250 x 365	43-6-10/280 x 365

Required:
Analyse the information given and discuss how the information might affect the negotiations for the overdraft.

Solution:

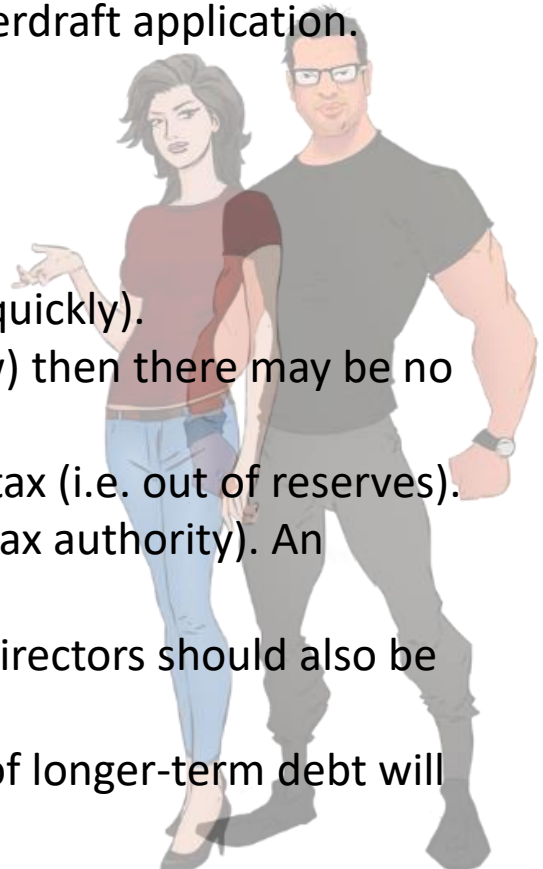
Analysis and Interpretation

Profitability

• ROCE and net profit percentage both fell significantly in 2016.
• The bank manager will want to know the reasons for the fall in profitability when considering the overdraft application.
• 2017 could result in a loss if resources cannot be used more efficiently.

Working capital management

• The customers' collection period has lengthened and the suppliers‘ payment period has shortened.
• Credit control appears to have weakened as customers are being allowed more time to settle their accounts in each successive year (yet suppliers are being paid more quickly).
• This increases the need for working capital. If Titus could reverse these trends (i.e. improve cash flow) then there may be no immediate overdraft requirement.
• The bank manager may be concerned that the company has paid a dividend in excess of profit after tax (i.e. out of reserves).
• At 31 December 2016, Titus has only $2,000 in the bank and owes $43,000 (including $6,000 to the tax authority). An overdraft facility will enable equity shareholders to be paid a return–this will not expand the business.
• An overdraft providing working capital alone is unlikely to meet the directors' expansion plans. The directors should also be negotiating for medium-/long-term finance.
• As the company has no long-term debt, it is an option for the company to explore. The finance cost of longer-term debt will generally be cheaper than short-term overdrafts.



This Finance Reporting book was written by Zeeshan Hasan the founder and trainer at Accountansea.com
Zeeshan Hasan has more then 7 years of teaching experience, Along with it he Possess a working experience in Big Four Accounting Firm as well as in Well known organizations.

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