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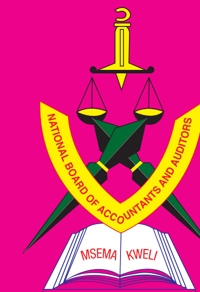
C1 CORPORATE REPORTING

CORPORATE REPORTING

STUDY TEXT

C1

Final Level



THE NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS TANZANIA (NBAA)

C1

CORPORATE REPORTING

STUDY TEXT

NBAA

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FOREWORD

The National Board of Accountants and Auditors in Tanzania is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 as amended by Act No 2 of 1995. The Board has been charged among other things, the responsibility to promote, develop and regulate the accounting profession in the country.

In fulfilling its role, NBAA has revised its national accountancy examination scheme and syllabi for students aspiring to sit for Accounting Technician and Professional Examinations. For effective implementation of these syllabi and improve examination results, the Board has prepared study materials for all subjects to assist both examination candidates and trainers in the course of learning and teaching respectively.

The study guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The study guides cover the wide range of the topics in the syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a leaner to pass the examinations.

These study guides for each subject from ATEC I to final Professional Level will ensure that learners understand all important concepts, know all the workload involved and provide practice they need to do before examinations. The guides have right amount of information with plain language -easy-to-understand, plenty of practice exercises and sample examination questions which are set in a competence based approach.

Competency based study guides have been developed aiming at developing a competent workforce. The guides emphasize on what the individual can do in a workplace after completing a period of training. The training programme therefore is directly related to the expectations of the employer.

These study guides which have been developed under competence based approach are characterized by the following features:-

1. Focus on outcome – The outcomes shown in every topic are relevant to employment industry

2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge to the tasks to be performed at a workplace. This is different from traditional training where the concern has been expressed that theoretical or book knowledge is often emphasized at the expense of the ability to perform the job.

3. Assessments as judgments of competence – The assessment will take into consideration the knowledge, skills and attitudes acquired and the actual performance of the competency.

Study guides are also useful to trainers specifically those who are teaching in the review classes preparing leaners to sit for the professional examinations. They will make use of these study guides together with their additional learning materials from other sources in ensuring that the learners are getting sufficient knowledge and skills not only to enable them pass examinations but make them competent enough to perform effectively in their respectively workplace.

NBAA believes that these standard study guides are about assisting candidates to acquire skills and knowledge so they are able to perform a task to a specified standards. The outcomes to be achieved are clearly stated so that learners know exactly what they have to be able to do, and on the other hand trainers know what training is to be provided and organizations as well know the skills level acquired by their expected accountants.

The unique approach used in the development of these study guides will inspire the learners especially Board's examination candidates to acquire the knowledge and skills they need in their respective examinations and become competent professional accountants in the labor market thereafter.

Pius A. Maneno
Executive Director

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Total Page Count: **408**

Features of the book

‘The book covers the entire syllabus split into various chapters (referred to as Study Guides in the book). Each chapter discusses the various Learning Outcomes as mentioned in the syllabus.

Contents of each Study Guide

‘Get Through Intro’: explains **why** the particular Study Guide is important through real life examples.

‘Learning Outcomes’: on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

‘Definition’: explains the meaning of important terminologies discussed in the learning Outcome.

‘Example’: makes easy complex concepts.

‘Tip’: helps to understand how to deal with complicated portions.

‘Important’: highlights important concepts, formats, Acts, sections, standards, etc.

‘Summary’: highlights the key points of the Learning Outcomes.

‘Diagram’: facilitates memory retention.

‘Test yourself’: contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

Self-Examination Questions’: contains exam standard questions relating to the learning outcomes given at the end of each Study Guide.

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination.

The examination will consist of two sections.

Section A	One compulsory question on consolidated financial statements	40 marks
Section B	Three questions out of Five	60 marks

SECTION A

PROFESSIONAL ETHICS AND DUTIES OF AN ACCOUNTANT

A1

STUDY GUIDE A1: PROFESSIONAL ETHICS AND DUTIES OF AN ACCOUNTANT

Get Through Intro

For making economic decisions regarding putting one's money into some form of investment or lending, people need information. Some people have financial knowledge but may not have the authority to call for and verify information. Others may not have the requisite expert knowledge. Both of them may like to invest their surplus funds.

These people have to rely on the financial statements prepared by entities. They need a person who has all the expertise and access to all the information, and who verifies it and gives a trustworthy opinion as to whether the representations in the financial statements are true and fair.

People put their hard-earned money into the businesses, believing in the financial statements prepared and / or audited by professional accountants. If the statements turn out to be untrue and unfair, the financial health of the concerned business may not be good enough to survive in the market place. Consequently, the money invested may be lost. This is what happened in cases like Enron and WorldCom.

Accounting is one of the noble professions which the society holds in high esteem. The professional accountants have to maintain the nobility of the profession if they want this faith to be maintained. For this, they have to comply with ethical requirements. As an aspiring professional, you need to understand and remember these requirements all the time.

Learning Outcomes

a) Identify and evaluate the ethical and professional considerations when undertaking work, giving advice on financial accounting and reporting (including common dilemmas that may be faced based on the type of business) and reporting scenarios.
b) Discuss the creative accounting, its objectives, ethical implications and the extent to which this can be practised in line with IFRSs.
c) Design alternative reporting when departure from international standard is inevitable and communicate the departure in the notes.

1. Identify and evaluate the ethical and professional considerations when undertaking work, giving advice on financial accounting and reporting (including common dilemmas that may be faced based on the type of business) and reporting scenarios.
[Learning Outcome a]

Most of the professional and ethical issues faced by accountants are covered in detail in Paper B3 and C2, which may be referred to. In this Learning Outcome, we will discuss these briefly.

1.1 Purpose of financial statements

The objective of general purpose financial statements is to provide information to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. The information contained in the statements is used by the users in making economic decisions such as buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

In order that the financial statements meet their objective of being useful for making economic decisions, they have to be transparent, comparable and of high quality. The professional accountants have to take due care while preparing or auditing the financial statements so as to ensure that the statements contain the required qualities. This is where the ethical and professional considerations come into picture.

1.2 Ethical and professional considerations

International Ethics Standards Board for Accountants (IESBA) has issued a Code of Ethics for Professional Accountants which lists the following Fundamental Principles in paragraph 100.5

A professional accountant shall comply with the following fundamental principles:

1. **Integrity**: to be straightforward and honest in all professional and business relationships.

2. **Objectivity:** to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

3. **Professional competence and due care:** to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

4. **Confidentiality:** to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authorisation.

5. **Authority:** unless there is a legal or professional right or duty to disclose, a professional accountant should not use the information for the personal advantage or share such information with third parties.

6. **Professional behaviour:** to comply with relevant laws and regulations and avoid any action that discredits the profession.

1.3 Common dilemma

The word dilemma indicates being in a tight spot, or being at crossroads where one has to decide which road to take. Certain situations may pose potential threats to the compliance with fundamental principles where the accountant has to decide upon a course of action.

Case Study

The case concerns Queens Moat House Hotels Plc. (QMH) a company that was listed on the London Stock Exchange. QMH grew over twenty years from being a small owner managed group with a few hotels into a major listed group with nearly 200 hotels around the world. At its peak QMH had a market capitalisation of nearly £1 billion.

Over those twenty years QMH was portrayed as a successful, profitable and well-managed group. That image allowed the group to raise significant share and loan capital to fund its expansion.

In reality QMH reported substantially rising profits year after year only through unacceptable accounting practices that began as creative accounting and aggressive earnings management but ended up as fraudulent misrepresentation of the results and position. Had it not been for the misstatement the group would not have expanded and neither QMH nor their executive board would have survived as long as they did.

QMH collapsed in 1993 when it shares were suspended and its accounts payables refused to provide essential finance. The stock market had expected a profit for 1992 of £85 million, eventually following a DTI investigation and adjustments the result was a loss of £101 million along with exceptional charges of £939 million!

The group had been run by John Bairstow a forceful personality who was both dominant and highly persuasive but with a cavalier attitude. Bairstow instilled QMH with his culture of ‘let the manager manage’ whereby **he needed a minimal head office and only limited central accounting** thus reducing his overheads and in his view creating local focus. In reality the approach was questionable since many economies of scale were missed.

Bairstow did not seem to believe that accounting standards applied to him and recruited two newly qualified accountants with high rewards to compile his financial statements and management accounts. In effect he ‘bought’ the loyalty of Martin Marcus and David Hersey who both became board members and with Bairstow perpetrated the fraud that covered up the real position of QMH and in effect defrauded many others.

Bairstow also ‘bought’ his auditors Bird Luckin a small firm who rarely questioned any matters and did not qualify their opinion in the face of accounting manipulation on a grand scale. The audit partner even attended board meetings and like the hapless non-executive directors saw only incomplete monthly management reports all supporting the ‘story of success’.

Ultimately the audit partner retired and took up a position as non-executive director leaving the new audit partner effectively emasculated and lacking in independence. Bird Luckin were incompetent in their work and influenced by the scale of their fees and the pressure of their position.

The collapse of QMH drew criticism from almost all quarters since it showed how poor internal and external corporate governance had allowed Bairstow to apply a poorly thought through business model with high risks for stakeholders and ultimately involving fraud resulting in losses for investors, accounts payables, employees and the public.

The above case study shows how two accountants who were highly rewarded, in effect sold their objectivity in order to support accounting manipulations that resulted in fraud and disguised the reality of how the company grew and how ultimately it became insolvent. The two accountants effectively did what their chief executive wanted.

The accountants faced the ethical dilemma of whether to act in accordance with ‘Bairstow’s instructions’ or lose their job. Had the accountants acted ethically, the situation might have been different.

An accountant needs to:

1. Identify threats to compliance with the fundamental principles;
2. Evaluate the significance of the threats identified; and
3. Apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.

Example

In situations where the fees received from a particular client form a significant portion of the firm's income, the dependence on that client and concern about losing the client creates a self-interest or intimidation threat.

The firm can implement the following safeguards to ensure that there is no threat to the auditor's independence:

a) Increase the number of its clients
b) Get another accountant, not connected with the firm, to carry out a second review
c) Consult a third party, such as a professional regulatory body or a professional accountant, on key audit judgments

If the firm is not able to ensure the above safeguards, the firm should refuse the audit assignment.

---

2. Discuss the creative accounting, its objectives, ethical implications and the extent to which this can be practised in line with IFRSs.

[Learning Outcome b]

Usually after the transactions or events take place, the accountants record them by applying the guidance given in the relevant accounting standards. Accounting is expected to just reflect the facts or substance of the transactions.

2.1 Creative accounting

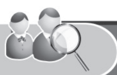
Creative accounting involves presenting income, expense, assets, or liabilities with the intent to influence readers towards the interpretations desired by the authors. It becomes a financial number game and is a systematic misrepresentation of net income or net assets. This is achieved through the aggressive choice and application of accounting principles, fraudulent financial reporting, earnings management or income smoothing.

The facts may be twisted or the freedom given in accounting standards may be misused. Ultimately, the financial statements do not reflect a true and fair view, but a view that the author desires. This involves 'Creativity' on the part of the accountant and hence is called 'creative accounting'.

Instances of creative accounting practices

1. Revenue in a wrong period or a fictitious revenue

Sometimes, revenue is recognised in a period earlier or later than that called for by GAAP. This would be either premature or delayed revenue recognition. At other times, non-existent or fictitious revenue is recognised.



Example

Vednor Soft Inc's accounting policy was to recognise revenue from sales when the risks and rewards associated with the ownership are transferred, which happens when products are shipped to the customers. A large lot of products worth Tshs10 million was shipped soon after the end of its financial year 20X3. The company recognized revenue on this lot during the financial year in 20X3. This is premature revenue recognition, perhaps done to boost up revenue and profit.

Similarly, certain products of Vednor Soft Inc., worth Tshs.2 million were shipped during financial year 20X3. The company had no reasonable expectation that the customer would accept and pay for the products shipped. The company recognized revenue on these products during the financial year 20X3. Furthermore, at the time of shipment, sufficient provision for returns had not been recorded as per the requirements of IFRS15. These shipments were later returned to the company and recorded as sales returns. This is fictitious revenue recognition.

---

2. Expense in a wrong period or fictitious expense

Just as income, expenses also may be recorded too early or too late or fictitiously. If an entity wants to show higher costs and lower profits in the current financial year, it may create higher expense provisions or recognise them earlier than are warranted by the facts.

3. Aggressive Capitalisation and Amortisation Policies

The application of rules regarding capitalisation of expenses is usually straightforward. They involve identification of costs in buying the asset and installing it at a place and in a condition ready for use. However, in some cases, management judgement is required, which may be used in such a manner as to tilt the result in favour of the desired financial presentation. When expenses are capitalised today and amortised in future, current year's costs are reduced and those of future years are increased.

Example

Smithprime Co. constructs a factory and erects machinery in it. While capitalising the preoperative expenses as cost of the assets, it includes certain administration and other general overhead costs under the garb of costs of site preparation and installation and assembly costs. According to IAS 16, Property, Plant and Equipment, the former are not allowed to be capitalised while the latter are.

Similarly, capital expenditure may be presented as revenue expenditure if a company wants to reduce reported profit.

4. Assets and liabilities manipulation

Certain current assets such as inventories, receivables and some investments need a regular review of the realisable value. If the expected net realisable values are less than the carrying values, then one has to actually write off/ write down the assets or create a provision for write down of inventories / investments or create an allowance for doubtful debts.

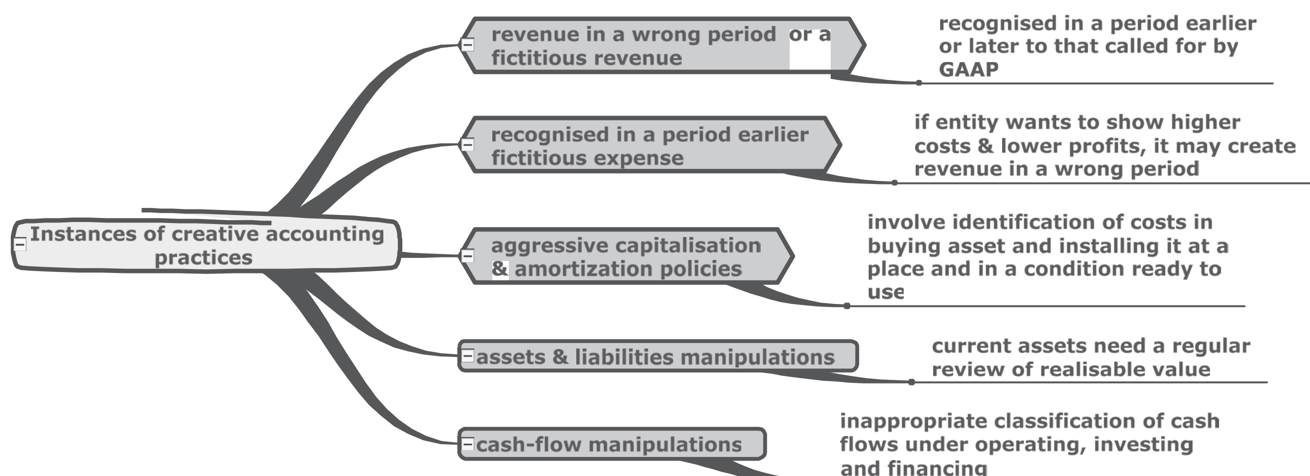
Similarly, financial statements usually include certain provisions such as accrued expenses or environmental costs. There may be deliberate attempts to underestimate or over-estimate these costs and provisions.

5. Cash-flow manipulation

Statement of cash flow divides the cash flows into operating activities, investing activities, and financing activities. Users can assess the level and sustainability of cash flows from this statement.

Consistent cash flows from operating activity indicate sustainability of cash flows. Companies may be tempted to show higher operating cash flows so as to present a rosy picture of sustainable cash flows. This could be done by classifying operating cash outflow as an investing or financing item or by presenting investing or financing cash inflow as an operating item.

SUMMARY



2.2 Objectives of creative accounting

1. To maximize benefits from profit based bonus plans

Many companies offer bonus plans to its executives based on profits earned. In some cases the bonus may be a straight percentage of profits. In other cases, the executives could be eligible for bonus only after the amount of profits crosses a certain limit. In all such cases, those executives may be tempted to use creative accounting so as to increase the reported profits.

2. To obtain desired effects on share price

(a) Higher value of stock options

First the income is exaggerated so as to result in higher stock prices. Then the options are exercised, which results in the purchase of shares at predetermined concessional prices. Thereafter, the stock is sold at increased market prices, thus gaining an inflated profit.

(b) Higher market valuation of the company

When stock prices go up, the market capitalisation of the company goes up. This in itself is seen as a sign of success of the management team, improving the image of the company and management. Similarly, higher value may help the company in negotiating mergers and acquisitions at favourable terms.

(c) Lower cost of equity capital

When the market capitalisation of the company goes up, its cost of equity capital comes down. Cost of equity capital is the rate of return required by the equity investors through dividends. Since the investors are getting good capital appreciation, they may not expect high dividends.

(d) Lower share-price volatility

Manipulating the period to period income in such a manner as to show consistent earning power helps the company in controlling share price volatility.

3. To obtain better borrowing terms:

Higher earnings result in higher equity, higher assets and lower liabilities. This leads to better borrowing terms. These benefits accrue through the following factors:

a) Improved financial ratios
b) Improved credit quality
c) Higher debt rating
d) Lower borrowing costs
e) Less stringent financial covenants.

Covenants are of two types:

(i) Positive covenants require the borrower to maintain certain financial ratios .e.g. maintaining certain ratios as current ratio or debt –equity ratio within certain limit
(ii) Negative covenants prevent certain actions by borrowers, such as additional borrowings from other sources

With better financials, these covenants are expected to be less stringent.

4. To avoid higher taxes

Taxes such as income tax are based on reported income. Some entities may try to reduce reported income so as to reduce income tax.

5. To reduce chances of regulatory interventions

If the entities earn supernormal profits, it may prompt the regulators to raise taxes on such “super profits “or “windfall profits”. They may resort to creative accounting such as postponing revenue recognition or preponing expense recognition so as to avoid showing super profits.

2.3 Extent to which creative accounting can be practised in line with IFRSs

1. Compliance with IFRSs is expected to lead to true and fair view

The main objective of the IASB is to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based on clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors and other participants in the various capital markets of the world and other users of financial information to make economic decisions: **Para 6(a) of the Preface to International Financial Reporting Standards**

Generally, application of IFRSs is expected to lead to a true and fair view. While determining the accounting treatment and presentation in the financial statements, IFRSs lay emphasis on the substance rather than form of the transaction. Therefore, it is expected that when one follows IFRSs in its true spirit, the scope for creative accounting is greatly reduced.

2. However, there are some ways in which one may try and employ creative accounting to a limited extent in spite of application of IFRSs. Here are few examples:

(a) Flexibility in financial reporting

The IASB intends not to permit choices in accounting treatment. Also, the IASB has reconsidered, and will continue to reconsider, those transactions and events for which IFRSs permit a choice of accounting treatment, with the objective of reducing the number of those choices. - **Para 12, Preface**

However, in real life situations the transactions and circumstances are not identical. This provides much room for judgment in certain areas. Due to the choice and application of accounting policies, the results and financial position in similar circumstances may differ from company to company.

Example

IAS 16 allows the use of the cost model or revaluation model for its property, plant and equipment. Two similar companies having identical assets under this head may present different values of property, plant and equipment. In the days of rising prices, the company wanting to show higher net worth in the statement of financial position may select the revaluation model while another company may not.

(b) Estimates

In addition to the effect of transactions with specific amounts, the financial statements contain estimates to a significant extent. Estimates are used, for example, in allowance for doubtful debts; write down of inventory, determining useful lives of assets and impairment testing.

Example

Mellamore Plc has a significant amount of goodwill allocated to a cash generating unit (CGU) which is to be tested for impairment according to IAS 36, Impairment of Assets. It has to compute the cash generating units (CGU's) recoverable amount. For this purpose, it needs to estimate future cash flows expected from the CGU.

Mellamore, which wants to restrict the hit to the profit by impairment loss, projects future cash flows in such a manner as to reduce the impairment to a level desired by the company. It justifies these cash flows by stating the measures it has taken to improve the situation. This is creative accounting within the four corners of IFRS.

2.4 Ethical implication

Not adhering to the code of ethics

When accountants undertake creative accounting practices, they would not be adhering to the following fundamental principles of code of ethics:

1. **Integrity:** the accountant will be dishonest in his work

2. **Objectivity:** the accountant will make inappropriate business judgements by recording transaction incorrectly.

3. **Professional behaviour:** the accountant will not adhere to the financial reporting framework and thereby cause discredit to the profession

Threats

The accountant is faced with a threat of self-interest while carrying out creative accounting practices.

Safeguards

There are no safeguards which can mitigate the threat faced by the accountant to an acceptable level. **Therefore the accountant should refuse to indulge in creative accounting practices.**

Test Yourself 1

A new CEO has taken over at Swaphire Co during 20X3. Immediately thereafter, the company decides to restructure its business. It lays down a detailed plan and formally informs all those who are likely to be affected, and immediately starts implementing the plan in 20X3.

The management claims that the charge for restructuring costs should be recorded in the year of the restructuring and should incorporate all anticipated costs of its implementation. It estimates restructuring provisions at Tshs10 billion. These estimates include, among others, write down of assets and inventory at Tshs2 billion and environmental costs at Tshs1.5 billion.

Required:

Discuss the implication of the accountant recording the restructuring cost in accordance with the management's suggestion.

---

3. Design alternative reporting when departure from international standard is inevitable and communicate the departure in the notes.

[Learning Outcome c]

3.1 Departure from international standards

Departure from international standard is also called a true and fair override. It simply means that management overrides the requirements of the IFRSs in order to ensure that the financial statements present a true and fair view. This is a very rare situation because normally **compliance** with IFRSs (**rather than a departure** from it) is expected to lead to a true and fair presentation.

IAS 1 envisages that in extremely rare circumstances, management may conclude that compliance with the requirements of a Standard or Interpretation would be **so misleading** that it would conflict with the objectives of financial statements as set out in the **Framework.** Therefore, management may **override** the requirements. In other words, it may depart from the Standards and potentially the Framework.

Example

Hale and Hearty Pub spends large amounts every year on repairs and modifications of its decorative wooden structure, to keep it looking like new. It charges the entire cost as expense. Neither does it capitalise the new expense, nor does it derecognise the cost of the replaced parts.

This is against the IAS 16 requirement that the expenditure should be capitalised if it meets the recognition criteria and depreciation should be charged on the asset. However, management feels that these requirements conflict with the objectives of the financial statements since it spends large amounts every year for replacing substantial parts. It overrides the IFRSs requirements.

When does information conflict with the objectives of the financial statements? When the item of information **does not faithfully represent** the transactions, events or conditions that it is supposed to represent. As a result, users may not be able to take correct economic decisions based on the financial statements.

If management is considering departing from a standard, it has to consider the following:

Why is the objective of the financial statements not achieved by applying the Standard?
How do the circumstances of the entity differ from those of the other entities that do follow the requirements?

If other entities follow the requirements, there is a rebuttable presumption that compliance with the IFRSs is not so misleading. In such a situation, the override is not available.

Communication of departures

Departures from Standards **(or override) to ensure true and fair presentation of financial statements are classified into two types:**

If the relevant regulatory framework requires, or otherwise does not prohibit, the departure.
If the relevant regulatory framework **prohibits** the departure.

1. **If the relevant regulatory framework requires, or otherwise does not prohibit, the departure, it shall disclose the following:**

   a) A statement that the financial statements present fairly the financial position, financial performance and cash flows.

   b) A declaration that it has complied with all the applicable accounting standards and interpretations, except the departure from the particular requirement in order to achieve a fair presentation.

   c) Details of the departure in the period of departure:

      i. Title of the Standard or Interpretation.
      ii. The nature of departure
      iii. The treatment that the Standard would require, and why it would be misleading so as to conflict with the objectives of the financial statements.
      iv. The treatment adopted.
      v. For each period reported the impact of the departure on each item of the financial statements.

   d) Details of the departure in the subsequent period: if the departure affects the amounts recognised in the subsequent period, then only the disclosure given in paragraph 3 above is applicable.

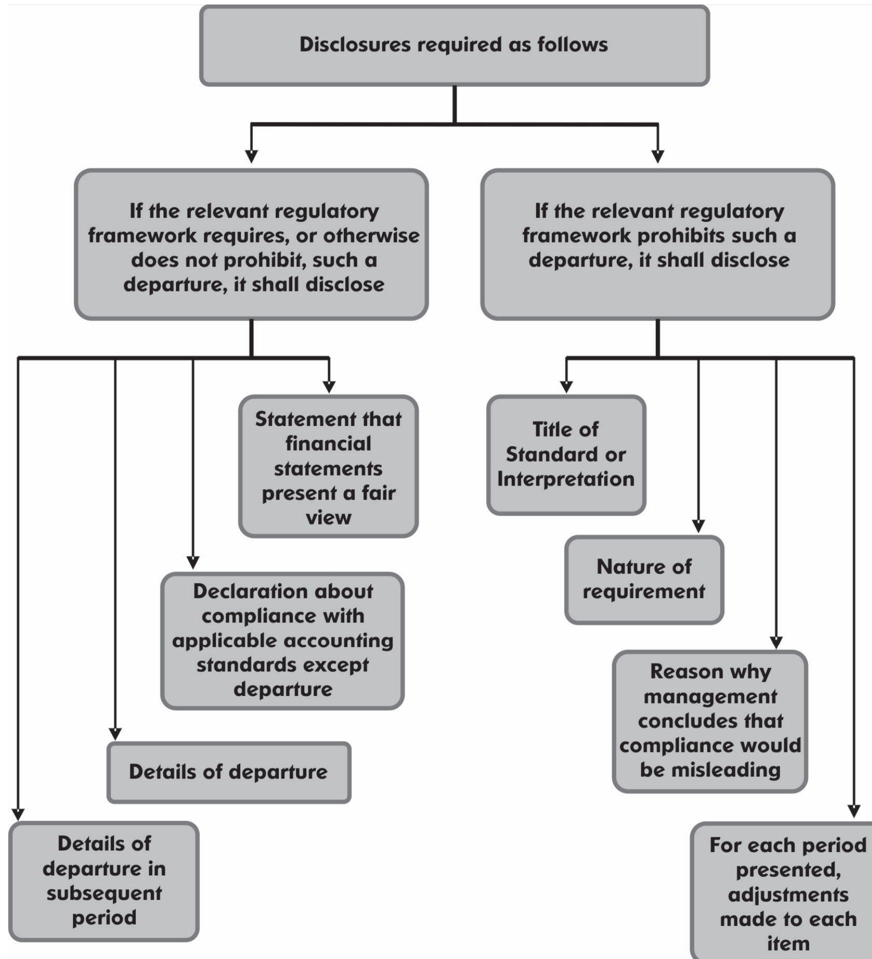
2. **If the relevant regulatory framework prohibits the departure, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:**

   a) Title of the Standard or the Interpretation.
   b) The nature of the requirement.
   c) The reason why the management has concluded that the compliance would be misleading to the objects of the financial statements.
   d) For each period presented, the adjustments made to each item.

Test Yourself 2

With the help of the guidance given above, draft a communication about departure in the notes to financial statements for the example of Hale and Hearty Pub discussed earlier.

Diagram 2: Disclosures if there is a departure



Answers to Test Yourself

Answer to TY 1

IAS 37 Provisions, Contingent Liabilities and Contingent Assets provides guidance regarding restructuring provisions. The timing of the provision (the year 20X3) appears acceptable under IAS 37.

IAS 37 stipulates that a restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

a) Necessarily entailed by the restructuring; and
b) Not associated with the ongoing activities of the entity.

The write-downs of inventory and fixed assets do not seem to have been necessarily entailed by restructuring. Similarly, environmental provisions may be associated with the ongoing activities rather than the restructuring, unless they specifically relate to an activity that is being stopped as a part of restructuring. Such write downs or provisions reduce future year expenses and increase those of the current year.

This could be a creative accounting tool used by the new CEO to boost the profits for the future period so as to benefit his image or perhaps to gain higher performance based incentives.

If the accountant acts in accordance with management's suggestion, he will be adhering to the fundamental principles of integrity, objectivity and professional behaviour. However, he needs to check all the calculations in detail and see if the provision amount is true and fair and is in line with IAS 37.

Answer to TY 2

Hale and Hearty Pub Inc.

Note no ___ to the financial statements as at / for the year ended 31 December 20X3.

1. The financial statements present the financial position, financial performance and cash flows fairly.
2. The company has complied with all the applicable IFRSs and interpretations, except the departure from certain requirements of IAS 16, Property, Plant and Equipment (as explained in serial no.3 below) , in order to achieve a fair presentation.
3. Details of the departure:

   a) **Title of the Standard or Interpretation:** IAS 16, Property, Plant and Equipment

   b) **The treatment adopted:** The Company incurs expenses on repairs, renewals and modifications of decorative wooden structures each year, so as to keep the pub looking like new. Since almost the entire structure is modified every year, the entire cost is charged as repairs. The initial or the new costs are not capitalised, nor is the asset depreciated.

   c) **The accounting treatment the Standard requires, why the departure would be misleading so as to conflict with the objectives of the financial statements and the nature of departure:** IAS 16 requires that cost of replacing parts of assets should be recognised in the carrying amount of an asset if it meets the recognition criteria and the carrying amount of those parts that are replaced should be derecognised.

   d) If the company were to capitalise the cost of replacements, that would mean that the company would be carrying forward assets which have uncertain / immaterial recoverable value. The statements may no more be true and fair.

   e) **The impact of the departure on each item of the financial statements:** If the company had capitalised the modification expenses in the year 20X3, the property, plant and equipment would have been higher by Tshs10 million (previous year Tshs9.5 million). The cost of the replaced parts worth Tshs9.5 million would have been derecognised and charged to 'PPE derecognised account' under admin costs (previous year Tshs9.2 million), the net profits would have been higher by Tshs0.5 million. (Previous year Tshs0.3 million)

Quick Quiz

1. Do accounting estimates pose a threat to the truth and fairness of financial statements?
2. Should IASB eliminate choice of accounting policies totally and stipulate one standard policy for each case?
3. Allowing departure from international standard will dilute the utility of IFRSs. Is the statement true?
4. Synergistic Industries Co is passing through difficult times and the management is finding it difficult to keep up with the projections given while issuing its shares to public around two years ago. Helen is the CFO of the company and is concerned that she may not get another job should she lose this one. What kind of pressures she may face while preparing financial statements?
5. Is it possible that aggressive accounting practices in areas such as fixed asset useful lives and residual values could have material effects on the financial statements?

Answers to Quick Quiz

1. Accounting estimates are used as a routine in accounting. However, they do not necessarily create a threat to truth and fairness. It is only when someone prepares the statements with mala fide intentions that the estimated can be misused
2. Although the IASB is working towards an objective of reducing the number of accounting choices, it may be difficult to eliminate them altogether since the real life situations cannot be uniform in all respects.
3. It is in extremely rare circumstances that departure from international standard is allowed. There also, a detailed justification and presentation is required. Hence it does not dilute the utility of IFRSs.
4. Helen may face pressures from management to 'cook up' the figures in the financial statements and bring them closer to the figures promised in the public issue documents.
5. Yes. In the case of companies with heavy investments in capital assets, deliberate over or under estimation of useful lives and residual values could help accountants to show the results desired by them or the management.

Self-Examination Questions

Question 1

Kevinson Builders has undertaken construction of large bridge. The work started in January 20X2 and is expected to be completed by September 20X5. The value of the contract is worth Tshs50 billion. The total costs estimated at the initial stage were Tshs45 billion. At the end of 20X3, the stage of completion was estimated at 55% and detailed estimates were prepared by management wherein an expected loss of Tshs10 billion was shown. Kevinson provided for this loss in the financial statements of 20X3.

Required:

What precautions should the accountant take before recording the above mentioned transactions?

Question 2

Nova Chemicals acquired a machine costing Tshs500 million on lease for a period of 10 years where annual lease payments amount to Tshs60 million. The lease was for almost the entire useful life of the machine. The accountant presented the lease as an operating lease in the financial statements. The amount of annual instalment of Tshs60 million was included in cost of sales. There was no other accounting treatment in the financial statements.

Required:

Has the accountant deviated from the international financial reporting standard? Can alternative reporting be done?

Answer to Self-Examination Questions

Answer to SEQ 1

Estimates form part of day to day accounting. For accounting under IAS 11, Construction Contracts, where stage of completion or percentage completion method is followed, the total expected revenues are compared with the total expected total costs. Expected total costs include actual costs till date and the costs to complete the project. If loss is expected, IAS 11 Construction Contracts requires that the total loss should be provided for. It appears from the given figures that the initial estimates have changed substantially. Where a profit of Tshs5 million was expected initially, a loss of Tshs10 million is expected now. There is a movement of Tshs15 million.

Calculation of costs to complete the project involves judgement on part of management. If the management is so inclined, it may increase or decrease the costs to complete so as to obtain the desired result. Since a loss of Tshs10 million is expected, the total expected costs seem to be Tshs60 million now. Compared to the initial estimates of Tshs45 million, this is an increase of Tshs15 million or 33.33%.

This is a substantial amount. The calculations should be checked in detail along with the justifications. There could be some penalty clauses in the contract or costs could have gone up. Similarly, it should be verified if there is any escalation clause where any of the additional costs can be recovered. Construction contracts are spread over longer periods and hence have inherent uncertainty. The movement in the figures could be genuine. However, one has to be careful and check if this is a creative accounting trick.

Answer to SEQ 2

IAS 17 Leases is proposed to be changed and an exposure draft is issued. However, as the provisions stand today, if a lease is treated as an operating lease then only the lease payment is shown as expense and no asset or liability is presented. On the other hand, if a lease is a finance lease, the asset and the resultant lease liability both are recorded. The lease payment is split between principal and interest. Interest is shown as expense and the principal part is debited to liability. Like on the other assets, depreciation is charged on the leased assets.

In the given case, the lease appears to be a finance lease, since the lease period covers almost the entire economic life of the asset. However, the accountant wants to treat it as an operating lease. The reason could be that he wants to avoid showing the lease liability in the statement of financial position. Certain ratios such as debt equity ratio may be adversely affected if the liability increases. Prima facie, this appears to be a window dressing of the financial statements and is not permitted under IFRSs. If the accountant does not make changes, as suggested, it will deviate from the international standard and there will be no alternative reporting.

SECTION B

REPORTING THE FINANCIAL PERFORMANCE OF ENTITIES

B1

STUDY GUIDE B1: EMPLOYEE BENEFITS

Get Through Intro

Employee benefits form a very important constituent of an entity's expenses. Employers offer benefits that can be enjoyed by employees during the period commencing from the completion of the employee's service. These benefits are offered as a part of the remuneration package.

In this Study Guide we deal with post-employment benefits. These are retirement benefits normally in the form of a pension. Under the schemes formulated in earlier years, payments were made on a "pay as you go" basis - where costs were charged to the statement of profit or loss as and when payments were made. However, there have been plenty of changes in the benefit schemes for post-employment.

As professionals, you will be required to handle employment benefit schemes for your clients. This Study Guide will help you to understand post-employment schemes, the methods of measuring and recognising these schemes and how to account for them in the financial statements.

Learning Outcomes

a) Define and account for short-term employee benefits.
b) Explain the key features of defined contribution and defined benefit plans and distinguish between them.
c) Describe and apply the accounting treatment of defined benefit plans.
d) Explain the disclosure requirements under IAS 19 Employee Benefits.

1. Define and account for short-term employee benefits.

[Learning Outcome a]

1.1 Meaning of short-term employee benefits

Definition

Short-term employee benefits are employee benefits (other than termination benefits) that are due to be settled within twelve months after the end of the period in which the employees render the related service

IAS 19 Para 7

1. Short-term employee benefits include items such as:

(a) Wages, salaries and social security contributions;

(b) short-term compensated absences (such as paid annual leave and paid sick leave) where the compensation for the absences is due to be settled within twelve months after the end of the period in which the employees render the related employee service;

(c) profit-sharing and bonuses payable within twelve months after the end of the period in which the employees render the related service; and

(d) Non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.

1.2 Accounting treatment of short-term employee benefits

A short-term benefit should be recognised as an employee provides the services to the entity by reference to which the benefits are payable (i.e. in accordance with accrual concept). The benefit will normally be treated as an expense, and a liability should be recognised for any unpaid balance at the end of the reporting period.

1. Short-term compensated absences

In short term compensated absences the employee receives some form of payment, for example paid annual vacation and paid sick leave.

These benefits are categorised into:

(a) Accumulating compensated absences.

Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. It should be recognised as an expense as the employee provides the services by reference to which the entitlement to such benefits accrues, for example paid privilege leave which can be accumulated

(b) Non-accumulating compensated absences

Unlike accumulated compensated absences, these are not normally capable of being carried forward to the following period if they are unused during the period, for example paid sick leave, maternity. These do not entitle employees to a cash payment for unused entitlement on leaving the entity. An entity recognises no liability or expense until the time of the absence, because employee service does not increase the amount of the benefit.

Example

Zenith Ltd has 10 employees. Each employee is entitled to 15 days paid vacation per year. The rate per day is Tshs.100,000. Out of the 15 days, 5 days unused vacation can be carried forward to the following year.

All 10 employees work for the entity throughout the year and are therefore entitled to their 15 days of vacation. An expense should be recognised in profit or loss for:

Total expense in the statement of profit or loss- 10 employees x 15 days x Tshs.100,000 = Tshs15,000,000

Continued on the next page

Part of this, to the extent utilised, will be recorded through the payment of remuneration 5 of the employees use their complete entitlement for the year

5 employees have used part (5 days each). The equivalent amounts are:
5 employees x 15 days x Tshs100,000 = Tshs7,500,000 (completely availed)
5 employees x 5 days x Tshs100,000 = Tshs2,500,000 (partly availed)

These 5 employees are permitted to carry 5 days to the following period.

Remaining 5 days each are lapsed. The equivalent amount that does not come into accounting is

5 employees x 5 days x Tshs100,000 = Tshs2,500,000

A liability will be recognised at the end of the reporting period for:

5 employee x 5 days x Tshs100,000 = Tshs2,500,000. For this amount, expense will be debited and provision for vacation costs will be credited.

---

2. Profit-sharing and bonus plans

An entity should recognise an expense and a corresponding liability for the cost of providing profit-sharing arrangements and bonus payments when:

The entity has a present legal or constructive obligation to make such payments as a result of past events and a reliable estimate of the obligation can be made

A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments.

Example

According to a profit-sharing plan an entity is required to pay a 3% of its profit for the year to employees who serve throughout the year.

If no employees leave during the year - the total profit-sharing payments for the year will be 3% of profit.

Say if the entity estimates that staff turnover will reduce the payments to 2.5% of profit. The entity recognises a liability and an expense of 2.5% of profit.

Test Yourself 1

Neptune Ltd has been paying annual bonuses to its employees each year in the past. On 30 April 2012, Neptune Ltd issued annual bonus of 5% of its pre-tax profits of Tshs10 million, before charging the bonus to those employee who remain in employment on 30 September 2012.

The bonus will be allocated in proportion to the net salaries of employees. Based on the management experience, 10% of annual salaries will leave the employment by 30 September 2012.

Required:

Calculate the bonus be recognised in the financial statements.

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2. Explain the key features of defined contribution and defined benefit plans and distinguish between them.

[Learning Outcome b]

Post-employment benefits are employee benefits payable after the completion of employment. They include retirement benefits, such as pensions, post-employment life insurance and post-employment medical care.

Arrangements whereby an entity provides post-employment benefits are known as post-employment benefit plans.

Post-employment benefit plans are either:

1. Defined Contribution Plans; or
2. Defined Benefit Plans

2.1 What are Defined Contribution Plans?

Definition

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

IAS 19 Para 8

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1. Key features of defined contribution plans

(a) The amount of the entity's **liability** towards post-retirement benefit is **restricted to the fixed contributions** to a separate entity or fund.

(b) The amount of post-employment **benefits received by the employee depends on** the **contributions** paid by the entity and the employee (if any) to a post-employment benefit plan or to an insurance company, together with **any investment returns** arising from the contributions made.

Therefore the **actuarial risk and investment risks rest fully with the employee**. There is no way to know how much the plan will ultimately give the employee upon retirement

(c) Since the actuarial risks (that benefits will be less than expected) rest with the employee, an actuary's advice is not normally required, except where such advice is used to estimate future benefits.

(d) In view of the risk of investment returns, participants are interested in knowing whether contributions have been received and proper control has been exercised to protect the rights of beneficiaries.

(e) An employer is interested in the efficient and fair operation of the plan.

(f) The financial statements of a defined contribution plan shall contain:

(i) A statement of the net assets available for benefits
(ii) A description of the funding policy

Example

Sunshine Ltd has a defined contribution plan with Frontline Insurance Co. According to the terms of the scheme, Sunshine Ltd has to pay a monthly fixed amount of Tshs.320,000 per employee per month to Frontline Insurance Co.

Frontline Insurance will then invest this in assets which it hopes will increase the value of the overall plan in the future. The liability of Sunshine Ltd is still restricted to a fixed amount – Tshs.320,000 per month. This is a defined contribution scheme.

Accounting for defined contribution plans

As the time period for which an employee has worked for a company grows, the fixed contribution to a retirement benefits plan accrues. Recognise the contribution paid as an expense, unless another standard requires / permits the inclusion of the contribution in the cost of an asset (e.g. IAS 2 and IAS 16).

Dr	Employee costs	X	
Cr	Employee cost payable		X
Being accrual of the expenditure			

Dr	Employee costs payable	X	
Cr	Cash		X
Being payment of the contribution			

If the contribution already paid exceeds the contribution due for service before the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or cash refund.

Discounting: usually contributions are not discounted since they represent the current expenditure to be paid immediately. However, where contributions to a defined contribution plan do not fall due wholly within twelve months after the end of the period in which the employees render the related service, they shall be discounted.

Tip

The discount rate to be used for this purpose shall be determined by reference to market yields at the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the reporting date) on government bonds shall be used. This rate would be used for any discounting under any scheme.

The accounting for defined contribution plans is relatively simple and should not pose a major challenge to you. In this Study Guide we will be focussing on accounting for defined benefit plan in the next Learning Outcome which is a little complex.

2.2 Defined Benefit Plans

Definition

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

IAS 19 Para 7

1. **Key features of defined benefit plans:**

   The **entity's obligation is to provide the agreed benefits** to current and former employees.
   Actuarial risk and investment risk fall, in substance, **on the entity**. If actuarial or investment experience is worse than expected, the entity's obligation may be increased.

This basically means that employers agree to give their employees for example, a **defined benefit** when they retire e.g. a pension payable after they retire, of 30% of their final salary. The problems faced by employers are the following:

How much should the employer pay into the pension fund to be sure that it can pay the employees 30% of their final salary?
How does the employer know how many of its employees will stay with them to retirement?
How does the employer know what the final salary of an employee will be?

As you can see, there are many issues surrounding defined benefit plans! These issues are discussed and the answers to the above questions are given below.

2. Generally, the amount of retirement benefits is calculated using a formula which includes:

   The earnings of the employee; and
   The number of years of service of the employee

Example

Moonlight Ltd has a defined benefit plan, to offer post-retirement benefits to its employees. According to the arrangement, the amount of post-retirement benefit offered is Tshs100,000 per month for each year of completed service. If Mr Raj retires from Moonlight Ltd after 30 years of service, the pension payable to him would be Tshs.3,000,000 per month for his lifetime.

To ensure that the pre-determined amount is offered at the time of retirement, the amount of contribution Moonlight makes to the fund will not be fixed. It will change depending on the present value of the post-retirement benefit fund.

Here, the actual return on investments of the fund will have no bearing on the pension paid to Mr Raj. Even if the fund has received a poor return on its investments it will still be bound to pay the pre-determined amount to Mr Raj. This will be done by Moonlight having to make additional contributions to the fund. Therefore, Moonlight has to consult an actuary to know the amount to be contributed so that it can pay the defined benefit to the employees after their retirement.

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3. The amount of promised retirement benefits depends on:

   i. The financial position of the plan (the value of the assets in the plan or fund)
   ii. The ability of contributors to make future contributions
   iii. Investment performance and efficiency of the plan

4. The periodic advice of an actuary will be needed to assess the financial condition of the plan, review the assumptions and recommend future contribution levels.

5. The financial statements will contain either:

   i. A statement of the net assets available for benefits
   ii. The actuarial present value of promised retirement benefits
   iii. The resulting excess or deficit

   Or

   i. A statement of net assets available for benefits including either:
   ii. A note disclosing the actuarial present value of promised retirement benefits; or
   iii. If an actuarial valuation has not been prepared at the date of the financial statements, the most recent valuation shall be used as a base and the date of the valuation disclosed

6. The financial statements should also explain the relationship between:

   i. the actuarial present value of promised retirement benefits and the net assets available for benefit; and
   ii. the policy for the funding of promised benefits

The following case study gives an example of a disclosure regarding the actuarial present value of promised retirement benefits and the resulting deficit.

Tip

Under a defined contribution plan, the amount contributed is fixed, but the benefit is not. However under a defined benefit plan, the benefit is fixed and not the contribution.

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7. Defined benefit plans may be funded plans or unfunded plans.

(a) **Funded Plans** are pension plans which have assets allocated to meet future obligations. The contributions are paid into separate legal entities and these entities are managed independently by the trustees. Wholly funded plans are pension plans whose allocated assets cover the future obligations fully.

(b) **Unfunded Plans** are plan which are held within the employers legal entities and managed by the employer's management team. Though the assets allocated to the unfunded plans are used to discharge the retirement benefit obligation, these assets remain the assets of the employer. Unfunded plans may not cover the retirement benefit obligations wholly.

Example

Moonbeam Ltd has a defined benefit plan for the provision of post-employment benefits. It contributes each month to a pension fund.

This fund invests the amounts of contributions and makes payments towards pension out of the returns on investments. This plan is a funded plan.

2.3 Major differences between a defined contribution plan and a defined benefit plan

Features	Defined contribution plan	Defined benefit plan
Fixed	Contribution by the employer	Benefits to the employees
Liability of the employer	Restricted – to the fixed contribution	Not restricted to contribution but linked to the benefits payable
Risk	Lies with employees	Lies with employer – may have to pay more if present contribution is not sufficient to pay the fixed benefit
Presentation in financial statements	No liability unless contribution is unpaid	Liability is shown net of plan assets

Example

Max Ltd has a retirement plan, under which the pension amount payable to its employees is 2% of the last salary drawn for each year of completed service. Identify whether this is a defined benefit plan or a defined contribution plan.

Answer

This is a defined benefit plan since the amount of benefit is a pre-determined amount.

Example

Mini Ltd has a retirement plan for its employees. Its liability is restricted to 3% of their salary each year for all employees in service.

Answer

This is a defined contribution obligation since the amount of contribution is fixed.

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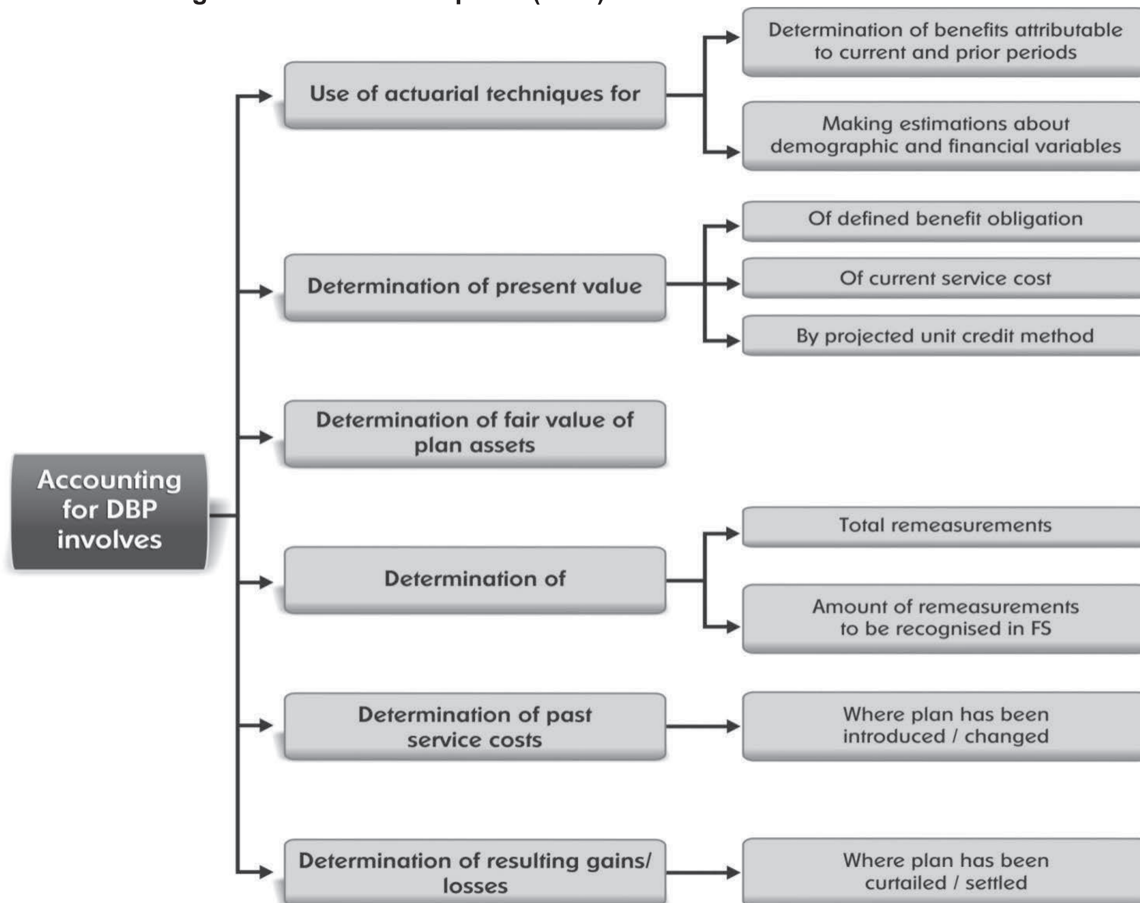
3. Describe and apply the accounting treatment of defined benefit plans.

[Learning outcomes c]

3.1 Accounting of defined benefit plans

Accounting for defined benefit plans by an entity involves the following steps:

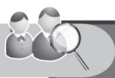
Diagram 1: Accounting for defined benefit plans (DBP)



The above concepts and the methods followed for accounting for defined benefit plans are explained below:

1. Determination of benefit for the current period and prior period

(a) According to the standard, an entity shall **attribute benefit to periods of service** under the plan's benefit formula i.e. the amount of pension which is payable on retirement needs to be attributed to each financial period until the time when the obligation materialises.



Example

Saturn Ltd has a defined benefit plan for its employees. According to the plan, a lump sum of Tshs2,500,000 is payable on retirement for each year of service. The benefit of Tshs2,500,000 is attributable to each year of service.

That means, for an employee completing 15 years of service in the entity, benefit payable is Tshs37,500,000 (Tshs2,500,000 x 15).

(b) In some cases, employee service gives rise to an obligation under a defined benefit plan **where the benefits are conditional on future employment**. Therefore, **while attributing the benefits to the period of service, the probability of some employees not meeting the required conditions needs to be considered**.

Example

Continuing from the above example of Saturn Ltd

The employees are eligible for additional pension when they turn 70 years. While determining the present value of the obligation the probability that not all employees will live till they are 70 years old needs to be considered. Saturn will estimate that, say for example, 80% of employees will reach the age of 70.

(c) In some cases, the plan's benefit formula sets a particular benefit subject to the fulfilment of certain conditions. Therefore the obligation will increase each year only until the time when the condition is fulfilled.

Example

Cara Ltd has a defined benefit plan where it pays a lump sum pension of Tshs3 million on completion of five years of service. The company's employment benefit obligation crystallises after each employee completes five years of service. It does not change afterwards.

(d) Where the plans benefit formula sets out that the employee's service in later years will lead to a materially higher level of benefit than in earlier years, the entity shall attribute benefit on a straight-line basis from:

The date when service by the employee first leads to benefits under the plan; until
The date when further service by the employee will lead to no material amount of further benefits

Example

Cara Ltd has a defined benefit plan where it pays 22% of the final salary as pension. In addition, the amount of pension increases to 30% of the final salary if the employee completes 20 years of service. Here the employee benefit is to be calculated on a straight line basis. The period for calculation is from the date of joining up to the date of completion of 20 years of service.

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2. Actuarial assumptions

Actuarial assumptions are an **entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits.** They are made up of demographic assumptions and financial assumptions

Demographic assumptions	Financial assumptions
Mortality, both during and after employment Rates of employee turnover, disability and early retirement The proportion of plan members with dependants who will be eligible for benefits Claim rates under medical plans	The discount rate Future salary and benefit levels In the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments The expected rate of return on plan assets

Each of the above factors will have an effect on the pension payable, so these factors need to be considered so as to make an appropriate estimate.

Actuarial assumptions should be unbiased and mutually compatible.
Actuarial assumptions should be neither imprudent nor excessively conservative. Only then will the assumptions be unbiased.
Actuarial assumptions need to reflect the economic relationships between factors such as inflation, rates of salary increase, the return on plan assets and discount rates. Only then will the actuarial assumptions be mutually compatible e.g. all assumptions depending on a particular inflation level (such as interest rates, salary etc.) in any given future period, should have the same inflation level for that period.

Example

Moti Ltd has a defined benefit obligation plan for its employees. While determining the present value of the obligation it will consider the effect of inflation on the salary and thereby the amount of obligation will be determined.

Financial assumptions shall be based on market expectations, at the reporting date, for the period over which the obligations are to be settled.

3. Determination of present value

(a) An entity discounts the whole of a post-employment benefit obligation, even if part of the obligation is expected to be settled before twelve months after the reporting period.

An entity should determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity so that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the reporting date.

Interest cost which is recognised each period is calculated by applying the **discount rate at the start** of the period **to the present value** of the defined benefit obligation at the **start of the period**.

The discount rate is determined by taking into consideration the market yields at the end of the reporting period on high quality corporate bonds. In case there is no deep market available for such bonds, the market yields on government bonds are considered.

Example

An entity's defined benefit liability on 31 December 20X6 and 20X7 is measured as follows:

	20X6 Tshs'000	20X7 Tshs'000
Defined benefit obligation	1,187,500	1,437,500

Amounts in Tshs'000

The discount rates used for calculating the defined benefit obligation were 6.5% on 31 December 20X6, and 6% on 31 December 20X7.

The interest cost for 20X7 is calculated by multiplying the defined obligation at the start of the period by the discount rate at the start of the period, so:

Tshs.1,187.5 million x 6.5% = Tshs.77.187 million

(b) Projected unit credit method to discount the benefit to the present value

An entity **shall use the projected unit credit method** to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

Under the projected unit credit method, each year of service gives rise to an additional unit of benefit entitlement which is charged to the statement of profit or loss and also added to the defined benefit obligation.

Calculation of present value under this method is illustrated in the example given below.

Example

(All amounts in Tshs'000)

A lump sum benefit is payable on termination of service and equal to 1% of final salary for each year of service. The salary in year 1 is Tshs.15,000 and is assumed to increase at 9% (compound) each year. The discount rate used is 10% per annum. The following table shows how the obligation builds up for an employee who is expected to leave at the end of year 7, assuming that there are no changes in actuarial assumption.

For simplicity, this example ignores the additional adjustment needed to reflect the probability that the employee may leave the entity at an earlier or later date.

Required:

Determine the present value of the benefit obligation and show how this builds up over the years?

Answer (Amounts in Tshs'000)

Step 1: Determine the salary at the time of retirement as follows:

Salary at the time of retirement
= Salary of first year x (1 + rate of salary increase) $^{(\text{No. of years of service left} - 1)}$
= Final salary at year 7 (Tshs.15,000 compounded at 9%)
=Tshs.15,000 x $(1 + 0.09)^6$
= 25,157

Step 2: Determine the expected pension as follows:

1% of final salary attributed to each year (Tshs25,157 x 1%) = Tshs251.572
Expected final benefit = 7 years x Tshs251.572 = Tshs1,761

Step 3: Calculate the present value of the current service cost for each year of service:

Current service cost = Tshs252 (rounded off)

Present value in year 1 = Current service cost x (1+Discount rate) $^{(\text{No of years of service} - 1)}$
Present value in year 2 = Current service cost x (1+Discount rate) $^{(\text{No of years of service} - 2)}$

Current service cost, being present value of 252 discounted at 10%: e.g.

Year 1	Tshs252 x $(1 + 0.1)^{-6}$ = Tshs142
Year 2	Tshs252 x $(1 + 0.1)^{-5}$ = Tshs156
Year 3	Tshs252 x $(1 + 0.1)^{-4}$ = Tshs172
Year 4	Tshs252 x $(1 + 0.1)^{-3}$ = Tshs189
Year 5	Tshs252 x $(1 + 0.1)^{-2}$ = Tshs208
Year 6	Tshs252 x $(1 + 0.1)^{-1}$ = Tshs229
Year 7	Tshs252

Step 4: Determine the benefits attributed to current period and prior period as given above

Step 5: Determine the obligation for each period as given above

Continued on the next page

Step 6: Interest is to be determined on the opening obligation x Rate of interest

Year	1	2	3	4	5	6	7
	Tshs'000						
Benefit attributed to:							
Prior year	-	252	504	756	1,008	1,260	1,512
Current year (1% of final salary) (see step 1 and 2)	252	252	252	252	252	252	252
Current and prior years	**252**	**504**	**756**	**1,008**	**1,260**	**1,512**	**1,764***
Opening Obligation	-	142	312	515	755	1,039	1,372
Interest at 10%(see step 6)	-	14	31	51	76	104	137
Current service cost (see step 2)	142	156	172	189	208	229	252
Closing obligation	**142**	**312**	**515**	**755**	**1,039**	**1,372**	**1,761***

* rounding off

Interest & current service cost are expenses in SOPL

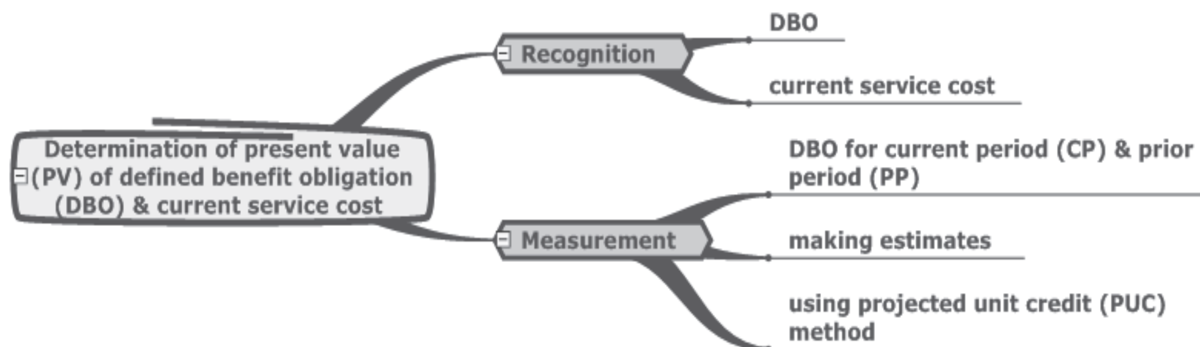
Notes

The opening obligation is the present value of benefit attributed to prior years.
The current service cost is the present value of benefit attributed to the current year.
The closing obligation is the present value of benefit attributed to current and prior years.

Tip

The rate used to discount post-employment benefit obligations shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used.

SUMMARY



Test Yourself 2

A lump sum benefit is payable on termination of service and equal to 1% of final salary for each year of service. The salary in the first year isTshs20 million and is assumed to increase at 7% (compound) each year. The discount rate used is 10% per annum. The following table shows how the obligation builds up for an employee who is expected to leave at the end of the fifth year, assuming that there are no changes in actuarial assumption.

Required:

Determine the present value of the benefit obligation and show how this builds up over the years?

4. Plan Assets

In order to discharge the obligation under the defined benefit plan, the contribution by the employer/employees is invested in some plans. In this way, the plan assets come into existence. An employer does not show the assets (such investment) in the financial statements as its assets but deducts the fair value of the assets from the present value of the obligation and the net deficit or surplus is presented in the statement of financial position.

(a) Composition of plan assets

In accordance with IAS19R, Plan assets comprises of asset held by a long-term employee benefit fund; and qualifying insurance policies.

(i) Assets held by a long-term employee benefit fund are assets that:

Are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

Example

Joy Insurance manages a pension fund for various entities of the banking sector. Here, the employers of various banks pay contributions to the scheme. Therefore the pension fund managed by Joy Insurance holds assets and the Joy Insurance pension fund is legally separate from the banking companies which are participants of the scheme. The assets held by the pension fund therefore qualify for assets held by a long-term employee benefit fund.

Are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own account payables (even in bankruptcy), and cannot be returned to the reporting entity.

Example

Continuing the above example, the assets held by Joy Insurance are used to make payments of employee benefits only. If Roop Bank which is a member of the fund becomes bankrupt, the assets of the pension fund will not be available to make payments to Roop Bank's account payables. It will be held for employees of Roop Bank.

(ii) Qualifying Insurance policy

A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in IAS 24 Related Party Disclosures) of the reporting entity. The funds from the proceeds of the policy are not available for the existing trade payables and can be used only to pay or fund employee benefits under a defined benefit plan

(b) Assets excluded from the plan assets

Plan assets do not include:

i. Unpaid contributions due from the reporting entity to the fund.
ii. Any non-transferable financial instruments issued by the entity and held by the fund.

(c) Measurement of Plan Assets

As already mentioned above, plan assets are to be measured at their **fair value**.

Definition

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

IAS 19 Para 8

Therefore fair value is the price at which an asset can be exchanged / liability settled at an arm's length price. We have already explained the concept of arm's length price in the Study Guide D2 on related party disclosures.

The bid price should be used for measuring the fair value of quoted investment

Example

Rogers Ltd, which has a pension fund, holds investments in the form of shares in Tee Ltd. The shares of Tee Ltd are traded and, as at the reporting date, each share is quoted at Tshs.1,500. Rogers Ltd pension fund has 300 shares of the pension fund.

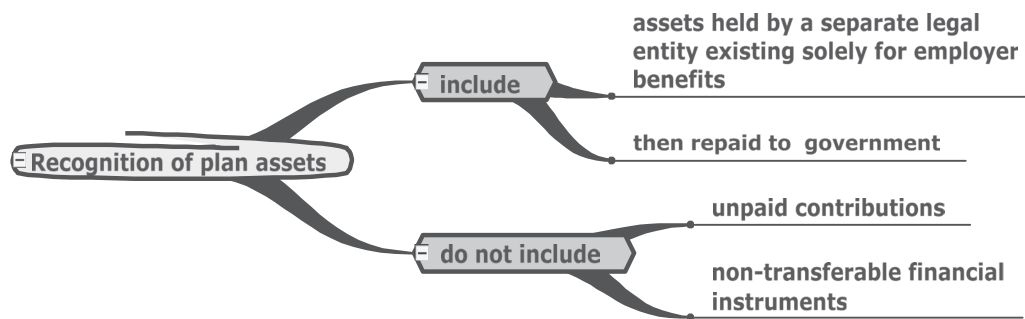
The assets will be valued at 300 x Tshs.1,500 = Tshs.450,000

For unquoted securities where the market price is not available, the fair value needs to be estimated.

According to IFRS 13, they are valued using the level of inputs available and justified; the following techniques can be used:

Recent arm's length transaction to determine the price
Discounted cash flow
Option pricing model

SUMMARY



5. Net interest

Definition

Net interest on the net defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

IAS 19 Para 8

Net interest means the interest expense\income calculated on the net defined benefit liability/ asset. The Net interest is calculated by multiplying discount rate used to measure defined benefit liability with net defined benefit liability or asset as the case may be. Thus, net interest leads to interest expense in case of net defined benefit liability and interest income if there is a net defined benefit asset.

Example

The opening balance of net defined benefit liability in the books of ABC Inc is Tshs2 million in 20X9. During 20X8, the opening balance was a net defined benefit asset of Tshs1 million. The discount rate used to measure defined benefit liability is 10%.

Therefore the net interest for 20X9 will be 10% of Tshs2 million i.e. Tshs0.2 million. As it's a net defined benefit liability, an interest expense of Tshs0.2 million will arise.

For 20X8 an interest income of 10% of Tshs1 million i.e. Tshs0.1 million would have been recognised in the statement of profit or loss.

The net interest on the net defined benefit liability (asset) can be disaggregated into:

i. Interest cost on the defined benefit obligation
ii. Interest income on plan assets; and
iii. Interest on the effect of the asset ceiling

Refer the example in re-measurements to understand the above disaggregation.

Test Yourself 3

The accountant of Pepco is unable to calculate the net interest on the pension plan for year ended 20Y1. He asks for your help and gives you the following details:

	Tshs'000
Defined benefit liability as at 31/12/20Y0	6,000
Defined benefit liability as at 31/12/20Y1	8,000
Fair value of plan assets as at 31/12/20Y1	10,000
Fair value of plan assets as at 31/12/20Y0	7,000
Discount rate used to calculate defined benefit liability	10%

6. Re-measurements

The concept of re-measurement is a new concept introduced by IAS 19 issued in June 2011. Re-measurements of net defined benefit liability (asset) comprises of:

i. Actuarial gains and losses on the defined benefit obligation
ii. The return on plan assets, excluding amounts included in net interest on the net defined benefits liability (asset); and
iii. Any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (Asset)

Note - The asset ceiling is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

Methods for recognition of re-measurements

In accordance with IAS 19R actuarial gains or losses are now a part of re-measurements. Earlier IAS 19 provided three options to defer the actuarial gains or losses using corridor method either to the statement of profit or loss or to the other comprehensive income.

The IAS 19R does not provide any option to recognise actuarial losses or gains in profit or loss. Effects of re-measurements are recognised in other comprehensive income and they cannot be recycled through profit or loss in subsequent periods. Thus, the only treatment for re-measurements is to recognise them in other comprehensive income.

In accordance with IAS 19R, the changes in the effect of the asset ceiling are presented both in profit or loss within net interest, for the interest effect on the asset ceiling, and in other comprehensive income as part of re-measurements for the remainder. Refer to the example below for understanding the method of accounting.

Asset ceiling is a ceiling or threshold which is placed to ensure that an entity does not recognise a surplus, i.e. net assets, over this particular limit, thus ensuring that the entity does not recognise any savings (net defined benefit asset), from the defined benefit plans in excess of this ceiling.

Look at the example below to understand this better.

Example

Prestige Ltd introduced a pension plan for its employees. Prestige accounts for the plan in accordance with defined benefit plan.

The amounts recognised in respect of that plan in Prestige's financial statements at 31 December 2010 and 31 December 2011 and their reconciliation are set out below.

Prestige Ltd has determined that the ceiling on recognising a net defined benefit asset in relation to the plan is Tshs.1,500 million at both the start and end of the period.

	Defined benefit obligation	Fair value of plan asset	Effect of asset ceiling	Net Defined benefit asset/ (liability)
	Tshs. million	**Tshs. million**	**Tshs. million**	**Tshs. million**
Opening balances - 1 January 2011	(1,500)	1,950	(300)	150
Service cost	(75)	-	-	(75)
Net interest cost based on 10% discount rate	(150) (1,500 x 10%)	195 (1,950 x 10%)	(30) (300 x 10%)	15 (150 x 10%)
Total amounts before computing the re-measurements	**(1,725)**	**2,145**	**(330)**	**90**
Re-measurements	(75) (1,800 – 1,725)	105 (2,250 – 2,145)	30 (330 – 300)	60
Closing balances - 31 December 2011	**(1,800)**	**2,250**	**(300)**	**150**

Under the revised IAS19, Prestige Ltd will recognise a net interest income of Tshs15 million in the profit and loss. The net interest income can be disaggregated as follows:

i. Interest cost on the DBO of Tshs150 million
ii. Interest income on the plan assets of Tshs195 million
iii. Interest cost on the effect of asset ceiling of Tshs30 million

The re-measurements of Tshs60 million would be recognised in the other comprehensive income. The re-measurement can be disaggregated as follows:

i. Actuarial loss on DBO of Tshs75 million
ii. Return on plan assets (excluding interest income included under net interest) of Tshs105 million
iii. Change in the effect of asset ceiling (excluding interest cost included under net interest) of Tshs30 million

7. Defined benefit liability (asset)

Definition

The net defined benefit liability (asset) is the deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

The deficit or surplus is:

a) the present value of the defined benefit obligation
less
b) the fair value of plan assets (if any)

IAS 19 Para 8

IAS 19 requires that net defined benefit liability (asset) is to be recognised in the statement of financial position. The net defined benefit asset or liability is equal to amount owned or owed from a plan. The term is similar to receivable or payables used in normal course.

Net defined benefit liability (asset) comprise of:

(i) The present value of defined benefit obligation
(ii) Less: the fair value of any plan asset (including the deficit or surplus in a defined benefit plan); adjusted for
(iii) Any effect of limiting net defined benefit asset to the asset ceiling

IAS 19R require entities to recognise all changes in the net defined benefit liability (asset) in the period in which those changes occur, and to disaggregate and recognise defined benefit cost as follows:

Components	Where to recognise
Service cost	Profit or loss
Net interest on the net defined benefit liability (asset)	Profit or loss
Re-measurements	Other comprehensive income

8. Determination of past service cost where a plan has been introduced or changed

Past service cost

Definition

Past service cost, is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan).

IAS 19 Para 8

Thus, past service cost occurs either due to an introduction or a change to a post-employment benefits plan. It is the change in the present value of the defined benefit obligation for employee service in prior periods. It may either be positive or negative i.e. it may either increase or decrease the present value of defined benefit obligation

Example

An enterprise operates a pension plan that provides a pension of 1.5% of final salary for each year of service. The benefits become vested (are given) after seven years of service. On 1 January 20X6 the enterprise improves the pension to 2% of final salary for each year of service starting from 1 January 1999.

In this case there is a change to a post-employment benefit plan i.e. from 1.5% to 2%.This additional 0.5% is payable for the past period also. Therefore the past service cost occurs.

Definition

Vested employee benefits are employee benefits that are not conditional on future employment.

As per IAS 19 Revised Past service cost is to be measured and recognised immediately in the statement of profit or loss when any of the following occurs:

i. When restructuring costs i.e. cost related to restructuring which results in past service costs, arises
ii. When termination benefits related to amendments which results in past service costs are recognised
iii. When Plan amendments which result in past service costs occurs

Test Yourself 4

A pension plan of a company provides a pension of 1.5% of final salary for each year of service. The benefits are vested after four years of service. However, on 1 January 20X6 the company changes the pension to 1.25% of final salary for each year of service starting from 1 January 19W9.

The present value of the differential benefits for service from 1 January 19W9 to 1 January 20X6 at the date of the changes as follows:

	Tshs million
Employees with more than four service on 01/01/20X6	125
Employees with less than four years' service on 01/01/20X6 (Average period until vesting - four years)	121
Total	**246**

Required:

Determine the amounts recognised in respect of past service costs?

Example

A defined benefit plan has the following characteristics for the year 2010:

	Tshs'000
Fair value of plan assets – 1 January 2010	21,000
Fair value of plan assets – 31 December 2010	22,380
Defined benefit obligation - 1 January 2010 (based on actuarial valuation)	22,500
Defined benefit obligation - 31 December 2010 (based on actuarial valuation)	26,115
Contributions for the period	1,575
Benefits paid during the year	1,500
Current service costs	800

The discount rate used is determined with reference to market yields at the end of the reporting period on high quality corporate bonds, which is 6%.

Required:

Prepare extracts of statement of financial position and statement of profit or loss and other comprehensive income after accounting for the defined benefit obligation.

Plan assets	**Tshs'000**
Fair value of plan assets – 1 January 2010	21,000
Return on plan assets (6% of Tshs21,000)	1,260
Contributions for the period	1,575
Benefits paid during the year	(1,500)
Expected fair value of plan assets - 31 December 2010	**22,335**
Fair value of plan assets – 31 December 2010	22,380
Re-measurements recognised in OCI in respect of plan assets	**45**

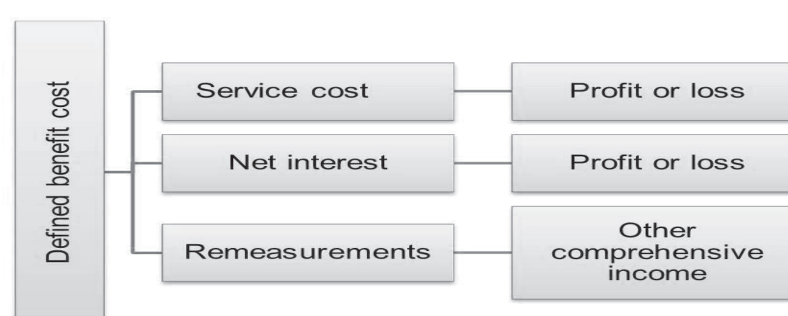
Defined benefit obligation	**Tshs'000**
Defined benefit obligation - 1 January 2010 (based on actuarial valuation)	22,500
Interest cost (6% of 22,500)	1,350
Current service costs	800
Benefits paid during the year	(1,500)
Expected obligations on 31 December 2010	**23,150**
Defined benefit obligation - 31 December 2010 (based on actuarial valuation)	26,115
Re-measurements recognised in OCI in respect of defined benefit obligation	**2,965**

Continued on the next page

Statement of profit or loss and OCI extracts	Tshs'000
Finance costs (Net interest cost (1,260 - 1,350))	90
Current service cost	800
Other comprehensive income	
Re-measurement loss on net obligations (Tshs2,965 – Tshs45)	2,920

Statement of financial position extracts	Tshs'000
Equity and liability	
Other components of equity – Re-measurements on DBO	2,920
Non-current liabilities	
Net Defined benefit obligation	3,735

Diagram 2: Summary of provisions under revised IAS 19



Cause of movement in net defined benefit liability (asset)	Provisions under IAS 19R
Service cost	Profit or loss
Interest cost on obligation and expected return on plan assets	Net interest income or expense on the net liability (asset) recognised in profit or loss
Past service cost	Profit or loss (including unvested past service cost), as part of service cost
Actuarial gains and losses/ re-measurements	Immediate recognition in OCI
Effect of asset ceiling,	Immediate recognition, partly in net interest and the remainder in OCI as part of re-measurement

3.2 Other issues

1. Business combinations

An entity may acquire another entity with assets and liabilities related to post-employment benefits. In such a case, an entity recognises assets and liabilities arising from post-employment benefits in accordance with IAS 19.

2. Reimbursements

An entity may have arrangements where another party will reimburse some or all of the expenditure required to settle a defined benefit obligation. If and only if it is virtually certain that the party will reimburse the expenditure, the right to reimbursement may be recognised as a separate asset (and not as a part of the plan asset) and measured at fair value. In all other respects (other than measurement) the asset will be treated in the same way as a plan asset. In the **statement of profit or loss**, the **related expense** may be presented **net of reimbursement**.

3. Multiple plans and offsetting

While presenting the amounts in the financial statements, the offsetting of an asset of one plan against a liability of another plan is permitted only if the entity:

b) has a legally enforceable right to use a surplus in one plan to settle obligations under the other plan; and

c) intends either to settle the obligations on a net basis

4. Curtailment

Before those amendments, IAS 19 defined the curtailment of a plan as follows:

A curtailment occurs when an entity either:

(a) Is demonstrably committed to make a **material reduction** in the **number of employees covered by a plan** or;
(b) Amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits, or will qualify only for reduced benefits.

A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan. **Curtailments are often linked to a restructuring**. A curtailment normally has an effect on the future benefit obligation.

Example

Share Ltd had a benefit plan for its employees. Under the pension plan, the pension paid was 2% of the retirement salary for each year of service. In 20X6, the entity decided that the future service by the current employees will not qualify for pension. This amounts to curtailment.

Under the revised IAS 19, the Board noted that recognising unvested past service cost immediately results in the same accounting for past service cost and curtailments. As a result, the amendments made in 2011 revised the definitions of plan amendments and curtailments.

However, because the amendments made in 2011 require immediate recognition of unvested past service costs, there is no longer any reason to make a distinction between past service cost and the second part of the definition of curtailments. Accordingly, the Board removed the second part of that definition. Consequently, past service cost will include amounts attributed to past service resulting from any plan amendment, and would be recognised immediately.

The revised definition of curtailment is as follows:

A curtailment occurs when an entity significantly reduces the number of employees covered by a plan.

Accounting treatment

The accounting for curtailments is in line with the treatment of past service cost.

5. Settlement

A **settlement arises when the** entity makes a payment to the employees covered by the plan or third party that eliminates all further liability (either legal or constructive) under the plan.

Accounting treatment

Settlement gain or loss is defined as the difference between

(a) The present value of the defined benefit obligation being settled on the settlement date, and

(b) The settlement price, including any plan assets transferred and any payments made directly by the

entity. The difference between (a) and (b) will be recognised in the profit or loss when the settlement occurs.

4. Explain the Disclosure requirements under IAS19 on Employee Benefits

[Learning outcomes d]

1. Disclosure in the statement of financial position

An entity shall recognise the net defined benefit liability (asset) in the statement of financial position

2. Disclosure in the statement of profit or loss

Paragraph 120 requires an entity to recognise service cost and net interest on the net defined benefit liability (asset) in profit or loss. This Standard does not specify how an entity should present service cost and net interest on the net defined benefit liability (asset). An entity presents those components in accordance with IAS 1 Presentation of financial statements.

3. Disclosure in the notes to the accounts

An entity shall disclose information that:

(a) Explains the characteristics of its defined benefit plans and risks associated with them);
(b) Identifies and explains the amounts in its financial statements arising from its defined benefit plans and
(c) Describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows

The detailed disclosure are discussed below

Characteristics and risks associated with defined benefit plans

(i) Information about the characteristics of the entity's defined benefit plans, including:
The nature of the benefits provided by the plan;
A brief description of the regulatory framework in which the plan operates; and
Details of any other entity's responsibilities for the governance of the plan, for example responsibilities of trustees or board members of the plan.

(ii) A description of the risks to which the plan exposes the entity, focused on any unusual, entity- specific or plan-specific risks, and of any significant concentrations of risk.

(iii) Descriptions regarding plan amendments, curtailments and settlements.

Explanation of amounts in the financial statements

Numerical reconciliation from the opening balance to the closing balance for each of the following:

(i) the net defined benefit liability (asset), showing separate reconciliations for:
  - Plan assets;
  - The present value of the defined benefit obligation; and
  - The effect of the asset ceiling; and

(ii) Any reimbursement rights (together with an explanation of the relationship between any reimbursement right and the related obligation).

For these reconciliations each of the following should be shown:

(i) Current service cost;

(ii) Interest income or expense;

(iii) Re-measurements of the net defined benefit liability (asset), showing separately:
  - The return on plan assets, excluding amounts presented as interest income;
  - Actuarial gains and losses and experience gains and losses arising from changes in demographic assumptions;
  - Actuarial gains and losses and experience gains and losses arising from changes in financial assumptions; and

- The effect of the asset ceiling limit on a defined benefit asset (together with details of how the entity determined the maximum economic benefit available, i.e. whether those benefits would be in the form of refunds, reductions in future contributions or a combination of both);

(iv) Past service cost (which includes curtailments) and gains and losses arising from settlements, which need not be distinguished if they occur together;

(v) The effect of changes in foreign currency exchange rates;

(vi) Contributions to the plan, showing separately those by the employer and by plan participants;

(vii) Payments from the plan, showing separately the amount paid in respect of any settlements; and

(viii) The effects of business combinations and disposals.

Other disclosures

(i) Numerical disclosure disaggregating the fair value of the plan assets into classes that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market and those that do not.

(ii) The fair value of the entity's own transferable financial instruments that are held as plan assets and fair value of plan assets used by the entity.

(iii) The significant actuarial assumptions used to determine the defined benefit obligation. Such disclosure is in absolute terms, i.e. as an absolute percentage

Test Yourself 5

A defined benefit plan has the following characteristics:

	Tshs'000
Present value of the obligation – 31 December 20X9	1,400
Fair value of plan assets – 31 December 20X9	1,000
Present value of the obligation – 1 January 20X9	1,050
Fair value of plan assets – 1 January 20X9	800
Unrecognised increase in the liability on initial adoption of the standard	43

Required:

Determine the amount to be disclosed in the statement of financial position with respect to the defined benefit obligation as at 31 December 20X9.

Answers to Test Yourself

Answer to TY 1

The bonus to be recognised as an expense in the year ended 30 June 20X5 is:
Tshs10 million × 5% × (100% – 10%) = Tshs.450,000.

Answer to TY 2

Amounts in Tshs'000

Step 1: Determine the salary at the time of retirement as follows:

Salary at the time of retirement = Salary of first year x (1 + Rate of salary increase) $^{\text{(No. of years of service left – 1)}}$

= Final salary at year 5 (20,000 compounded at 7%) = 20,000 x $(1 + 0.07)^4$ = 26,215

Step 2: Determine the expected pension as follows:

1% of final salary attributed to each year = 262
Expected final benefit = 5 year x 1% x 26,215 = 1,311

Step 3: Calculate the present value of the current service cost for each year of service:

Current service cost = 262 (as calculated above)

Present Value in Year 1 = Current service cost x $(1+\text{discount rate})^{(\text{No of years of service} - 1)}$
Present Value in Year 2 = Current service cost x $(1+\text{discount rate})^{(\text{No of years of service} - 2)}$
Current service cost, being present value of 262 discounted at 10%: e.g.

Year 1	$262 \times (1 + 0.1)^{-4} = 179$
Year 2	$262 \times (1 + 0.1)^{-3} = 197$
Year 3	$262 \times (1 + 0.1)^{-2} = 217$
Year 4	$262 \times (1 + 0.1)^{-1} = 238$
Year 5	262

Step 4: Determine the benefits attributed to current period and prior period as given above

Step 5: Determine the obligation for each period as given above

Step 6: Interest is to be determined on the opening obligation x Rate of interest

Benefit attributed to:	Year 1	Year 2	Year 3	Year 4	Year 5
Prior year	0	262	524	786	1,048
Current year (1% of final salary) (see step 1)	262	262	262	262	262
Current and prior years	262	524	786	1,048	1,310*
Opening Obligation		178	392	649	952
Interest at 10%		18	39	65	95
Current service cost (see step 2)	178	197	217	238	262
Closing obligation	**178**	**393**	**649**	**952**	**1,309***

* rounding error

Notes

- The opening obligation is the present value of benefit attributed to prior years.
- The current service cost is the present value of benefit attributed to the current year.
- The closing obligation is the present value of benefit attributed to current and prior years.

Answer to TY 3

	Tshs'000
Defined benefit liability as at 31/12/20Y0	6,000
Fair value of plan asset as at 31/12/20Y0	7,000
Net defined benefit liability (asset)	**(1,000)**

Net interest income (as it's an asset) is 10% of Tshs1,000 = Tshs100

Answer to TY 4

The enterprise recognises the whole amount of past service costs of Tshs246 million immediately since IAS 19 - Revised states that past service costs are to be recognised immediately, when any of the three events specified occurs:

- When restructuring costs i.e. costs related to restructuring that result in past service costs arise
- When termination benefits related to amendments that result in past service costs are recognised
- When plan amendments which result in past service costs occur

Answer to TY 5

	Tshs'000
Present value of the obligation – 31 December 20X9	1,400
Fair value of plan assets– 31 December 20X9	(1,000)
Therefore the deficit (net defined benefit liability) to be disclosed is	**400**

Quick Quiz

1. What is the definition of a defined contribution plans?
2. Explain two differences between defined benefit plans and defined contribution plans.
3. Name the items which are disclosed in the statement of profit or loss of a defined benefit plan.

Answers to Quick Quiz

1. Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

2.

Defined benefit plan	Defined contribution plan
The contribution towards the plan is variable i.e. it depends on the returns on investment, regularity of contributions paid and so on	The contribution towards the plan is fixed
The actuarial risk rests with the employer	The actuarial risk rests with the employee

3. An entity is to recognise the following amounts as expense or income in the statement of profit or loss:

   - Current service cost
   - Net interest cost
   - Past service cost

Self-Examination Questions

Question 1

The following information relates to a defined benefit plan of Crown Ltd

Plan assets at 1 January 2011	Tshs.142,500,000
Defined benefit obligation at 1 January 2011	Tshs.150,000,000
Unrecognised net actuarial loss at 1 January 2011	Tshs.30,000,000
Average remaining working life of employees at 1 January 2011	10 years
Service cost for 2011	Tshs.13,500,000
Discount rate at 1 January 2011	6%
Expected return on plan assets at 1 January 2011	Tshs.10,000,000
Re-measurement loss arising in 2011 (amended IAS 19)	Tshs2,250,000
Past service cost arising on 1 January 2011	Tshs4,500,000
Vesting period for past service cost	5 years

Required:

(a) Calculate the amounts to be presented in the statement of profit or loss and other comprehensive income.

(b) Account for the unrecognized net actuarial gains as at 1 January 2011 under the revised IAS 19

Question 2

Wildlife Adventure, a listed company, executes a funded defined benefit plan for its employees. According to the plan, the pension provided is 1% of the final salary for each year of service. The projected unit credit method is used to determine the cost for the year. This primarily incorporates actuarial assumptions regarding discount rates that are based on the market yields of high quality corporate bonds.

Twelve years is the expected average remaining working life of Wildlife Adventure's employees. The following information has been provided by the directors about the defined benefit plan for the year ended 31 December 20X5:

(i) During the year ended 31 December 20X5, the actuarial cost of providing benefits in respect of employees' service was Tshs32 million which is the present value of the pension benefits earned by the employees in the year.

(ii) Former employees were paid Tshs33 million pension benefits during the year.

(iii) Wildlife Adventure's contributions due to the fund were Tshs22 million; however, because of cash flow problems, Tshs6 million had not been paid by 31 December 20X5.

(iv) For current and former employees the present value of the obligation to be provided is:

	31 December 20X4	31 December 20X5
	Tshs million	Tshs million
Present value of obligation (based on actuarial valuation)	2,400	2,700
Fair value of the plan assets (based on the market value)	2,320	*2,356

* - Figure includes contributions owed by Wildlife Adventure

(v) On 1 January 20X5, the company amended the plan and the employees were now provided with an increased pension entitlement having a present value of Tshs100 million. Out of the Tshs100 million, Tshs80 million vest immediately and remaining Tshs20 million are non-vested. These benefits will vest over a period of 3 years.

(vi) Discount rate used to calculate net interest cost is 10%.

Required:

Under IAS 19 Employee Benefits, determine the amounts that will be recognised in the financial statements of Wildlife Adventures for the year ended 31 December 20X5.

(In your calculations ignore any deferred taxation effects, assume that pension benefits and the contributions paid were settled at 31 December 20X5 and show the changes in the present value of the obligation and the fair value of the plan assets during the year).

Answers to Self Examination Questions

Answer to SEQ 1

(a) The following amounts will be recognised in the statement of profit or loss and other comprehensive income:

	Tshs'000
Current service cost	13,500
Net interest cost (6% of (Tshs150,000 - Tshs142,500))	450
Past service cost	4,500
Net cost for the year recognised in profit or loss	**18,450**
Other comprehensive income	
Re-measurements recognised in OCI	2,250
Net cost for the year recognised in total comprehensive income	**20,700**

(b) Treatment of unrecognised actuarial gains

In accordance with Para 173 of IAS 19, the standard needs to be applied retrospectively. Thus Crown Ltd may recognise previously unrecognised actuarial gains and losses and past service cost by adjusting equity, instead of by allocating part of those adjustments against the carrying amount of plan assets.

Answer to SEQ 2

Extracts of statement of financial position

	31/12/20X4 Tshs million	31/12/20X5 Tshs million
Present value of obligation	2,400	2,700
Fair value of plan assets (2,536-6)	(2,320)	(2,530)
Net defined benefit obligation	**80**	**170**

Extracts of statement of profit or loss and other comprehensive income for year ended 31 December 20X5

	Tshs million
Current service cost	32
Net interest cost – W1	8
Past service cost - W3	100
Net Expense in profit or loss	**140**
Other comprehensive income	
Re-measurements costs – W2	50
Net expenses recognised in total comprehensive income	**190**

Workings

W1 Net interest cost

10% of opening net liability or asset = 10% of (Tshs.2,400 – Tshs2,320) = Tshs8 million

Re-measurements

Plan assets	Tshs. million
Fair value of plan assets – 1 January 20X5	2,320
Return on plan assets (10% of Tshs2,320)	232
Contributions for the period	22
Benefits paid during the year	(33)
Expected fair value of plan assets - 31 December 20X5	2,541
Fair value of plan assets – 31 December 20X5	2,530
Re-measurements recognised in OCI in respect of plan assets	**11**

The fair value of the plan assets is (2,536 – 6) I.e. net of contributions not paid.

Defined benefit obligation	Tshs million
Defined benefit obligation - 1 January 20X5 (based on actuarial valuation)	2,400
Interest cost (10% of Tshs2,400)	240
Current service costs	32
Benefits paid during the year	(33)
Expected obligations on 31 December 20X5	2,639
Defined benefit obligation - 31 December 20X5 (based on actuarial valuation)	2,700
Re-measurements recognised in OCI in respect of defined benefit obligation	**61**

Net re-measurement loss during the year = Tshs61 million - Tshs11 million = Tshs50 million

W3 Past service cost

Tshs100 million will be recognised immediately as past service costs in the statement of profit or loss irrespective whether benefits vested or non-vested. This is in accordance with the revised IAS 19.

SECTION B

REPORTING THE FINANCIAL PERFORMANCE OF ENTITIES

B2

STUDY GUIDE B2: INCOME TAXES

Get Through Intro

The name of this Study Guide 'income taxes'; does not mean that having an income is taxing! Understanding this Study Guide will help you become familiar with concepts like deferred tax assets, deferred tax liabilities, temporary differences, permanent differences etc.

What is the meaning of these words? Deferred tax means future tax asset or liability. The need for deferred tax accounting arises because of differences in financial accounting and calculations for taxation purposes. For example, the rate of depreciation for financial accounting and taxation purposes may be different.

Some differences are temporary and some are permanent. For example, an asset costing Tshs20 million is depreciated (on a straight line basis) at 20% in the financial accounts and at 100% in taxation accounts. The table given below shows how the difference of Tshs4 million in the carrying value (hence in the profits since the depreciation will be different) at the end of Year 1. This is reduced to zero by the end of year 5. Hence this difference is only temporary

Carrying Value	For financial accounting	For taxation accounting	Difference in total carrying value
	Tshs'000	Tshs'000	Tshs'000
Year 1	16,000	20,000	(4,000)
Year 2	12,000	-	12,000
Year 3	8,000	-	8,000
Year 4	4,000	-	4,000
Year 5	-	-	-

However, think of a penalty paid by a company. Penalty will be shown as an expense in financial accounts but will never be allowed in taxation accounts. Hence, this difference is permanent.

A deferred tax liability is the amount of income tax payable in future periods in respect of temporary tax differences. A deferred tax asset is the amount of income tax receivable in future periods in respect of deductible temporary tax differences.

This Study Guide discusses the recognition and measurement of deferred tax assets and liabilities. This knowledge will enable you to recognise deferred tax assets and liabilities for your company correctly. This will provide a more accurate picture of the accrual earnings and equity position of the company.

Learning Outcomes

a) Apply and discuss the recognition and measurement of deferred tax liabilities and deferred tax assets.
b) Determine the recognition of tax expense or income and its inclusion in the financial statements.

1. Apply and discuss the recognition and measurement of deferred tax liabilities and deferred tax assets.

[Learning Outcome a]

IAS 12 deals with taxes on income (current as well as deferred tax). Current tax is a tax related to the current year whereas deferred tax is a matching accounting tool, used to correct the mismatch between accounting and taxation figures.

Recognition of deferred tax is based on the principle that when an asset or liability is recognised, it is obvious that the entity will recover or settle the carrying amount of that asset or liability. If as a result of such recovery or settlement of the carrying amount, future tax payments get affected, IAS 12 requires that in order to ensure the matching principle, the entity should recognise a deferred tax liability / deferred tax asset when the related asset or liability is recognised.

The calculation of deferred tax liabilities and assets is based on temporary difference that is taxable and deductible. These concepts are discussed in detail in Paper B2 Financial Accounting. This is just a revision.

Definition

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences may be either:

a) Taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

b) Deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Accounting profit is profit or loss for a period before deducting tax expense.

IAS 12, Para 5

1.1 Temporary differences

Accountants base their figures on generally accepted accounting principles and standards, whereas the calculation of taxable profits is based on the applicable tax laws. There could be a difference between the two figures. The word ‘temporary’ indicates that the differences arise in one accounting period and reverse in another. For example, expenses charged in the accounts on an accrual basis but allowable in taxation only on a payment basis, which happens in a different accounting period.

1.2 Difference that is not temporary (i.e. not reversible)

There are some differences between accounting and tax incomes which never reverse. Consider the example of a fine or penalty. This expense **will never be allowed** as a deduction in the calculation of taxable profits, although it is treated an accounting expense. Similarly, unimpaired goodwill is never deductible for tax purposes. These differences do not give rise to recognition of deferred tax asset or liability. In some countries, these differences are called **permanent differences.**

Tip

As a principle, always remember that if an entity expects to recover the carrying amount of an asset or settle the carrying amount of a liability without affecting taxable profit, no temporary difference (deferred tax) arises in respect of the asset or liability. In that case, carrying amount = tax base.

1.3 Tax base

The tax base of an asset or liability is the **amount attributed to it for tax purposes.**

1. For assets

(a) In **the case of expenses**, the **tax base** is the amount that will be **deductible for tax purposes** from the taxable economic benefits flowing to the entity when it recovers the carrying amount of an asset. The carrying amount of an asset can be recovered by using the asset or selling it.

(b) **In the case of income**, the **tax base** is the amount that will **NOT** be **taxable in future,** when the carrying amount of an asset is recovered.

(c) If there is a carrying value of an asset which is **not taxable in future**, its carrying value will be treated as a tax base.

2. For liabilities

(a) **Payables**: the tax base will be the carrying amount of the liability less the amount deductible for tax purposes against that liability in future.

(b) **Income received in advance**: the tax base is the carrying amount, less any amount of revenue that will NOT be taxable against that item in future.

Tip

Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which IAS 12 is based: that an entity shall, with certain limited exceptions, recognise **a deferred tax liability (asset)** whenever recovery or settlement of the carrying amount of an asset or liability **would make future tax payments larger (smaller**) than they would be if such recovery or settlement were to have no tax consequences.

1.4 Temporary difference

1. Taxable temporary differences

These are the temporary differences that result in lower taxable profits than accounting profits in the current or earlier periods. Being temporary, they will reverse in the future. On reversal, in future, taxable profits will be higher than accounting profits.

Since the TTD are subject to **tax in the future** they are called as **taxable differences.**

(a) Assets

For assets, a taxable temporary difference occurs when depreciation or amortisation is accelerated for tax purposes.

Example

The cost of an asset is Tshs100 million. For the first year, accounting depreciation is Tshs16 million while tax depreciation is Tshs25 million. The accounting profit will be Tshs9 million (Tshs25 million – Tshs16 million) higher than taxable profit.

The carrying amount of an asset is Tshs84 million. **In future,** the entity will **earn taxable income and recover this carrying amount.** When it does so, for tax purposes it can deduct only Tshs75 million (Tshs100 million – Tshs25 million), the tax base, on which depreciation is yet to be allowed.

On the difference of Tshs9 million, it will have to pay tax, i.e. it is a taxable difference.

(b) Liabilities

If a particular liability has already been allowed as a deduction for tax purposes but has not been deducted in the accounts, a taxable temporary difference occurs. This situation is seen less frequently in real life.

Example

Peanut Co incurred development costs during the year and recognised them as an intangible asset. They are to be amortised in the accounts over 10 years. However, for tax purposes, they are deducted fully when incurred.

Since the timing of recognition is different, it gives rise to temporary difference. For tax purposes, the development costs are deducted fully when incurred.

In later years, when the accounts show expenditure by way of amortisation, the expenditure will not be allowed again for tax purposes. As a result, taxable profit will be more in future and therefore this is a temporary taxable difference.

Example

An entity records a loan at the proceeds received, net of transaction costs. The transaction costs are deducted in the first period to calculate taxable profits. They are amortised gradually in accounts, thereby increasing the carrying amount of the loan.

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2. Deductible temporary differences

This situation is the **reverse of taxable temporary differences.** Taxable temporary differences result in higher taxable profits in future whereas deductible temporary differences result in lower taxable profits in future.

In other words, these differences are **deductible in future** for taxation purpose therefore **deductible differences.**

The following are examples of situations when deductible temporary difference arises.

(a) Assets

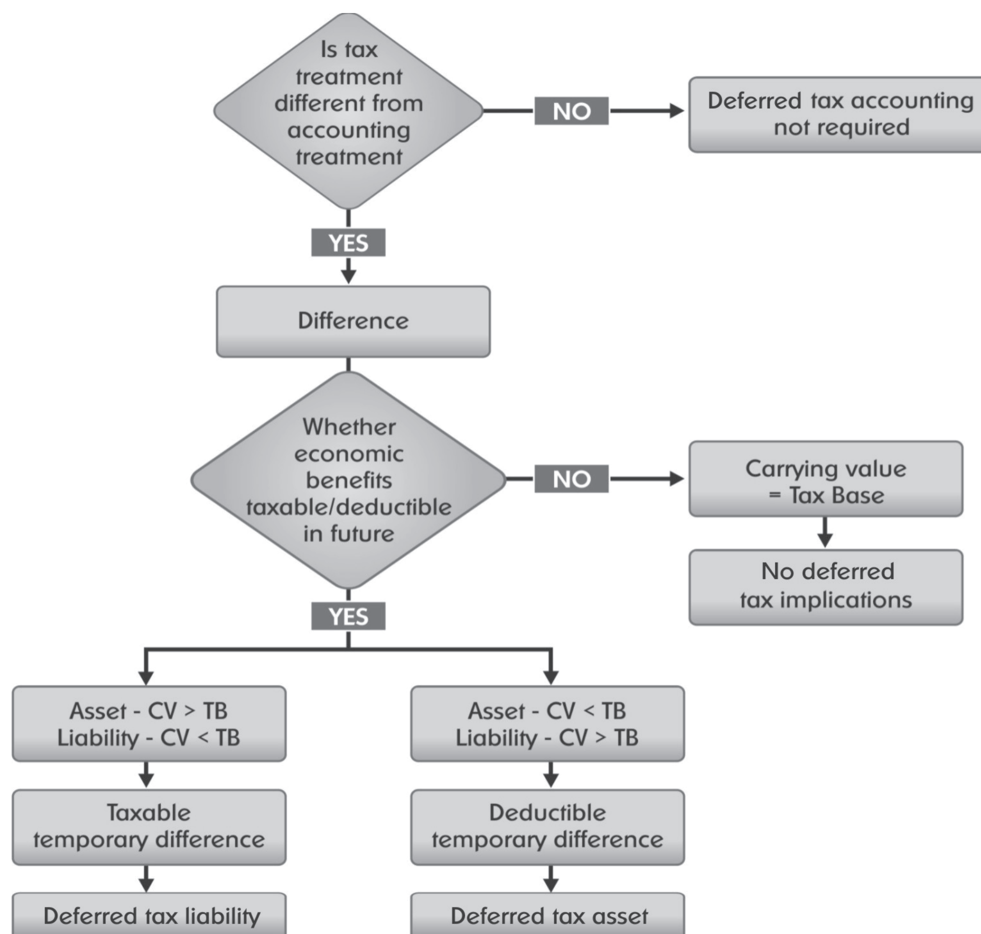
In some jurisdictions, the depreciation rate for accounting purposes may be at a higher rate than that specified in the tax laws.

(b) Liabilities

In some jurisdictions, certain amounts of expenses are deductible from income only on a payment basis. If a liability has been deducted for accounting purposes but not for tax purposes, it would create a deductible difference.

Summary of deferred tax effects

Diagram 1: Determination of deferred tax asset and liability



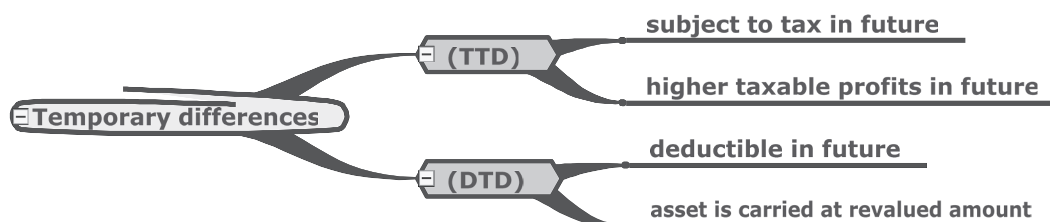
Test Yourself 1

Si Company obtained a loan of Tshs15m, with transaction costs of Tshs0.30m. Full transaction costs of Tshs0.30m are deducted from taxable profits in the first year. They are amortised in the accounts at 20% per year.

Required:

Determine the temporary difference and state whether it is taxable or deductible.

SUMMARY



1.5 Meaning and calculation of deferred tax assets and liabilities

IAS 12 uses the SOFP approach, which means when an asset or liability is recognised. If its recognition has an impact for taxation purposes, the tax consequences of the item should also be recognised. This ensures adherence to the matching principle.

Definition

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

1. Deductible temporary differences
2. The carry-forward of unused tax losses
3. The carry-forward of unused tax credits

IAS 12, Para 5

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1. Deferred tax liabilities and assets

All taxable temporary differences give rise to deferred tax liabilities and all deductible temporary differences give rise to deferred tax asset, except in the following cases:

> These exceptions are discussed in detail at a later stage in this Study Guide

1. The initial recognition of goodwill
2. The initial recognition of an asset or liability in a transaction which

(a) Is not a business combination; and
(b) At the time of the transaction affects neither accounting nor taxable profit (tax loss)

However, deferred tax assets are to be recognised **only to the extent it is probable that taxable profits will be available** against which the deductible temporary differences can be used.

If, as a result of recognition of an item in the accounts, the amount of tax payable in the future is higher than it would be if such recovery or settlement were to have no tax consequences, it will give rise to a taxable temporary difference. The obligation to pay the resulting income taxes in future periods is a deferred tax liability. A corresponding amount is to be recognised as an expense.

On the other hand, if as a result of recognition of any item, future taxable profits are lower than accounting profits this would give rise to a deductible temporary difference and hence a deferred tax asset.

A **deferred tax asset is recognised**, giving rise to deferred tax income. This deferred tax income will nullify the extra amount in the current tax expense. In future, when the related profit is recognised, this deferred tax asset should be transferred to tax expense.

Example

The following details are for a comprehensive example for the year ended 30 September 20X5 which is also the reporting date of Lingo Ltd:

1. The accounting profit includes accrued interest receivable of Tshs80 million which will be included in the taxable profit when cash is collected.

2. A development cost of Tshs160 million was incurred. These expenses were capitalised and are to be amortised over future periods while calculating the accounting profit. However, for determining the taxable profit for 20X4-05 the amount is deducted.

3. A provision for retirement benefits of Tshs32 million is made (unpaid on the reporting date) for determining accounting profits. The amount is deductible for tax purposes when payment of the contributions is made.

4. Research costs of Tshs19.20 million are recognised as an expense for determining accounting profits. Under local tax laws the amount is deductible on fulfilment of certain conditions in future.

Lingo's management wants you to calculate the tax base, temporary difference and deferred tax asset or liability (Assume a tax rate of 30%) for each item.

Give the accounting entries for the tax adjustments.

Continued on the next page

Answer

Step 1: Calculate tax base

1. As the revenues do not affect taxable profit until cash is collected, the tax base of any receivable recognised in the statement of financial position with respect to such revenues is nil.
2. The development costs have already been deducted from taxable profit so have a tax base of nil.
3. The carrying amount of retirement benefits is Tshs32 million and the amount deductible in future isTshs32 million. Therefore the tax base of retirement benefits is nil (Tshs32 million - Tshs32 million).
4. The taxation authorities will permit the amount of the research costs to be deducted in future periods giving rise to a tax base Tshs19.20 million.

Step 2: Calculate and determine the type of temporary differences: (Carrying value – Tax base)

1. Tshs.80 million — Nil = (Tshs.80 million); taxable temporary difference
2. Tshs.160 million — Nil = (Tshs.160 million); taxable temporary difference
3. Tshs.32 million — Nil = Tshs.32 million; deductible temporary difference
4. Nil — Tshs.19.20 million = Tshs.19.20 million; deductible temporary difference

It may help if you regard assets as positive and liabilities as negative to determine either positive (taxable) or negative (deductible) TDs

Step 3: Calculate deferred tax asset / liability:

1. (Tshs.24 million) (i.e. Tshs.80 million x 30%) deferred tax liability
2. (Tshs.48 million) (i.e. Tshs.160 million x 30%) deferred tax liability
3. Tshs.9.6 million (i.e. Tshs.32 million x 30%) deferred tax asset
4. Tshs.5.76 million (i.e. Tshs.19.20 million x 30%) deferred tax asset

Step 4: Accounting entries

Dr Deferred tax expense	Tshs72 million	
Cr Deferred tax liability		Tshs72 million
Being the entry to record the deferred tax liability on the taxable temporary differences. (Tshs24 million + Tshs48 million)		
Dr Deferred tax asset	Tshs15.36 million	
Cr Deferred tax expense		Tshs15.36 million
Being the entry to record the deferred tax asset on the deductible temporary differences (Tshs9.60 million + Tshs5.76 million)		

Step 5: Presentation in the financial statements

Extract from statement of financial position

	Tshs. million
Non-current liability Deferred tax liability (net) (Tshs72 million – Tshs15.36 million)	56.640

Note: the DTL is shown net assuming that the criteria for set off are met.

Extract from statement of profit or loss and OCI

	Tshs. million
Tax expenses (Tshs72 million – Tshs15.36 million)	56.64

1.6 Measurement of deferred tax assets and liabilities

1. Measurement shall be **at the tax rates expected to apply** to the period when the asset is realised or liability is settled.

2. The rates used shall be those **enacted or substantially enacted by the end of the reporting period.**

3. Measurement **depends upon the expectations about the manner** in which the recovery of tax asset or settlement of tax liability will take place.

4. Normally, if an asset or liability to be realised / settled in future is recognised today, its discounted value should be considered. **However, in the case of deferred tax assets and liabilities, IAS 12 specifically lays down that the values are not to be discounted**.

Example

Straw Co has an asset with a carrying amount of Tshs100 million and tax base of Tshs60 million. According to the local laws, a tax rate of 20% is applicable to receipt arising from sale of asset and 30% is applicable to other income.

In this case, the company would require recognition of a deferred tax liability. However, the rate to be used depends upon the manner in which management wishes to recover the carrying value of the asset. This means that if management decides to sell the asset, the deferred tax liability will be Tshs8 million (Tshs40 million x 20%). On the other hand, if management wishes to recover the amount by using the asset, the amount of liability will be Tshs12 million (Tshs40 million x 30%).

1.7 Deferred tax assets against unused tax losses and unused credits

In addition to the deductible temporary differences, deferred tax assets may also be recognised in respect of the following:

The carry-forward of unused tax losses and
The carry-forward of unused tax credits

The DTA should always be recognised only to the extent probable that taxable profit will be available against which the above losses or credits can be utilised.

From the profits earned in future, the amounts of unused tax losses and unused tax credits will be deducted for the calculation of taxable profits. As a result, the possible **taxable profits to be earned in future will be reduced**. Therefore deferred tax assets should be recognised which can be settled in future. It is the same as there being a **tax asset today that** will be set off against the future tax liability.

IAS 12 advises a cautious approach towards such deferred tax assets since the existence of unused tax losses is strong evidence that future taxable profits may not be available.

Example

Zorium Tempo Co has unused tax losses of Tshs300 million. It expects to earn taxable profits in future and set off these losses. The tax rate applicable is 30%.

It can recognise a deferred tax asset for Tshs90 million (Tshs300 million x 30%) only if there is evidence that future taxable profits will be available to offset the loss. In addition to this, it will also have to disclose the nature of the evidence in the financial statements.

If Zorium expects to earn taxable profits in the future to set-off losses only to the extent of Tshs200 million, a deferred tax asset for only Tshs60 million (Tshs200 million x 30%) will be recognised.

The carrying value of deferred tax asset shall be reviewed at the end of each reporting period. If appropriate, the value should be reduced. This reduction may be reversed in future if the situation changes.

Example

Continuing with the example of Zorium Tempo Co

If, at the end of the reporting date, Zorium expects to earn taxable profits in future to set-off losses only to the extent of Tshs150 million, a deferred tax asset for only Tshs45 (Tshs150 million x 30%) will be recognised and Tshs15 million (Tshs60 million - Tshs45 million) should be reversed.

Re-assessment of unrecognised tax assets

Deferred tax is not recognised initially if it does not satisfy the general conditions for recognising an asset. However, this is to be reviewed at **the end of each reporting period**; and, if it has become probable that the future economic benefits will allow deferred tax assets to be recovered, then the asset is recognised.

This is also applicable to the losses and the credit carried forward in business combinations. This is discussed in 1.11 below.

1.8 Presentation of deferred tax

(a) Expenses / income

(i) In the statement of profit or loss: unless the following paragraph applies, or the tax arises from a business combination, both current and deferred taxes are to be **treated as an expense / income** and included in the calculations of profit or loss for the period i.e. recognised in the statement of profit or loss.

(ii) In the statement of financial position (under equity): if the tax relates to **items that are credited or charged**, in the same period or a different period, directly **to equity,** current tax and deferred tax shall **also be charged or credited directly to equity.**

(b) Assets and liabilities

(a) Deferred tax assets and deferred tax liabilities shall be disclosed **separately**.

(b) Offset of deferred tax assets and liabilities against each other is permitted **if and only if:**

(i) The entity has a legally enforceable right to set off the amounts.
(ii) Both relate to income taxes levied by the same taxation authority; either

- On the same taxable entity; or
- On different entities that intend to settle the net amount or to realise / settle the asset / liability at the same time.

Example

Continuing the example of Zorium Tempo Co

In addition to the deferred tax asset of Tshs60 million, Zorium Tempo Co has deferred tax liabilities of Tshs90 million.

If it has a legally enforceable right to set off the amounts it can disclose the net amount as Tshs30 million (Tshs90 million – Tshs60 million) in the statement of financial position only.

1.9 Disclosures

1. IAS 12 requires the following disclosures

(a) Major components of tax expense or income are to be **disclosed separately**. Generally, the major components would include the following:

(i) Current tax expense or income
(ii) Any adjustments to **current tax or prior years** recognised during the reporting period
(iii) Deferred tax expense resulting from origination or reversal of **temporary differences**
(iv) Deferred tax expense resulting from **changes in tax rates and imposition of new taxes**
(v) Benefit arising from previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce:
- Current tax expense; or
- Deferred tax expense

(b) Deferred tax expense or income resulting from **write-down** or **reversal of previous write-down** of a deferred tax asset.

(c) Tax expense or income resulting from **changes in accounting policies and errors** that is included in statement of profit or loss in accordance with IAS 8.

2. Specific disclosures for deferred tax asset

An entity shall disclose the **amount** of a deferred tax asset and **the nature of the evidence supporting its recognition**, when:

(a) The utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences.

(b) The entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

1.10 Exception to the recognition rule

As discussed earlier, in the following situations temporary differences do not give rise to deferred tax assets / Liabilities. A deferred tax liability need not be recognised for:

(a) The initial recognition of goodwill
(b) The initial recognition of an asset or liability in a transaction which:

(i) Is not a business combination; and
(ii) At the time of the transaction affects neither accounting nor taxable profit (tax loss)

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognised. This is discussed separately in paragraph 1.12.

(a) Goodwill

Goodwill arising in a business combination is measured as the excess of the cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. Taxation authorities in many jurisdictions do not allow reductions in the carrying amount of goodwill as a deductible expense in determining taxable profit. Moreover, the cost of goodwill is often not deductible when a subsidiary disposes of its underlying business. Therefore, in all these cases, goodwill has a tax base of nil.

Any difference between the carrying amount of goodwill and its tax base of nil is a taxable temporary difference. However, **IAS 12 does not permit the recognition of the resulting deferred tax liability**. The recognition of the deferred tax liability would increase the carrying amount of goodwill because goodwill is measured as a residual. Again the increase in goodwill would create an additional deferred tax liability! This would be an unending spiral.

The prohibition on recognising the deferred tax liability or change in that liability applies **to subsequent reductions in a deferred tax liability** that is unrecognised because it arises from the initial recognition of goodwill.

Example

In a business combination, if goodwill acquired is Tshs50 million and has a tax base of nil, the entity is prohibited from recognising the resulting deferred tax liability. If there is a subsequent impairment loss of Tshs10 million which is recognised for goodwill, then the amount of the taxable temporary difference relating to the goodwill is decreased from Tshs50 million to Tshs40 million, with a resulting decrease in the value of the unrecognised deferred tax liability. This decrease in the value of the unrecognised deferred tax liability is also prohibited from recognition as it is also relating to the initial recognition of the goodwill.

However, to the extent they do not arise from the initial recognition of goodwill, deferred tax liabilities for taxable temporary differences relating to goodwill are recognised. Where goodwill is tax deductible, subsequent to initial recognition, new temporary differences may arise due to interaction between tax deductions claimed and impairments, if any.

Example

Assume that, in a business combination, goodwill acquired is Tshs50 million and for tax purposes it is deductible at a rate of 20% per annum from the date of acquisition. On initial recognition, the tax base of the goodwill is Tshs50 million and Tshs40 million at the end of the year of acquisition. If, at the end of the acquisition year, the carrying amount of goodwill remains unchanged at Tshs50 million, a taxable temporary difference of Tshs10 million arises at the end of that year. Since the taxable temporary difference in the above example does not relate to the initial recognition of the goodwill (the difference is due to change in the tax base), the resulting deferred tax liability is recognised.

(b) Initial recognition of an asset or liability

A temporary difference may arise on initial recognition of an asset or liability. Recognition of temporary difference depends upon the circumstances giving rise to the asset or liability.

(i) In a business combination, an entity recognises any deferred tax liability or asset and this affects the amount of goodwill (positive or negative). This is dealt with in paragraph 1.11.
(ii) If the transaction affects either accounting profit or taxable profit, an entity recognises any deferred tax liability or asset and recognises the resulting deferred tax expense or income in the statement of profit or loss.

Example

Some tax authorities do not tax the gain or loss on disposal of an equity investment; the tax base of such an investment is therefore zero.

If the transaction does not relate to any of the above two cases, no deferred tax is recognised.

IAS 12 specifically states that the above prohibition on recognising a deferred tax asset or liability also applies to a deferred tax asset arising on initial recognition of an asset when there is a non-taxable government grant related to the asset. The grant is not treated as taxable income but is either deducted from the carrying amount or treated as deferred income. In either case, the prohibition applies.

Example

Initial recognition of an asset

Garry Ltd purchases an asset with a useful life of 5 years at a cost of Tshs500 million, with an intention to use it throughout its useful life and then dispose of it for a nil residual value. The tax rate is 40%. For tax purposes, depreciation of the asset is not deductible. Capital gain or loss, if any, would not be taxable on disposal. Garry Ltd recovers the carrying amount of the asset so it earns a taxable income of Tshs500 million and pays Tshs200 million in tax. Garry Ltd does not recognise the resulting deferred tax liability of Tshs200 million as it results from the initial recognition of the asset.

In the subsequent year, the carrying amount of the asset is Tshs400 million. In earning taxable income of Tshs400 million, the entity will pay tax of Tshs160 million. Garry Ltd does not recognise the deferred tax liability of Tshs160 million as it results from the initial recognition of the asset.

1.11 Deferred tax arising from a business combination

1. Initial recognition

Deferred tax accounting is required when the identifiable assets acquired and liabilities assumed in a business combination are recognised at their fair values in accordance with IFRS 3 Business Combinations, but no equivalent adjustment is made for tax purposes. Such resulting deferred tax assets (to the extent that they meet the recognition criteria) or deferred tax liabilities as a result of business combination should be recognised as identifiable assets and liabilities at the acquisition date. This affects the net assets taken over and, therefore, the goodwill or gain on bargain purchase amount.

Example

Alpha Co acquired 100% share capital of Beta Co on 1 January 20X9. The carrying amount and fair value of assets as on the date of acquisition was as follows:

	Fair value on acquisition date	Carrying values	Change
	Tshs'000	**Tshs'000**	**Tshs'000**
Land	60,000	50,000	10,000
Plant and equipment	110,000	90,000	20,000
Inventory Brand	16,000	20,000	(4,000)
name Contingent	4,000	-	4,000
liability	(5,000)	-	(5,000)
	185,000	**160,000**	**25,000**

Fair values of the assets and liability as on the acquisition date are more by Tshs25 million. This gives rise to deferred tax, as for income tax purposes the values will remain Tshs160 million. Since carrying values are higher by Tshs25 million, a deferred tax liability will be recognised on acquisition. Assuming the tax rate to be 20%, deferred tax asset will be Tshs5 million.

Reassessment of unrecognised tax assets

The provision of reassessment of unrecognised tax assets is also applicable to the losses and credits carried forward in the business combinations. An entity shall recognise acquired deferred tax benefits that it realises **after the business combination** as follows:

> Acquired deferred tax benefits recognised within the measurement period that result from new information about **facts and circumstances that existed at the acquisition date** shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in the statement of profit or loss.
>
> All other acquired deferred tax benefits realised shall be recognised in the profit or loss, except where they are required to be recognised in other comprehensive income or directly in equity.

2. Intra-group transactions

Deferred tax liability / asset arises when unrealised losses / profits resulting from intra-group transactions are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

Example

A parent company sold inventory to its subsidiary, costing Tshs1 million after adding a profit of Tshs.0.10 million. The subsidiary held the inventory at the reporting date. This unrealised profit will be eliminated in the consolidated financial statements. However, such adjustments are not made for taxation purposes. This creates a deductible difference. Assuming the tax rate as 30%, a deferred tax asset of Tshs.30,000 (Tshs100,000 x 30%) is created.

Note: IAS 12 uses the SOFP approach, which means whenever you recognise an asset or liability; you should recognise the tax consequences of the item. As a result, for each transaction having at least one effect on an SOFP related account, a temporary difference would arise.

This means that if, for a transaction, both effects are in respect of statement of profit or loss related accounts, then there is no impact on net profit or loss and therefore there will be no temporary difference.

Tax rate to be applied to the temporary differences related to unrealised intra-group profits and losses in consolidated financial statements.

IAS 12 is silent on this issue. However, it is thought that the acquirer's tax rate would be more appropriate.

3. Anticipated intra-group dividends in future periods

Dividends are recognised in the books of paying and receiving entities only after they have been declared. The question that arises is whether the tax consequences need to be provided for the retained profits. An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both the following conditions are satisfied:

a) The parent, investor or venturer is able to control the timing of reversal of the temporary difference; and
b) It is probable that the temporary difference will not reverse in the foreseeable future.

4. Deferred tax recognition in the separate financial statements may be different from that in the consolidated financial statements

The measurement and presentation of elements in the consolidated financial statements may be different from the measurement and presentation in the separate financial statements. Accordingly, the effect on deferred tax may be different. The following example will clarify this.

Example

On 1 July 20X4, Needle Co acquired a wholly owned subsidiary, Tweedle Co, for a sum of Tshs480 million. Tweedle uses a functional currency different from that of Needle and is located in a tax jurisdiction of 30% while Needle is located in a tax jurisdiction of 40%. The following table (in accordance with the provisions as set out in IAS 12 which does not advocate any deferred tax to be recognised on goodwill) sets out the fair value of the identifiable assets and liabilities, with the exception of deferred tax assets and liabilities of Tweedle which were acquired by Needle plus Tweedle's tax base and the resulting temporary differences.

	Tshs million		
	Fair value	Tax base	Taxable / deductible temporary differences
Tangible fixed assets	216.0	124.0	(92.0)
Receivables	168.0	168.0	0.0
Inventory	139.2	99.2	(40.0)
Retirement benefit obligations	(24.0)	0.0	24.0
Payables	(96.0)	(96.0)	0.0
Fair value of assets acquired excluding deferred tax	403.2	295.2	(108.0)
Deferred tax	(43.2)		
Fair value of identifiable net assets acquired	360.0		
Goodwill (balance)	120.0		
Total cost of combination	480.0		

As on the date of the combination, no temporary differences are to be associated with Needle's investment in Tweedle, either in the consolidated financial statement or in separate financial statements. The consolidated financial statements would represent the investment in the net assets of Tweedle and the goodwill of Tshs120 million while the separate financial statements of Needle would carry the investment at a cost of Tshs480 million.

During the twelve months ended 30 June 20X5, Tweedle reported an after tax profit in Needle's consolidated financial statements of Tshs120 million. Of this amount, Tshs64 million was paid as dividend after deducting withholding tax thereby leaving a net profit of Tshs56 million as on 30 June 20X5. The **consolidated financial statements** of Needle reported a net loss of Tshs12 million on retranslating Tweedle's opening net assets and profit to the closing exchange rate reported for in accordance with IAS 21. Needle's consolidated financial statements also report an impairment loss of Tshs8 million in accordance with IAS 36.

Continued on the next page

After the above transactions were entered into, the carrying value of Needle's investments is changed according to the following:

	Tshs million
Opening net assets and goodwill	480
Retained profit	56
Exchange loss	(12)
impairment of goodwill	(8)
Closing net assets and goodwill	**516**

If we were to assume that the tax base in Needle's jurisdiction was to remain Tshs480 million (i.e. Needle's investment in Tweedle, a taxable temporary difference of Tshs36 million (Tshs516 million - Tshs480 million), Needle would be required to make appropriate disclosures in relation to deferred tax irrespective of whether provision is made for this purpose or not.

The amount of temporary differences in **Needle's financial statements** would depend upon its accounting policies and procedures. IAS 27 revised allows organisations to account for investments in group companies at cost less impairment or fair value.

Suppose that, in spite of the impairment of goodwill required to be recognised in the consolidated financial statements, Needle's investment in Tweedle as a whole is not impaired and its fair value is also Tshs528 million (Tshs516 million + Tshs12 million) as on 30 June 20X5.

If Needle were to account for its investment at a cost of Tshs480 million in its separate financial statements, the carrying amount as well as the tax base would both be Tshs480 million resulting in no temporary differences associated with Tweedle being recorded in Needle's separate financial statements.

On the other hand, if Needle were to account for its investment in Tweedle in its separate financial statements at fair value of Tshs528 million, a taxable temporary difference of Tshs48 million (Tshs528 - Tshs480) associated with Tweedle would arise. As mentioned before, Needle would be required to make appropriate disclosures in relation to this difference irrespective of whether provision is made for deferred tax or not.

Example

Business combination

Bubble Boo acquired 100% of the shares of Doddle Doo on 1 June 20X6 for a consideration of Tshs180 million. At the acquisition date, Bubble Boo's investment in Doddle Doo had a tax base of Tshs180 million in Bubble Boo's tax jurisdiction. For tax purposes, the decrease in the carrying amount of goodwill and the cost of goodwill are not deductible if Doddle Doo disposes of its underlying business.

	Tax rate
in Bubble Boo's tax jurisdiction	30%
in Doddle Doo's tax jurisdiction	40%

The following table shows the fair value of the identifiable assets acquired and liabilities assumed (excluding deferred tax assets and liabilities) by Bubble Boo with their tax bases in Doddle Doo's tax jurisdiction and the resulting temporary differences.

	Acquisition cost	Tax base	Temporary difference
	Tshs million	Tshs million	Tshs million
Property plant and equipment	81.0	46.5	34.5
Accounts receivable	63.0	63.0	-
Inventory	52.2	37.2	15.0
Retirement benefit obligations	(9.0)	-	(9.0)
Accounts payable	(36.0)	(36.0)	-
Fair value of the identifiable assets acquired and liabilities assumed, excluding deferred tax	151.2	110.7	40.5

Continued on the next page

The deferred tax asset arising from the retirement benefit obligations is set off against the deferred tax liabilities which arise from the property, plant and equipment and inventory.

For the cost of goodwill in Doddle Doo's jurisdiction, no deduction is available so the tax base of the goodwill in Doddle Doo's jurisdiction is nil. Bubble Boo does not recognise a deferred tax liability for the taxable temporary difference associated with the goodwill in Doddle Doo's tax jurisdiction.

The following is the carrying amount in Bubble Boo's consolidated financial statements, of its investment in Doddle Doo:

	Tshs. million
Fair value of identifiable assets acquired and liabilities assumed excluding deferred tax	151.2
Deferred tax liability	(16.2)
Fair value of identifiable assets acquired and liabilities assumed	135.0
Goodwill	45.0
Carrying amount	**180.0**

As at the date of acquisition in Bubble Boo's jurisdiction, the tax base of its investment in Doddle Doo is its cost of Tshs180 million and no temporary difference is associated with the investment in Bubble Boo's tax jurisdiction. The changes in Doddle Doo's equity during 20X6 as follows:

	Tshs. million
At 1 June 20X6	135
Retained profit for 20X6-X7 (net profit of Tshs45 million, less dividend payable of Tshs24 million)	21
At 31 May 20X7	156

Bubble Boo recognises a liability for any withholding tax or other taxes that it will incur on the accrued dividend receivable of Tshs24 million.

The carrying amount of Bubble Boo's underlying investment in Doddle Doo excluding the accrued dividend receivable is as follows:

	Tshs. million
Net assets of Doddle Doo	156
Goodwill	45
Carrying amount	**201**

The temporary difference associated with Bubble Boo's underlying investment is Tshs21 million which is equal to the cumulative retained profit since the acquisition date.

If Bubble Boo decides that it will not sell its investment and Doddle Doo does not distribute its retained profits in the foreseeable future, a deferred tax liability will not be recognised in relation to Bubble Boo's investment in Doddle Doo. This exception would apply to an investment in an associate if it has also been agreed that the profits of the associate will not be distributed in the foreseeable future. Bubble Boo discloses the amount of the temporary difference for which no deferred tax is recognised, i.e. Tshs21 million.

If Bubble wants to sell the investment in Doddle Doo, or Doddle Doo distributes its retained profits in the foreseeable future, Bubble will recognise a deferred tax liability to the extent that the temporary difference is expected to be reversed. The tax rate will be in the manner in which Bubble expects to recover the carrying amount of its investment. Bubble credits or charges the deferred tax to equity to the extent that the deferred tax results from foreign exchange translation differences which have been charged or credited directly to equity.

Bubble separately discloses the following:

(a) The amount of deferred tax directly credited or charged to equity; and
(b) The amount of any remaining temporary difference which is not expected to reverse in the foreseeable future and for which deferred tax is not recognised.

Test Yourself 2

Aqua Co acquired a subsidiary, Becta Co, on 1 January 20X7. At the time of acquisition, Becta had deductible temporary difference of Tshs400 million. On that date the tax rate was 35% but the resulting asset was not recognised on acquisition as it did not meet the criteria set in IAS 12.

On 30 November 20X7 Aqua found that the future taxable profit would probably be sufficient for the entity to recover the benefit of all the deductible temporary differences.

Required:

(a) State the accounting treatment for the subsequent recognition of the deferred tax asset on 30 November 20X7.

(b) Also, state the accounting treatment if there is a change in the tax rate. Assume:
(i) 40%
(ii) 30%

1.12 Investments in subsidiaries, branches and associates and interests in joint ventures

When the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures becomes different from the tax base of the investment or interest, temporary differences arise. Carrying amount here means the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill.

Such differences may arise in a number of different circumstances, for example:

(a) The existence of undistributed profits of subsidiaries, branches, associates and joint ventures. Frequently, the reason for profits remaining undistributed is that the distribution of such profits to the investor would trigger a tax liability.

(b) Changes in foreign exchange rates when a parent and its subsidiary are based in different countries; this affects provisions against or revaluations of the carrying value of investments.

(c) A reduction in the carrying amount of an investment in an associate to its recoverable amount.

(d) The non-monetary assets and liabilities of an entity are measured in its functional currency. The entity's taxable profit or tax loss (and hence, the tax base of its non-monetary assets and liabilities) may be determined in a different currency. In such a situation, normal rules are applied; changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or asset (except where initial recognition exemption applies). The resulting deferred tax is charged or credited to the statement of profit or loss.

In the consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements, if the parent carries the investment in its separate financial statements at cost or a revalued amount.

IAS 12 requires that an entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied:

(a) The parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
(b) It is probable that the temporary difference will not reverse in the foreseeable future.

A parent controls the dividend policy of its subsidiary; therefore it is able to control the timing of the reversal of temporary differences associated with that investment. This applies to the temporary differences arising not only from undistributed profits but also from any foreign exchange translation differences. It would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses.

When the parent has determined that those profits will not be distributed in the foreseeable future, the parent does not recognise a deferred tax liability. When the venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, **a deferred tax liability is not recognised.**

An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor is not able to control the timing of reversal of the temporary difference. Therefore, the **investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate.**

It may be the case that an investor is not able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this minimum amount.

IAS 12 requires that an entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that:
(a) The temporary difference will reverse in the foreseeable future; and
(b) Taxable profit will be available against which the temporary difference can be utilised.

A deferred tax asset is recognised only if it is probable that taxable profit will be available against which a deductible temporary difference can be utilised. This will happen when there are sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity which are expected to reverse:
(a) In the same period as the expected reversal of the deductible temporary difference; or
(b) In periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

1.13 Current and deferred tax arising from share-based payment transactions

The accounting for share-based payments is guided by IFRS 2, Share-based Payment. The tax deductions may not necessarily be in agreement with the accounting treatment. The amount of tax deduction may differ from the related cumulative remuneration expense, and may arise in a later accounting period.

Frequently, an entity may not receive a tax deduction until the share options are exercised, with the measurement of the tax deduction based on the entity's share price at the date of exercise. This measurement is its tax base and tax deductibility arises in a future period. The difference between the tax base of the employee services received to date and the carrying amount is a deductible temporary difference that results in a deferred tax asset. If the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period, it shall be estimated, based on information available at the end of the period.

The amount that the taxation authorities will permit as a deduction depends upon the entity's share price at a future date. Since the future price cannot be known today, the measurement of the deductible temporary difference should be based on the entity's share price at the end of the period.

Accounting treatment - Paragraph 58 of IAS 12 requires that current and deferred tax should be recognised as income or expense and included in the statement of profit or loss for the period, except to the extent that the tax arises from (a) a transaction or event which is recognised, in the same or a different period, directly in equity, or (b) a business combination. The amount of the tax deduction (or estimated future tax deduction) may sometimes exceed the amount of the related cumulative remuneration expense. This indicates that the tax deduction relates not only to remuneration expense but also to an equity item. The tax effect of this excess of amount deductible from income for tax purposes (tax deduction) over the related cumulative remuneration should be recognised directly in equity.

Example

Share-based payment transactions

Wave Force has recognised an expense for employee services consumption as consideration for share options granted according to IFRS 2 Share-based Payment. Until the options are exercised and the deduction is based on the options' intrinsic value at the exercise date, a tax deduction will not arise. A deductible temporary difference that results in a deferred tax asset is the difference between the tax base of the employee services received to date and the carrying amount of nil.

The amount should be estimated based on information available at the end of the period, if the amount the taxation authorities will permit as a deduction in future periods is not known at the end of the period. The measurement of the deductible temporary difference should be based on the entity's share price at the end of the period if the amount that the taxation authorities will permit as a deduction in future periods is dependent upon the entity's share price at a future date. Therefore the estimated future tax deduction should be based on the options' intrinsic value at the end of the period. If the tax deduction is greater than the related cumulative remuneration expense, this means the tax deduction is not only from remuneration expense but also from an equity item.

Continued on the next page

In this situation, the excess of the associated current or deferred tax is recognised directly in equity. Wave Force's tax rate is 40%. The options were granted at the start of year 1, vested at the end of year 3 and exercised at the end of year 5. The following are the details of the expense recognised for employee services received and consumed in each accounting period, the number of options outstanding at each year-end and the intrinsic value of the options at each year-end

	Employee Services expenses	Number of options at year-end	Intrinsic value Per option
	Tshs.		Tshs.
Year 1	37,600,000	10,000	500
Year 2	37,000,000	9,000	800
Year 3	38,000,000	8,000	1,300
Year 4	-	8,000	1,700
Year 5	-	8,000	2,000

Wave force recognises current tax income in year 5 and deferred tax asset and deferred tax income in years 1–4 as follows:

Some of the deferred and current tax income is recognised directly in equity in years 4 and 5, as the estimated (and actual) tax deduction exceeds the cumulative remuneration expense.

Year 1: Deferred tax asset and deferred tax income = (10,000 × Tshs500 × 1/3(*) × 0.40) = Tshs.666,667

* - Based on the intrinsic value of the options the tax base of the employee services is received and those options were granted for three years' services. It is necessary to multiply the option's intrinsic value by 1/3 to arrive at the tax base of the employee services received in year 1 as only one year's services have been received to date. As the estimated future tax deduction of Tshs.1,666,667 (10,000 × Tshs.500 × 1/3) is less than the cumulative remuneration expense of Tshs37,600,000, the deferred tax income is all recognised in profit or loss

Year 2

	Tshs.
DTA at year-end: (9,000 × Tshs800 x 2/3 × 0.40)	1,920,000
Less: DTA at start of year	(666,667)
Deferred tax income for year	1,253,333*
* This amount consists of the following:	
Deferred tax income for the temporary difference between the tax base of the employee services received during the year and their carrying amount of nil: (9,000 × Tshs800 ×1/3 x 0.40)	960,000
Tax income resulting from an adjustment to the tax base of employee services received in previous years:	
(a) increase in intrinsic value: (9,000 × Tshs300 × 1/3 x 0.40)	360,000
(b) decrease in number of options: (1,000 × Tshs500 × 1/3 x 0.40)	(66,667)
Deferred tax income for year	**1,253,333**

The deferred tax income is all recognised in profit or loss, because the estimated future tax deduction of Tshs.4,800,000 (9,000 × Tshs800 x 2/3) is less than the cumulative remuneration expense of Tshs.74,600,000 i.e. (Tshs.37,600,000 + Tshs.37,000,000).

Year 3

	Tshs
DTA at year-end (8,000 × Tshs.1,300 × 0.40)	4,160,000
Less: DTA at start of year	(1,920,000)
Deferred tax income for year	**2,240,000**

As the estimated future tax deduction of 10,400,000 (8,000 x Tshs1,300) is less than the cumulative remuneration expense of Tshs112,600,000 (Tshs37,600,000 + Tshs37,000,000 + Tshs38,000,000) the deferred tax income is all recognised in profit or loss.

Year 4

	Tshs.
DTA at year-end (8,000 × Tshs1,700 × 0.40)	5,440,000
Less: DTA at start of year	(4,160,000)
Deferred tax income for year	**1,280,000**

1.14 Other instances leading to deferred tax asset / liabilities:

1. Fair value adjustment

When fair value adjustments are made to the financial assets or investment property with a carrying amount different from the carrying value, no equivalent adjustment is made for tax purposes. The profit / loss will be recognised on sale of investments for tax purposes and the tax profit on sale will be different from the accounting profit. Therefore, a temporary difference would arise when such a fair value adjustment is made.

Example

Donald Co holds investment costing Tshs10 million which it carries at fair value. On 31 December 20X8, the fair value of the investment is Tshs8 million. For accounting purpose, Tshs2 million will be charged to the statement of profit or loss immediately and accordingly the accounting profit will reduce. However, for tax purpose, Tshs2 million will not be allowed as a deduction in the same year but will be allowed in the next year when the investment is sold for Tshs8 million.

This means, in 20X8, the tax base (Tshs10 million) of the investment was more than the carrying amount (Tshs8 million) by Tshs2 million; this will be reversed in 20X9 when it is sold. Therefore Tshs2 million should be considered a deductible temporary difference.

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2. Impairment

If the net realisable value of inventory or the recoverable amount of property, plant and equipment falls below the previous carrying amount, the entity reduces the carrying amount. These adjustments are ignored for tax purposes until the asset is sold. As a result, temporary difference will arise until the carrying value is realised.

3. Revaluation

The IFRSs permit or require certain assets to be carried at fair values or revalued amounts. This involves changing the carrying amounts of the assets in the accounts. Depending upon the local tax laws, sometimes, the tax base of these assets may not be adjusted by the equivalent amount. In such cases, a temporary difference arises.

Example

Teletubbies revalue its property, plant and equipment (under the revaluation model permitted in IAS 16) in the accounts by increasing the carrying value from Tshs.40 million to Tshs.48 million. However, for tax purposes, according to the local tax laws, the value remains at historical cost i.e. the tax base remains at Tshs.40 million.

1.15 Equity items with a tax base

The present definition of tax base includes assets or liabilities only and not equity. The IASB proposes to amend the definition to include equity.

Presently, there is a specific reference to equity in paragraph 23 of IAS 12. The issuer of a **compound financial instrument** (for example, a convertible bond) classifies the instrument's liability component as a liability and the equity component as equity.

This is in accordance with IAS 32 Financial Instruments: Presentation. In some jurisdictions, for taxation purposes, this distinction between equity and liability components is not made and the entire amount is treated as the tax base of the liability component on initial recognition.

The resulting taxable temporary difference arises from the initial recognition of the equity component separately from the liability component. Therefore, the exception set out regarding initial recognition of an asset or liability does not apply. **Consequently, an entity recognises the resulting deferred tax liability**.

The deferred tax is charged directly to the carrying amount of the equity component. Subsequent changes in the deferred tax liability are recognised in the statement of profit or loss as deferred tax expense (income).

Example

Compound financial instruments

Bee Ltd obtains a convertible loan with no interest bearing of Tshs200 million on 30 September 20X4 which is repayable at par on 1 October 20X8. Bee classifies the loan's liability component as a liability and the equity component as equity. The initial carrying amount of Tshs150.2 million is assigned to the liability component of the convertible loan and Tshs49.8 million to the equity component.

Later, at the beginning of each year, Bee recognises imputed discount as interest expense at an annual rate of 10% on the carrying amount of the liability component. Bee Ltd is not allowed to claim any deduction for the imputed discount on the liability component of the convertible loan. The tax rate is 40%.

The following are the temporary differences associated with the resulting deferred liability and deferred tax expense and income and the liability component:

	Year			
	20X4	**20X5**	**20X6**	**20X7**
	Tshs million			
Carrying amount of liability component	150.2	165.2	181.8	200.0
Tax base	200.0	200.0	200.0	200.0
Taxable temporary difference	49.8	34.8	18.2	-
Opening deferred tax liability at 40%	-	20.0	14.0	7.4
Deferred tax charged to equity	20.0	-	-	-
Deferred tax expense (income)	-	*(6.0)	*(6.6)	*(7.4)
Closing deferred tax liability at 40%	20.0	14.0	7.4	-

* Working notes (Amounts in Tshs million)

20.0-14 = 6.0
20.0-13.4=6.6
20.0-12.6=7.4

On 30 September 20X4, Bee Ltd recognises the resulting deferred tax liability by adjusting the initial carrying amount of the equity component of the convertible liability.

The following are the amounts recognised at that date:

	Tshs million
Liability component	150.2
Deferred tax liability	20.0
Equity component (49.8 – 20.0)	29.8
	200.0

The subsequent changes in the deferred tax liability are recognised in the profit and loss as tax income. Therefore the statement of profit or loss of Bee will be:

	Year			
	20X4	**20X5**	**20X6**	**20X7**
	Tshs million			
Interest expense (imputed discount)	-	15.0	16.6	18.2
Deferred tax expense (income) 40%	-	(6.0)	(6.6)	(7.2)
	-	**9.0**	**10.0**	**11.0**

2. Determine the recognition of tax expense or income and its inclusion in the financial statements.

[Learning Outcome b]

2.1 Meaning

Tax expenses, current tax, and recognition and measurement criteria for current tax have been discussed in Paper B2 Financial Accounting. This is a quick revision.

Tax expense or tax income is the amount that is deducted from or added to the accounting profits respectively in the statement of profit or loss, **in respect of** current and deferred tax.

Current tax is the amount of income tax payable (recoverable) in respect of the taxable profit (tax loss) for a period.

	Tshs
Tax liability for the year	X
± Under/over provision in the previous year	X
± Deferred tax expenses (income)	X
Tax expenses	**X**

Current tax

Tip

This deferred tax calculated above will exclude the deferred tax related to OCI or equity items.

Current taxes are to be **treated as an expense**. However, if the tax relates to **items that are credited or charged** directly **to equity,** current tax and deferred tax shall **also be charged or credited directly to equity.**

2.2 Measurement: current tax liabilities or assets are measured:

- For current and prior periods
- **At the amount expected to be paid to or recovered from** the taxation authorities
- **According to the tax rates** or laws that have **been enacted or substantially enacted**

Example

For 20X6, Turpid Plc. has a taxable income of Tshs250 million. The applicable tax rate is 30%. Turpid provided Tshs.50 million for income tax during 20X5. For 20X5, the actual liability decided was Tshs.54 million.

Required:

Advise the company on the required presentation in the financial statements. Would your answer be different if the actual liability for 20X5 was Tshs.47.5 million?

Answer:

	Tshs'000
Tax due for 20X6 (Tshs.250,000 x 30%)	75,000
Short provision for 20X5 (Tshs54,000 – Tshs.50,000)	4,000
Current tax expense	**79,000**

The liability would be Tshs.75,000.

Assume that the liability for 20X5 was settled at Tshs.47,500

	Tshs'000
Tax due for 20X6 (Tshs.250,000 x 30%)	75,000
Excess provision for 20X5 (Tshs.50,000 – Tshs.47,500)	(2,500)
Current tax expense	**72,500**

The liability would be Tshs.75,000.

2.3 Recognition

From the above discussion, it is clear that the tax for the current and prior years forms part of the tax expense deducted from the profit. This needs to be **compared with the payment up to the reporting date:**

1. **An entity shall recognise a current tax liability for tax payable on taxable** profit for the current and past periods**.**
2. If the amount paid for the current and past periods exceeds the amount payable for those periods, the entity shall recognise the excess as a current tax asset.

2.4 Tax losses carried back and carried forward

1. Tax losses can be carried back to earlier periods to recover the current tax of those periods in some jurisdictions.
2. These losses can be recognised as an asset, since they satisfy the criteria of the Framework, i.e. the benefits can be reliably measured, and it is probable that they will flow to the entity.

This is a case involving a deferred tax asset as discussed in the Learning Outcome 1 i.e. carried forward loss.

2.5 Presentation and disclosure

1. Current tax assets and current tax liabilities should be disclosed **separately.**
2. Offset of current assets and current liabilities against each other is permitted **if and only if:**
   The entity has a legally enforceable right to set off the amounts.
   The entity either intends to settle the net amount or to realise / settle the asset / liability at the same time.
3. **Tax expense:** the tax expense or income that is related to profit or loss from ordinary activities shall be presented on the face of the statement of profit or loss.

Test Yourself 3

Berry & co had made a provision of taxation of Tshs135 million. It ended up paying the same amount for 20X8. According to the assessment of tax by authorities, actual tax liability is Tshs170 million. In the year 20X9, Berry & Co. incurred a tax loss of Tshs60 million. The local tax laws permit carrying back of tax loss. The tax rate is 25%.

Which of the following is the journal entry passed to record the net amount paid?

A	Dr Current tax expense	Tshs35 million	
	Cr Current tax liability		Tshs35 million
B	Dr Current tax liability	Tshs15 million	
	Cr Tax repayment (income)		Tshs15 million
C	Dr Current Tax liability SOFP	Tshs35 million	
	Cr Cash /Bank		Tshs35 million
D	Dr Current tax liability	Tshs20 million	
	Cr Cash /Bank		Tshs20 million

Answers to Test Yourself

Answer to TY 1

In the first year, Tshs.0.06m will be amortised, leaving an unamortised balance of Tshs.0.24m. Assuming no repayments, the loan's carrying value will be Tshs.14.76m (Tshs.15.00m – Tshs.0.24m). For tax purposes, the Tshs.0.30m will be recognised in the first year, so in future years there will be taxable temporary differences of Tshs.0.24m until the transaction costs are fully amortised in the accounts.

Answer to TY 2

(a) If, subsequent to the acquisition, the acquirer realises that the deductible temporary difference as on the acquisition date is realisable, the acquirer shall recognise the resulting deferred tax income in the statement of profit or loss and recognise the deferred tax asset.

Also, it should reduce the carrying value of goodwill recognised earlier. However it should be noted that this is possible only in case of the measurement period specified under IFRS 3. If the deferred tax asset arises after the measurement period, an entity shall not adjust the accounting for prior business combinations if tax benefits failed to satisfy the criteria for separate recognition as of the acquisition date.

In this case, a deferred tax asset of Tshs.140 million (Tshs.400 million x 35%) should be recognised and deferred tax income of the same amount should be credited to the statement of profit or loss. In order to give this effect to goodwill, the goodwill will be reduced by Tshs.140 million and an expense of the same amount should be recognised.

(b) If the tax rate on the reporting date is different from the acquisition date, the deferred tax asset will be recognised using the rate on the reporting date. However, the amount by which goodwill is to be reduced is calculated using the rate on the acquisition date (possible only in the measurement period specified under IFRS 3).

(i) If the tax rate changes to 40%, the deferred tax to be recognised would be Tshs.160 million (Tshs.400 million x 40%) and there will be a corresponding entry in the statement of profit or loss. However goodwill will be reduced by Tshs.140 million with corresponding impact on the statement of profit or loss.

(ii) If the tax rate changes to 30%, the deferred tax to be recognised would be Tshs.120 million (Tshs.400 million x 30%) and the corresponding entry will be made in the statement of profit or loss. However, goodwill will be reduced by Tshs140 million with a corresponding impact on the statement of profit or loss.

Answer to TY 3

The correct option is **D.**

Entry in Option A is passed when the additional tax becomes payable (Tshs170 million - Tshs135 million)

Dr Current tax expense	Tshs.35 million	
Cr Current tax liability		Tshs.35 million

Entry in option B is passed when the tax receivable is adjusted against the tax liability

Dr Current tax liability	Tshs.15 million	
Cr Tax recoverable (asset)		Tshs.15 million

Entry in option C is incorrect.

The amount to be paid is incorrect.

Entry required when net amount is paid:

Dr Current tax liability	Tshs.20 million	
Cr Cash / bank		Tshs.20 million

Quick Quiz

1. Ferry Ltd has incurred a tax loss of Tshs.25 million for 20X4. It wants to recognise the tax benefit of the loss as an asset. Can it do so? If yes, what will the value of the tax asset be at a 30% tax rate?

2. What is the tax base in the following cases?

   (a) The carrying value of an asset is Tshs.30 million; its cost was Tshs.50 million and the depreciation allowed for tax purposes so far is Tshs.25 million.
   (b) Advance rent received of Tshs5 million is taxed on a cash basis.

3. Calculate the temporary differences for the items mentioned in Q2 above.

4. Calculate the deferred tax asset or liability for the temporary differences calculated in Q3 above. Assume a tax rate of 30%.

5. Set out the required accounting entries for the tax figures calculated for Q2-Q4 above.

Answers to Quick Quiz

1. Subject to certain conditions, it can do so:

   (a) If Ferry Ltd wants to carry it back to earlier periods to recover the current loss of those periods, it can recognise the tax benefit as a current tax asset. The value will be Tshs25 million x 30% = Tshs7.5 million.
   (b) If Ferry Ltd wants to carry it forward for offset against future taxable income, it can recognise the tax benefit of Tshs7.5 million as a deferred tax asset. However, it should be probable that future taxable profit will be available against which the unused tax losses can be used.

2. Tax bases of the items mentioned are:

   (a) Asset: Tshs.25 million, being the amount deductible for tax purposes in future.
   (b) Rent received: Nil, being carrying value (Tshs.5 million) less amount not deductible in future (Tshs.5 million).

3. Temporary differences:

   (a) Carrying value (Tshs.30 million) less tax base (Tshs.25 million) = Tshs.5 million. This is a taxable temporary difference.
   (b) Carrying value (Tshs.5 million) less tax base (Nil) = Tshs.5 million. This is a deductible temporary difference.

4. Deferred tax liability / asset

   (a) For the taxable temporary difference of Tshs.5 million, there will be a deferred tax liability of Tshs.1.5 million.
   (b) For the deductible temporary difference of Tshs.5 million, there will be a deferred tax asset of Tshs.1.5 million.

5. Accounting entries:

				Dr	Cr
(a)	Dr		Deferred tax expense	Tshs.1.5 million	
		Cr	Deferred tax liability		Tshs.1.5 million
(b)	Dr		Deferred tax asset	Tshs.1.5 million	
		Cr	Deferred tax income		Tshs.1.5 million

Self-Examination Questions

Question 1

Gold Line Transports has an accounting profit of Tshs.100 million for the year 20X6. The following additional information is available:

(1) Depreciation allowable under income tax rules is Tshs.10 million higher than accounting depreciation.

(2) A penalty of Tshs.6 million for the infringement of local laws is charged as an expense in the accounts, but never allowable under income tax.

(3) A provision of Tshs.8 million for expenses recorded in the accounts is allowable on a cash basis for tax purposes.

The applicable rate of tax is 25%.

Required:

Determine the accounting entries for current tax and deferred tax.

Question 2

The following information relates to Zeta Ltd for the year ended 31 March 2013.

The balance in the deferred tax provision account as on 1 April 2012 was Tshs.70 million. This amount was computed on a cumulative time difference of Tshs.200 million by applying a tax rate of 35%.

Capital allowances (tax depreciation) and depreciation for the year ended 31 March 2013 is as follows:

	Capital allowances	**Depreciation**
	Tshs'000	**Tshs'000**
2013 actual	200,000	180,000

The income tax rate for 2013 is 30% and is expected to remain at this level for the foreseeable future.

Required:

Account for deferred tax in accordance with IAS 12 for the year ended 31 March 2013.

Question 3

Creative Ltd, is a wholly owned subsidiary of Crafts Ltd and also satisfies the criteria of a cash generating unit in accordance with IAS 36 Impairment of assets. The value of the property, plant and equipment of Creative Ltd on 31 October 2012 was Tshs.12 million and purchased goodwill was Tshs.2 million before any impairment loss. Apart from the property, plant and equipment, Creative did not own or owe any other assets or liabilities.

O 31 October 2012, Crafts Ltd tested Creative Ltd for impairment and an impairment loss of Tshs.3.6 million had occurred. The tax base of the property, plant and equipment of Creative Ltd was Tshs.8 million as at 31 October 2012. The directors wish to know how the impairment loss will affect the deferred tax provision for the year. In the jurisdictions in which Crafts Ltd operates, Impairment losses are not an allowable expense for taxation purposes. Assume a tax rate of 30%.

Required:

Discuss accounting treatment of the above issue in accordance with IAS 12 'Income Taxes'.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) Current tax

	Tshs'000
Accounting profit	100,000
Less: Extra depreciation for tax purposes	(10,000)
Add: Penalty not allowable for tax purposes	6,000
Add: Provision for expenses allowable on cash basis	8,000
Taxable profit	**104,000**
Current tax at 25%	26,000

The accounting entry is

Dr Current tax expense Tshs.26 million
Cr Current tax liability Tshs.26 million

(b) Deferred tax

(1) Extra depreciation allowed will be reversed in future, when the depreciation deduction will be less and the taxable profits more. This is a taxable difference, leading to a deferred tax liability of Tshs.10 million x 25% = Tshs.2.5 million.

The accounting entry is:

Dr Deferred tax expense Tshs.2.5 million
Cr Deferred tax liability Tshs.2.5 million

(2) The penalty is permanently disallowed. It does not create any deferred tax assets or liabilities.

(3) Provision for expenses has been charged in the current period accounts, but will be deducted for tax purposes in future. This is a deductible difference, leading to a tax asset of Tshs8 million x 25% = Tshs.2 million, to be recognised if the entity expects to earn profits in future to offset the tax liability against it. The accounting entry is:

Dr Deferred tax asset Tshs.2 million
Cr Deferred tax income Tshs.2 million

Answer to SEQ 2

Timing difference as at 31 March 2013

	Tshs'000
Timing difference b/f	200,000
Add: Arising during the year	20,000
	220,000

The above difference is termed as a taxable temporary difference and deferred tax liability on above will Tshs.220 million x 30% = Tshs.66 million. This amount will be disclosed in the statement of financial position.

The decrease in provision (Tshs.70 million – Tshs.66 million = Tshs.2 million) will reduce the tax expense for the year.

The recognition of the impairment loss by Creative Ltd reduces the carrying value of the property, plant and equipment of Creative Ltd and hence this creates a taxable temporary difference. In accordance with IAS 12, a deferred tax liability will need to be provided for.

Answer to SEQ 3

No deferred tax would have been recognised on the goodwill in accordance with IAS 12 Income Taxes. This would therefore not impact deferred tax calculations. The allocation of impairment loss is shown below:

	Goodwill	**Property, plant and equipment**
	Tshs'000	**Tshs'000**
Balance 31 October 2012	2,000	12,000
Impairment loss	(2,000)	(16,000)
	-	**4,000**

Tax base of the PPE is Tshs.8 million.

DTL (before the impairment loss) = (Tshs.12 million – Tshs.8 million) x 30% = Tshs.1.2 million. DTL (after the impairment loss) = (Tshs.10.4 million – Tshs.8 million) x 30% = Tshs.0.72 million

The statement of financial position will show a DTL of Tshs.0.72 million and the statement of profit or loss will need to be credited by Tshs.0·48 million to reduce tax expense.

STUDY GUIDE B3: SHARE-BASED PAYMENT

Get Through Intro

In today's global economy big entities issue share options to their employees as part of the remuneration package. The hidden cost of shares issued to employees is a very important constituent of the employee cost incurred by the entity.

If an entity issues 100 share options each as a bonus to 10 of its employees.

Will this involve just printing a share certificate and issuing it to the employees?
Can the employee, in turn, realise the proceeds by selling the shares in the market?
In the process does the company incur any cost?

If this transaction is not accounted for as an expense in the financial books of an entity, it will present an incorrect picture of the financial health of the entity. IFRS 2 deals with the method of recognising and measuring this type of transaction. Until IFRS 2 was issued there was no other IFRS issued to deal with the recognition and measurement of this type of transaction. It is very important to measure these transactions scientifically using generally accepted techniques so that the transaction will reflect a correct picture of the financial health of the entity.

In this Study Guide we will deal with the transactions which involve issue of shares to employees and to others in exchange of services or goods procured by the entity and the method of recognising, measuring and accounting for such transactions.

Learning Outcomes

a) Define the key terms in IFRS 2 'Share-based Payment', including equity-settled and cash-settled share based payment.
b) Apply the principles of IFRS 2 to measure and recognise cash and equity settled share-based payment transactions.

1. Define the key terms in IFRS 2 'Share-based Payment', including equity-settled and cash-settled share based payment.

[Learning Outcome a]

1.1 Share-based payment transaction

Definition

A transaction in which the entity:

(a) Receives goods or services as consideration for equity instruments of the entity (including shares or share options), or

(b) Acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of the entity's shares or other equity instruments of the entity.

IFRS 2 Appendix A

This means, share-based payment involves:

1. Receipt of goods or services

The term 'goods' **include,** inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. Therefore it **excludes financial instruments.**

Example

Royal Ltd has invested in 75,000 shares of Quality Ltd. This transaction does not fall within the scope of IFRS 2, as there is no receipt of goods or services by Quality and shares are issued for cash. Cash being a financial asset is specifically excluded from IFRS 2.

The term 'services' includes:

(a) Services from external agencies
(b) All services provided by employees, including increased productivity commitment or other enhancements in employee work performance as a result of the incentives.

Example

Royal Ltd appointed a legal consultant. He was issued 2,500 equity shares of the company in return for the work carried out. This is a procurement of service by issuing equity shares as consideration. Therefore it is a share-based payment.

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2. Receipt of goods or services in exchange for either of the following:

(a) Issue of an entity's **equity instruments** (including **share options**)
(b) Incurring liabilities to the supplier of goods or services for amounts that are **based on the price** of the **entity's shares or other equity instruments**.

1.2 Equity instrument

Definition

Equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

IFRS 2 Appendix A

Equity instruments include shares and share options.

1.3 Share options

A share option:

- Is a contract that
- Gives the holder the right, but not the obligation, to purchase a certain number of shares
- Is at a predetermined price
- Is for a specified period of time
- The holder of the share option pays to obtain that right

The nature of a share option can be explained with the following examples:

Example

Lily Foods offers shares to its employees. The offer is based on the condition that the shares will be transferred in the names of the employees after five years at an exercise price of Tshs2,000 per share, provided the employees remain in continuous service for these five years. Does this transaction fall within the definition of a share option?

Under the terms of the contract, the employees have a right to subscribe for shares in the company. However, the employees are not under an obligation to subscribe for the shares. Furthermore, the transfer will take place after five years at a predetermined price. Hence this is a share option.

1.4 Equity-settled share-based payment transaction

Definition

A **share-based payment transaction** in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options).

IFRS 2 Appendix A

Example

Mars Ltd purchases a printing machine from Jupiter Ltd. The value of the machine is to be paid by Mars Ltd by issuing 35,000 shares of Mars. In this case the goods are received and the consideration is paid for by issue of **equity instruments** of Mars Ltd. Therefore it is an equity-settled transaction.

Test Yourself 1

Roxy Ltd offers a bonus scheme to its employees. Under this scheme, subject to their meeting the fixed targets, the employees will be issued shares of the entity.

Required:

Does this transaction qualify as an equity-settled share-based payment transaction?

1.5 Cash-settled share-based payment transaction

Definition

A **share-based payment transaction** in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of **equity instruments** (including shares or **share options**) of the entity or another group entity.

IFRS 2 Appendix A

In cash-settled transactions, the consideration is paid by a method other than issue of equity instruments but the consideration to be paid is measured based on the value of the entity's shares. Therefore a liability is created.

Remember that in such transactions, the liability is settled by transfer of cash or other assets to the suppliers of those goods or services.

Example

Common examples of cash-settled share-based payment transactions are:

- Share appreciation rights to employees and
- A right to employees to receive future payments in redeemable shares.

Tip

Share appreciation right is an incentive scheme for employees wherein the employee gets the increase in the share price from the date of the grant to the date of the exercise.

Test Yourself 2

Jupiter Ltd grants 50 share appreciation rights to each of its 100 employees to be paid in cash, on the condition that the employees will remain in employment for the next three years.

Required:

Does this transaction qualify as a cash-settled share-based payment transactions?

Transactions containing option to settle the obligation either in cash or by issue of equity-instruments

Example

Rogers Ltd acquires forklifts worth Tshs8 million from Roxy Ltd. Roxy Ltd can choose to settle the transaction by either:

(a) Receiving 200 of the entity's shares two years after delivery; or
(b) Receiving a payment equal to the market price of 90 shares at the end of the first year after

delivery. What kind of share-based transaction is this?

Here, the consideration is either transfer of equity shares of the entity or payment equal to the market price of 90 shares Therefore it is a transaction which can be treated either as:

(i) An equity-settled share-based payment by receiving 200 shares of the entity after two years of delivery; **or**
(ii) A cash-settled share-based payment, by receiving a payment equal to the market price of 90 shares at the end of the first year after delivery.

Under IFRS 2 Share-based Payment, a transaction in which the entity has the choice of settlement is **accounted for as equity-settled if the entity has the stated intent and ability to settle** in equity instruments; otherwise it is accounted for as cash-settled. If the counterparty has the choice of settlement, then the entity has granted a compound instrument that includes a liability component and an equity component, which are accounted for separately.

2. Apply the principles of IFRS 2 to measure and recognise cash and equity settled share-based payment transactions.

[Learning Outcome b]

2.1 Equity settled share-based transactions

1. Recognition of share-based payments

Share-based payments are to be recognised in the financial books of the entity as follows:

The expense (or an increase in assets, where relevant) on account of purchase of goods or services is required to be recognised in the financial records of the entity.

The corresponding amount will be recorded either as a liability or as an increase in equity, depending on whether the transaction is determined to be cash or equity settled.

For cash-settled transactions,

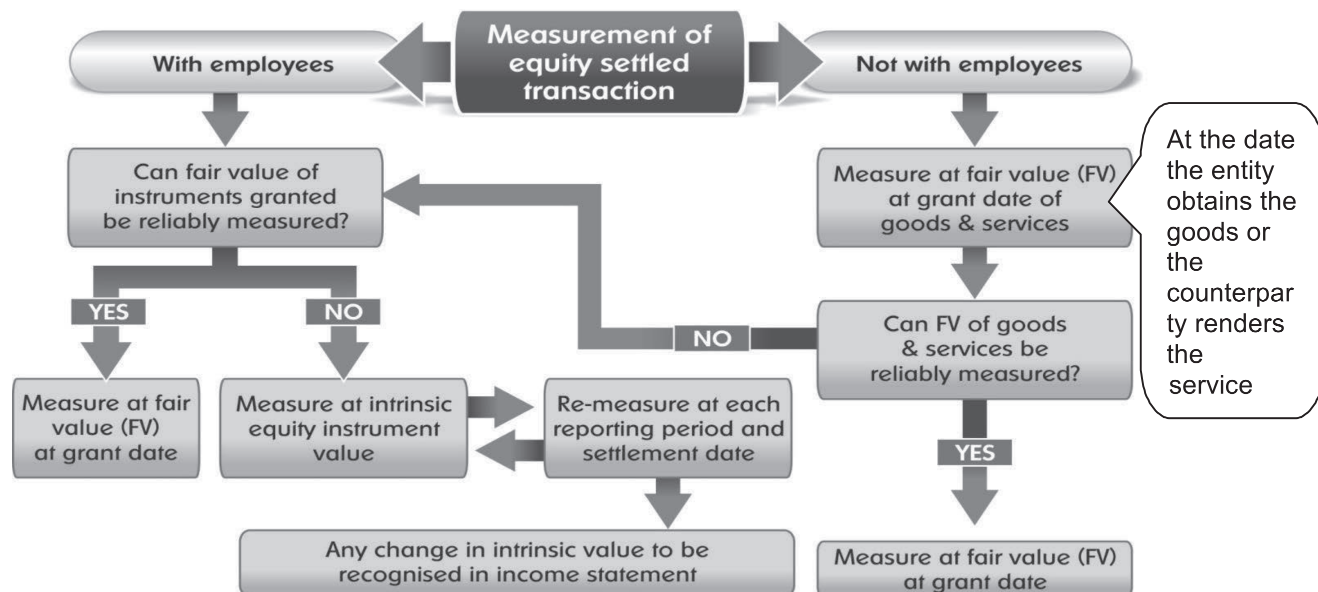
Dr	Goods /services / expense	X	
	Cr Cash / Liability		X

For equity -settled transactions,

Dr	Goods /services / expense	X	
	Cr Equity		X

2. Measurement of equity settled share based payment

Diagram 1: Measurement of equity-settled transaction



Example

Royal Foods issued 100 share options to each of its 50 employees on 31 December 2012. The grant date is 31 December 2012. This is a transaction with employees; hence, the value of the transaction would be determined based on the fair value of the share options as on the grant date i.e. 31 December 2012.

Example

Ramco Ltd buys a specialised machine from Balloons International. Ramco would issue 25,000 shares to Balloons Ltd. The machine is specialised and not available in India. Balloons Ltd has never sold such a machine earlier. The machine is received on 15 February 2012.

The fair value of the machine is not available. So the value of the transaction would have to be the fair value of the shares of Ramco Ltd as on 15 February 2012.

If the entity is **unable to estimate the fair value** of the equity instrument granted, the entity should **initially, at the date of receipt** of goods or services, **measure it at intrinsic value**.

In **subsequent periods,** on **each reporting date up to the date of final settlement,** only the **change in intrinsic value is recognised in the statement of profit or loss.**

3. Grant date

In a share-based payment arrangement, the grant date is the date when there is an understanding between the entity and the counterparty regarding the terms and conditions of the share-based payment arrangement.

When the agreement is subject to the approval of certain parties such as shareholders, the grant date would be the date of such approval.

Example

Jupiter Ltd has offered a rights issue at a substantial concession to the fair value to its employees in March 2012. The issue is subject to the approval of the shareholders. The issue was approved by the shareholders on 15 April 2012. The grant date is 15 April 2012.

Test Yourself 3

Pluto Ltd wants to buy a printing machine. It contacts Jupiter Ltd on 15 March 2011 and offers 100 shares if Jupiter Ltd manufactures the machine according to the specifications. The offer is valid for 6 months. Jupiter Ltd neither rejects nor accepts Pluto Ltd.'s offer. On 30 June 2011, Jupiter Ltd agrees to manufacture the machine for the 100 shares. On 30 October 2011, Jupiter Ltd delivers the machine to the company. On the same date, Pluto Ltd delivers the 100 shares to Jupiter Ltd.

Pluto Ltd has determined that it cannot measure reliably the fair value of the goods received and therefore measures the share-based payment by reference to the fair value of the shares issued.

Required:

Determine the measurement date under IFRS 2.

---

4. Vesting period

Whether or not the entire amount of expense needs to be recorded in the financial books in the year of issue of share options itself will depend on the vesting period.

Definition

Vesting period: is the period of time **before** shares are owned unconditionally by an employee / other e.g. an employee share option plan.

IFRS 2 Appendix A

An equity instrument is said to vest if the conditions on which the issue of the share option was made are satisfied. If it vests immediately, on the grant date, the entity shall recognise the services received in full, with a corresponding increase in equity.

Example

Jasmine Ltd made a bonus issue to its employees. This is a situation where the amount of bonus is given for past service. Therefore the equity instrument vests immediately (the shares are owned unconditionally as they are for past work performed by the employee). Therefore the entity shall recognise the share option on the date when the issue is granted.

Sometimes equity instruments are issued subject to fulfilment of certain conditions by the recipient of the equity instruments. The period of time taken for satisfaction of these conditions is referred to as the vesting period. If the equity instruments granted do not vest immediately, the entity shall recognise the services over the entire duration of the vesting period, with *a* corresponding increase in equity.

Example

Delta Ltd grants share options to its employees. This option is subject to the condition that the employees continue to remain in the services of the company for the next five years.

This option does not vest immediately. It will vest subject to the fulfilment of the condition that the employees continue to remain in the services of the company for the next five years. The period of five years is the vesting period. The expense should therefore be recognised over this period of 5 years.

---

5. Vesting conditions

The recognition of the option expense is dependent on the vesting conditions.

Vesting conditions are the conditions required to be fulfilled for the transfer of the equity instrument to take place.

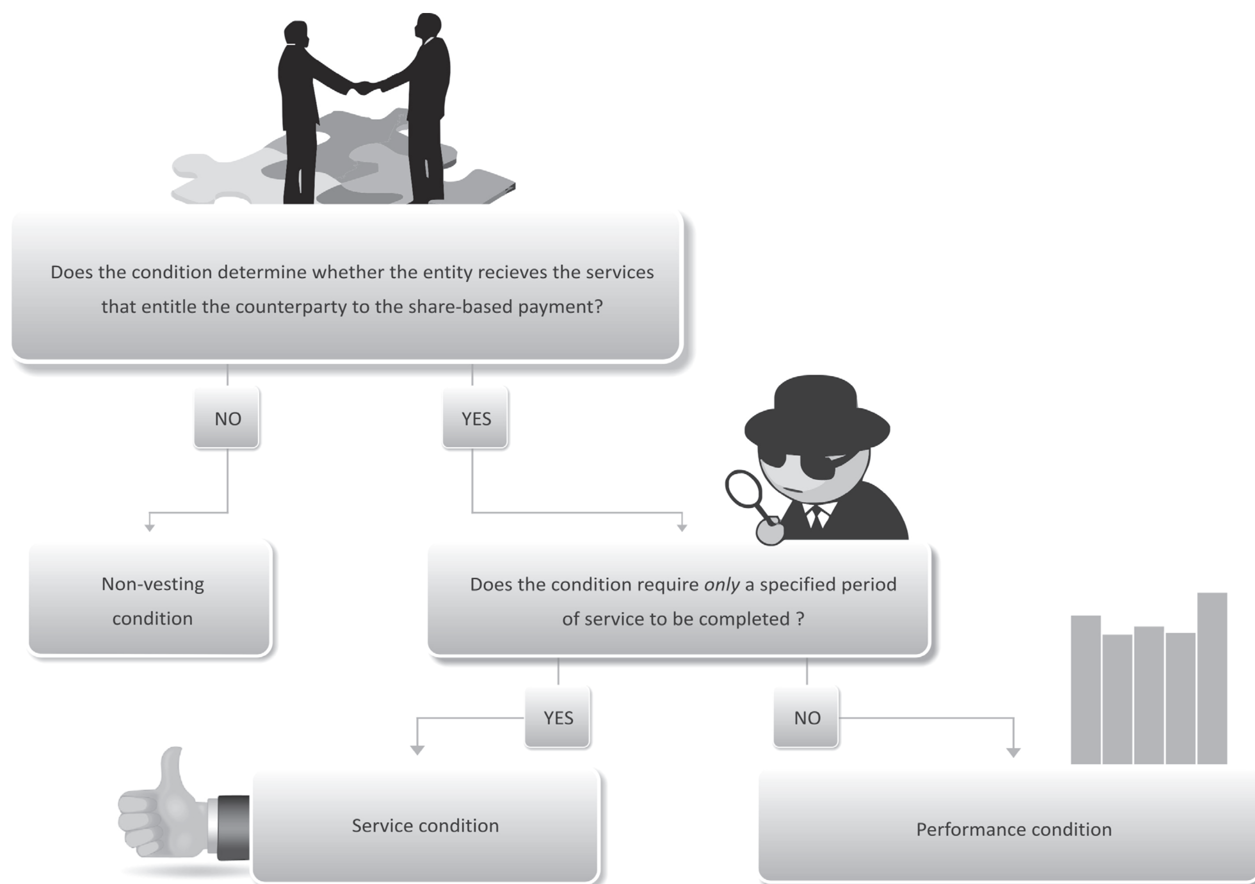
In the example of Delta Ltd mentioned above, the vesting condition was a continuous period of service for five years in the company.

Vesting conditions are either service conditions or performance conditions.

Service conditions require the counterparty to complete a specified period of service.

Performance conditions require the counterparty to complete a specified period of service and specified performance targets are to be met (such as a specified increase in the entity's profit over a specified period of time).

Diagram 2: A performance condition might include a market condition.



The vesting conditions are classified as:

Market conditions	Other than market conditions
It includes only performance conditions	It includes service or performance conditions
Instances where vesting conditions relate to market conditions: outperforming a share price index achieving total shareholder return	Instances where vesting conditions do not relate to market conditions: remaining in employment for a specified period of time achieving the EPS or profit target completing a project

2.2 Treatment of vesting conditions

The treatment of vesting conditions varies depending on **whether or not any of the conditions relate to the market price of the entity's equity instruments.**

1. Market conditions

Market conditions are taken into account while estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments the entity recognizes the goods or services received from other party which satisfies all the vesting conditions except for market conditions irrespective of whether that market condition is satisfied. Vesting conditions other than market conditions are not considered when estimating the fair value of the shares or share options at the measurement date. However these non-market vesting conditions are taken into account by adjusting the number of equity instruments issued so that, the amount is recognized for goods or services. Thus the amount recognised for goods or services is based on the number of equity instruments that actually vest.

Example

Orange Co offers a share option scheme to its employees. The option is conditional on the company`s share attaining a share price index of 90 points within two years.

The company has granted share options that become exercisable when the share price index crosses 90 points. At the end of year two, the share price index is only 75. Therefore the target has not been met.

The company should not revise the grant date fair value and should not reverse the expense already recognised, because the increase in share price is a market-based criterion i.e. it is dependent on market conditions. It was included in determining the fair value of the options on the grant date.

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2. Non market conditions

If an option has a vesting **condition not relating to the market conditions** and there is a change to the conditions, the estimate is only revised. It is revised to the actual number of instruments that vested or are likely to vest.

Example

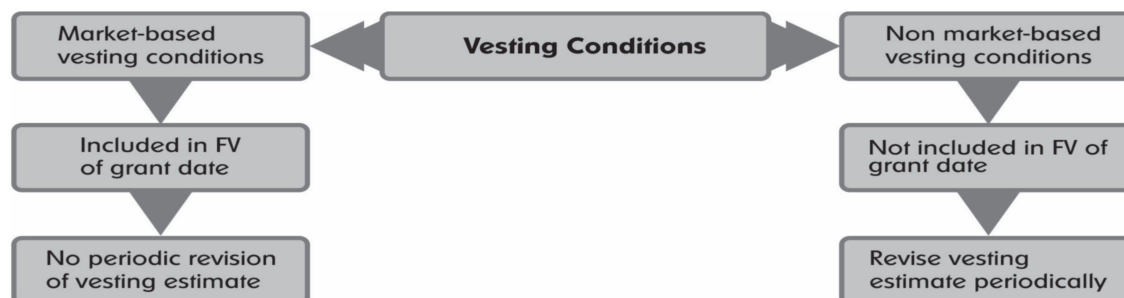
Continuing the above example of Orange Co

Orange Co offered 50 share options to each of its 100 employees and the options were conditional to the employees remaining in service for five years.

At the end of year five, only 95 employees had completed five years of service. The vesting condition of remaining in service is a condition other than a market condition. All the employees are not in service at the end of the vesting period.

The company should revise the estimate. The method of making the estimate is explained in the next example.

Diagram 3: Vesting conditions



Note: remember that if a transaction is subject to a vesting period, no entry will be made on the grant date – as it is not due on that date. The accounting entry will be made on the reporting date (when part of the vesting period has expired).

Test Yourself 4

Gama Ltd granted 1,000 share options to its full time director. The option was subject to the achievement of a sales target of Tshs95 million in 2011 and Tshs120 million in 2012.

Required:

When will the expense be recognised in the financial statements?

Summary of accounting treatment (where conditions are not market related)

At the end of the vesting period,

The cumulative charge = Number of equity instruments that have actually vested x Fair value (excluding effect of market conditions on the date of grant)

2.3 Steps to record the transaction

Step 1: Determine the fair value on grant date

Step 2: For each subsequent reporting period until the vesting period, the entity will calculate cumulative charge as follows:

Cumulative expenses = Fair Value on date of grant x Estimate of the number of options that will vest x Expired portion of vested period

Step 3: Calculate the charge to the statement of profit or loss for the current year using the following formula:

Cumulative expenses – Amounts already charged in the previous periods

Example

Jupiter Ltd has offered share options of 200 shares to each of its 1,000 employees. The vesting condition is that the employees need to remain in continuous employment for the next five years. The estimated fair value of each share option is Tshs3,000. The entity estimates that 25% of the employees will leave the organisation during the five-year period.

Based on the explanation given above the following amounts are to be recognised in the financial statements:

Step 1 Fair value on grant date = 200 x 1,000 x Tshs3,000 = Tshs600 million

Step 2 Cumulative charges:

Expired portion of the vesting period

Year 1: Tshs600 million x 75%* x (1/5) = Tshs90 million
Year 2: Tshs600 million x 75% x (2/5) = Tshs180 million
Year 3: Tshs600 million x 75% x (3/5) = Tshs270 million
Year 4: Tshs600 million x 75% x (4/5) = Tshs360 million
Year 5: Tshs600 million x 75% x (5/5) = Tshs450 million

Service period – non-market condition – therefore considered

Step 3 Expense for the period:

Amount calculated in 2 – Amount charged in previous period
Year 1: Tshs90 million - Nil = Tshs90 million
Year 2: Tshs180 million - Tshs90 million = Tshs90 million
Year 3: Tshs270 million - Tshs180 million = Tshs90 million
Year 4: Tshs360 million - Tshs270 million = Tshs90 million
Year 5: Tshs450 million - Tshs360 million = Tshs90 million

Note:

* The entity expects that 25% of the employees will leave so the options that will vest are 75% (as considered in step 2 above).

In the above example, the number of options that vested in each reportable period was fixed at 75%. However, if the estimate of the number of options that are likely to vest changes at the end of each reportable period, this estimated change in the options needs to be taken into account while calculating the cumulative expenses.

The following example will explain the method of calculating the expenses:

Test Yourself 5

Borealis Ltd offers 200 shares to each of its 1000 staff if they stay with them for 3 years. The fair value of the shares as on, that date is Tshs3,000. At the end of the first year, 15 employees leave and the entity estimates that 25% will have left at the end of the vesting period. During the second year a further 15 employees leave and the entity revises its estimate of total departures over the vesting period from 25% to 27%. During the third year a further 15 employees leave the entity.

Required:

Determine the amounts to be recognised in the statement of profit or loss and other comprehensive income.

2.4 Cancellation of vesting conditions

Though prior to its amendment, IFRS 2 described the treatment of failure to meet vesting conditions, it did not provide any specific guidance on the failure to meet a non-vesting condition. Hence, according to the amendments issued to IFRS 2:

a) Failure by either party (i.e. the entity or the counterparty) to meet the non-vesting condition will be treated as a cancellation non market conditions

b) For grants of equity instruments **with market conditions**, the entity shall recognise the goods or services received from a counterparty who satisfies all **other vesting conditions (i.e. other than market conditions).**

c) All cancellations, whether by the entity or by the counterparty, should receive the same accounting treatment.

d) Where a liability component is involved in the share-based payment, the liability should be valued at its fair value at the date of cancellation or settlement. Any payment made to settle the liability component should be accounted for as repayment of the liability.

e) If a grant of equity instruments is cancelled or settled by the entity or the counterparty, the related expense should be recognised immediately, instead of recognising it over the remainder of the vesting period.

2.5 Fair value of equity instruments

The fair value of the equity instruments needs to be based on:

- Market prices if available
- The terms and conditions upon which those equity instruments were granted on the grant date

Normally, market prices will not be available for shares that are not actively traded. In this case, the entity shall estimate the fair value of the equity instruments granted using a valuation technique. This generally happens for share options granted to employees; in many cases, market prices are not available because the options granted are subject to terms and conditions that do not apply to traded options.

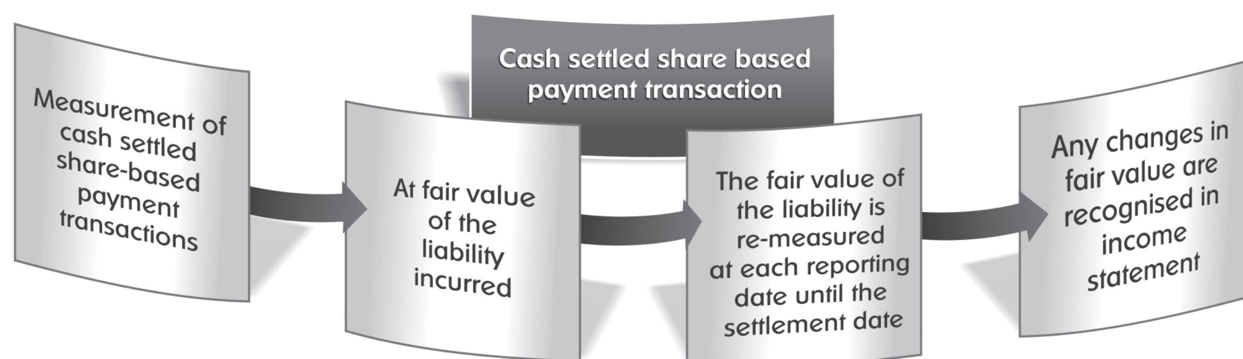
If traded options with similar terms and conditions do not exist, the fair value of the options granted shall be estimated by applying an option pricing model (you do not need to know these details for the exam). The valuation technique shall be consistent with generally accepted valuation techniques.

Example

Mercury Ltd issues share options to its directors on achievement of a sales target. The shares of Mercury Ltd are not listed on any stock exchange. Therefore the market price of the shares is not available. As a result, in order to determine the fair value of equity instruments on grant date, the valuation technique has to be used.

2.6 Cash-settled share-based payments

Diagram 4: Cash-settled share-based payments



The cash-settled share-based payment transactions are measured at **the fair value of the liability incurred.**

The fair value of the liability incurred in respect of a cash-settled transaction is re-measured at each reporting date until the date of settlement. Any changes in the fair value of the liability are recognised immediately in the statement of profit or loss.

1. The rules for determining vesting period are quite similar for equity-settled share-based payment and cash-settled share-based payment.

Summary of accounting treatment for cash-settled share-based payments

Ultimate cost is actual cash paid by the reporting entity = Fair value at settlement date.

Cumulative cost recognised until settlement represents a liability.

The determination of the liability is as follows:

At each reporting date between the grant date and settlement date - determine the fair value of the liability
During the vesting period, the liability recognised at each reporting period =Fair value of the liability x Expired portion for the vesting period.
From the end of the vesting period, the liability recognised is the full fair value of liability on the reporting date.
Changes in liability are recognised in the statement of profit or loss.

Example

A company granted share appreciation rights (to be settled in cash) to its 100 employees in March 2008, vesting in March 2011. The following estimates were made by management in March 2009:

Estimate as at 31 March 2009, of the shares that will vest	85%
Fair value of each share appreciation right at 31 March 2009	Tshs4,000
The fair value of the liability to be recorded at 31 March 2009 is	Tshs113,333
	(100 x Tshs4,000 x 85% x 1/3)

Management revised its estimates at 31 March 2010 as follows:

Estimate of the shares that will vest	90%
Fair value of each share appreciation right at 31 March 2010	Tshs5,000

The accrued liability at that reporting date is Tshs300,000) (i.e. 100 x Tshs5,000 x 90% x 2/3).

The increase in the liability of Tshs186,667 (Tshs300,000 - Tshs113,333) is recognised as an expense in the profit or loss section of the statement of profit or loss and other comprehensive income within ‘employee costs’.

Test Yourself 6

A company granted share appreciation rights to its 50 employees in March 2011, vesting in March 20X4. The following estimates were made by management in March 2012:

Estimate of the shares that will vest	75%
Fair value of each share appreciation right at 31 March 2012	Tshs2,000

Management revised its estimates in 31 March 2013 as follows:

Estimate of the awards that will vest	90%
Fair value of each share appreciation right at 31 March 2013	Tshs3,000

Required:

Calculate the amount of expenses to be recognised in March 2013.

2.7 Share-based payment transactions among group entities

The entries are made in the individual and separate financial statements. The amount recognised by one entity (receiving goods / services) may differ from the amount recognised by the consolidated group or by another group entity (settling the share-based payment transaction).

These are the transactions where one entity in a group grants rights to its own equity instruments to the employees of another entity in the group. For example, a parent company grants right to its shares to the employees of its subsidiary.

Recognition by an entity receiving goods / services

In all other circumstances, the transaction should be recognised as a cash-settled share-based payment transaction.

Initial recognition: the entity receiving the goods or services shall recognise the goods or services received as an equity-settled share-based payment transaction when:

(a) The awards granted are its own equity instruments, or
(b) The entity has no obligation to settle the share-based payment transaction.

The entity shall subsequently re-measure such an equity-settled share-based payment transaction only for changes in non-market vesting conditions.

Example

Avenue Inc. granted 300 share options to all of its 150 employees on the condition that the employees will not leave the company for the next 2 years.

The fair value of the options (nominal value of shares is Tshs1,000 each) at the grant date is Tshs450 each. On the grant date, the company estimated that 75% of the employees will complete the specified service period. At the end of the vesting period, 122 employees completed the required two years of service period, exercised the options and paid Tshs1,100 each.

The company measures the services received from the employees on the basis of the fair value of the share options at grant date. The initial amount as well as the change in the fair value i.e. increase in equity is treated as an expense in the financial statements of the company.

The company will record the transactions for each of the two year period as follows:

Year 1

Dr	Remuneration expense (300 x (150 x 75%) x Tshs450 x 1/2)	Tshs7,593,750	
	Cr Employee share options		Tshs7,593,750
	Being share option granted		

Continued on the next page

Year 2

Dr Remuneration expense Tshs8,876,250
(300 x 122 x Tshs450 – Tshs7,593,750)
Cr Employee share options Tshs8,876,250
Being share option granted

Dr Employee share options Tshs16,470,000
Dr Bank (amount received) Tshs40,260,000
(300 x 122 x Tshs1,100)
Cr Share Capital Tshs36,600,000
(300 x 122 x Tshs1,000)
Cr Share Premium Tshs20,130,000
(balancing figure)
Being shares issued against options granted

Note: If any part is not exercised, the proportionate amount will be transferred to retained earnings directly.

Example

A parent company granted 300 share options to all 150 employees of its subsidiary on the condition that the employees will not leave the company for the next 2 years.

The fair value of the options at the grant date is Tshs450 each. On the grant date, the company estimated that 75% of the employees will complete the specified service period. At the end of the vesting period, 122 employees completed the required two years of service period. The parent company does not require the subsidiary to pay for the shares needed to settle the grant of share options.

Paragraph B53 of IFRS 2 requires the subsidiary to measure the services received from the employees in accordance with the requirements of equity-settled share-based payment transactions. Thus, the subsidiary measures the services received from the employees on the basis of the fair value of the share options at grant date. The initial amount as well as the change in the fair value i.e. increase in equity is treated as a contribution from the parent company in the financial statements of the subsidiary.

The subsidiary will record the transactions for each of the two year period as follows:

Year 1

Dr Remuneration expense Tshs7,593,750
(300 x 150 x Tshs450 x 0.75/2)
Cr Equity (Contribution from the parent) Tshs7,593,750
Being share option granted

Year 2

Dr Remuneration expense Tshs8,876,250
(300 x 122 x Tshs450 – Tshs7,593,750)
Cr Equity (Contribution from the parent) Tshs8,876,250
Being share option granted

The parent shall record the transactions for each of the two year period as follows:

Year 1

Dr Investment in Subsidiary Tshs7,593,750
(300 x 150 x Tshs450 x 0.75/2)
Cr Share Options Tshs7,593,750
Being share option granted to employees of subsidiary

Year 2

Dr Investment in Subsidiary Tshs8,876,250
(300 x 122 x Tshs45 – Tshs7,593,750)
Cr Share Options Tshs8,876,250
Being share option granted to employees of subsidiary

Recognition by entity settling the transaction for another entity in the group

The entity can recognise the transaction as an equity-settled share-based payment transaction only if it is settled in the entity's own equity instruments. Otherwise, the transaction shall be recognised as a cash-settled share-based payment transaction.

Answers to Test Yourself

Answer to TY 1

In case of Roxy the transaction involves exchange of "services" and it is against the equity instruments of the entity. Therefore this transaction qualifies as an equity-settled share-based payment transaction.

Answer to TY 2

In case of Jupiter the transaction involves exchange of "services" and the amount of consideration is based on the value of the shares of Jupiter Ltd. Hence this qualifies as a cash-settled share-based payment transaction.

Answer to TY 3

The measurement date under IFRS 2 is 30 October 2011. For transactions with parties other than employees (and those providing similar services), the measurement date is defined as "the date the entity obtains the goods or the counterparty renders service." Therefore, the 100 shares would be valued on 30 October 2011 based on current market prices.

Answer to TY 4

This option is subject to the condition that the director achieves the sales targets in 2011 and 2012. As this option does not vest immediately, the vesting period is of two years. Therefore the expense should be recognised over this period. If the share options do not vest at the end of the vesting period (on account of non-fulfilment of the vesting conditions) then the credit balance in the share option account will be transferred to retained earnings directly.

Answer to TY 5

The following amounts are to be recognised in the financial statements:

Step 1 Fair value on grant date: 200 shares x 1,000 employees x Tshs3,000 = Tshs600 million

Step 2 Cumulative charge:

Year 1: Tshs600 million x 75% x (1/3) = Tshs150 million
Year 2: Tshs600 million x 73% x (2/3) = Tshs292 million
Year 3: 955 employees (W1)x Tshs3,000 x 200 shares x (3/3) = Tshs573 million

Step 3 Expense for the period:

Amount calculated in 2 – Amount charged in previous period
Year 1: Tshs150 million- 0 = Tshs 150 million
Year 2: Tshs292 million - Tshs150 million = Tshs142 million
Year 3: Tshs573 million - Tshs292 million = Tshs281 million

Working

W1 Total number of employees at the end of year 3

Total number of employees at the beginning – Total number of employees who have left the organisation = 1,000 –15 (year1) – 15 (year 2) – 15 (year 3) = 955

Answer to TY 6

The fair value of the liability to be recorded on 31 March 2012 is: 50 x Tshs2,000 x 75% x 1/3 = Tshs25,000.

The accrued liability at 31 March 2013 is Tshs90,000 (i.e. 50 x Tshs3,000 x 90% x 2/3). The increase in the liability of Tshs65,000 (Tshs90,000 - Tshs25,000) is recognised as an expense in the profit or loss part of the statement of profit or loss and other comprehensive income within 'employee costs'.

Quick Quiz

1. What is a share option?

2. Roxy Ltd has offered a rights issue to its shareholders that the shares of the entity (valued at Tshs1,000 each) may be procured within the next three months at a price of Tshs500 each. Does this transaction fall within the scope of share-based payment?

   A Yes
   B No

3. Roshan Steels procures steel from Steeline Ltd. Roshan Ltd issues 1,300 shares to Steeline Ltd. against the issue of shares. Does this qualify as an equity-settled, share-based payment?

   A Yes
   B No

Answers to Quick Quiz

1. A share option is a contract in which the holder pays to obtain the right, but not the obligation, to purchase:

   - A certain number of shares
   - At a predetermined price
   - During a specified period of time

2. The correct option is **A.**

   Under the terms of the contract, the shareholders have a right to subscribe for the shares of the company.

   However, no goods or services are received or to be received in exchange for these shares, hence this will not fall within the scope of IFRS 2, Share-based Payment, unless the shareholders are employees as well and material amount of discount is offered to them compared to non-employee shareholders.

3. The correct option is **A.**

   This transaction involves purchase of “goods”. Roshan Ltd has issued its shares in exchange for goods. Hence this qualifies as an equity-settled transaction.

Self-Examination Questions

Question 1

On 1 October 2010, Delta granted 100 employees options to purchase 100 equity shares which will on 1 October 2012. However to avail the share options these employees must remain employed with Delta until 1 October 2012. The share options allow the employees of Delta to purchase the shares for Tshs9,000 per share.

	Market price of the shares	**Market value of the options**
1 October 2010	Tshs9,000	Tshs3,000
1 October 2011	Tshs9,500	Tshs3,600

On 1 October 2010, the directors estimated that 10% of the relevant employees would leave in each of the years ended 30 September 2011 and 30 September 2012 respectively.

It turned out that 2% of the relevant employees left in the year ended 30 September 2011 and the directors now believe that a further 6% will leave in the year ended 30 September 2012.

Required:

Show the amounts that will appear in the financial statements of Delta for the year ended 30 September 2011 in respect of the share options.

Question 2

(a) On 1 April 20X7 the board of Alpha Ltd granted share options to some key employees. The options are subject to vesting conditions. Details of the award are as follows:

100 employees will receive 10,000 options each on 31 March 20X9. This will allow the employees to purchase the shares of the company any time in the year ending 31 March 20Y0. The share has a nominal value of Tshs1,000 per share but the fair value per share will be Tshs30,000. The scheme will be valid only if the employee remains with the company until 31 March 20X9 and the share price is at least Tshs40,000 by 31 March 20X9. On 1 April 20X7, the price of the share was Tshs30,000. By 31 March 20X8, the price had risen to Tshs36,000 and the board is reasonably confident that the price will reach Tshs40,000 by 31 March 20X9.

The management of the company estimated on 1 April 20X7 that 10 employees will leave the company in the next 2 years. However, 6 employees left in the year ended 31 March 20X8 and management estimates that 6 more will leave in the year to 31 March 20X9.

On 1 April 20X7 the directors estimated that the fair value of each granted option was Tshs9,000. This estimate had risen to Tshs10,000 by 31 March 20X8.

Required:

Show the impact of granting the share options on the financial statements of Alpha for the year ended 31 March 20X8. Ignore deferred taxation.

(b) Having read your analysis about the impact of the granting of the options on the financial statements for the year ended 31 March 20X8, the directors want to know the likely impact of the transactions in (a) on the financial statements of future years under the following assumptions:

The directors' estimates about the number of relevant employees who leave in the year ended 31 March 20X9 prove to be accurate.

The employees exercise their options in 90% of the cases in the year ended 31 March 20Y0 and the unexercised options lapse on 31 March 20Y0.

Required:

Show the impact of the above assumptions regarding the options on the financial statements of Alpha for the years ended 31 March 20X9 and 20Y0. Ignore deferred taxation.

Answers to Self-Examination Questions

Answer to SEQ 1

This transaction is an example of an equity-settled share-based payment transaction that is accounted for in accordance with IFRS 2 share-based payment. Such transactions are measured using the, market value of the relevant equity instrument on the grant date.

In this case, the relevant market value is Tshs3,000 (the market value of the share option on 1 October 2011). The cost of the grant is taken to the statement of profit or loss over the two year vesting period.

Where the grant is subject to future employment or future conditions then the latest known estimates of the extent of performance are used to determine the total cost. This means that, in this case, the total charge to the statement of profit or loss will be:

100 share options x 92 employees x Tshs3,000 = Tshs27,600,000.

In the year ended 30 September 2012, ½ of this amount, i.e. Tshs13,800,000, is debited to income as an operating cost and credited to equity.

Answer to SEQ 2

Alpha Ltd

(a) Extracts from financial statements for year ended 31 March 20X8

Estimate of total cost of award

1,000,000 share options (100 employees x 10,000 share options) can potentially be awarded.

Based on estimates of employee retention at the latest reporting date it is likely that 880,000 (88 employees x 10,000 share options) will actually be awarded. It is appropriate to take account of changed estimates of this nature.

The total expected cost of this award is Tshs7,920 million (880,000 x Tshs9,000). This cost is estimated using the fair value of the option at the grant date and is not adjusted where the fair value of the option subsequently changes.

The target share price is a market condition and so is ignored when assessing the amount vesting.

Treatment in financial statements for the year ended 31 March 20X8

Tshs3,960 million (1/2 of total costs i.e. Tshs7,920 million) are recognised in the financial statements

The debit entry is made either to the statement of profit or loss as an employment cost (taken to cost of sales, distribution costs or administrative expenses as appropriate) or to an asset such as inventory or PPE on the statement of financial position.

The credit entry is made to a share option account as a separate component of equity.

(b) Potential impact on financial statements for the years ended 31 March 20X9 and 20Y0

Year ended 31 March 20X9

According to part (a) the total estimated cost of the award is Tshs7,920 million. The estimates made previously have proved to be accurate.

Therefore a further charge of Tshs3,960 million is debited either to the statement of profit or loss or to an asset account and credited to a separate component of equity.

The closing balance on the separate equity component will be Tshs7,920 million.

Year ended 31 March 20Y0

The number of options that are exercised will be 792,000 share options (880,000 share options x 90%).

Alpha will receive cash of Tshs23,760 million (792,000 share options x Tshs30,000). Tshs7,128 million (Tshs7,920 million x 90%) will be transferred from the share options account within equity to the share premium account.

Tshs792 million will be included in the share capital account.

Tshs30,096 million (792,000 x (Tshs30,000 - Tshs1,000) + Tshs7,128 million) will be included in the share premium account.

The remaining balance of Tshs792 million (10% of Tshs7,920 million) on the share options account will be transferred directly to retained earnings when the options lapse.

There will be no impact on the statement of profit or loss.

SECTION B

REPORTING THE FINANCIAL PERFORMANCE OF ENTITIES

B4

STUDY GUIDE B4: REPORTING REQUIREMENTS OF SMALL AND MEDIUM-SIZED ENTITIES (SMEs)

Get Through Intro

The IASB has clearly stated that the primary objective of the IFRS is to meet the informational needs of investors in capital markets i.e. IFRS / IAS have been drafted from the capital market investor's point of view.

How correct is it then to expect SMEs to follow the provisions of IFRS? How would it be beneficial to them?

SMEs are usually family or single entrepreneur run businesses. These entrepreneurs invest capital derived from their own funds or borrowed funds or through specifically identified and agreed upon investors. SMEs often produce financial statements only for the use of owner-managers or only for the use of tax authorities or other governmental authorities. Hence, preparing financial statements in compliance with full IFRS may not have enough benefits to warrant the costs and the efforts.

Hence, the IASB has developed a separate accounting standard for SMEs. This Study Guide discusses the rationale for issuing the standard, few major differences between the full IFRS and IFRS for SMEs and implications of having such differences.

If you work in an SME you will have to refer to this standard.

Learning Outcomes

a) Explain the meaning of SMEs and the simplifications introduced by IASB.
b) Explain the differences in application of mainstream IFRSs and IFRS for SMEs in regards to preparing and presenting financial statements.

1. Explain the meaning of SMEs and the simplifications introduced by IASB.

2. Explain the differences in application of mainstream IFRSs and IFRS for SMEs in regards to preparing and presenting financial statements

[Learning Outcomes a and b]

1.1 Meaning of small and medium-sized entity (SME)

In July 2009, the IASB has issued a separate standard intended to apply to the general purpose financial statements, and other financial reporting of **small and medium-sized entities** (SMEs), private entities, and non-publicly accountable entities. The standard is called the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs).

However, this standard does not prohibit the SMEs from adopting the full IFRS.

1.2 Need for SME standard

The objective of developing IFRS by the International Accounting Standards Board (IASB) was to cater to the needs of quoted companies and not SMEs. However the vast majority of the world's companies are small and privately owned companies. Later on it was argued that adopting IFRS would be a lengthy exercise for the SMEs. This will require additional resources and guidance. To end these problems faced by SMEs, the IFRS for SMEs makes numerous simplifications to the recognition, measurement and disclosure requirements of full IFRS

1.3 Applicability of SME standard

Definition

Small and medium-sized entities are entities that:

- Do not have **public accountability**, and
- Publish **general purpose financial statements** for external users.

Examples of external users include owners who are not involved in managing the business, existing and potential trade payables, and credit rating agencies.

An entity has **public accountability** if:

- Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market; or
- It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.
- This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks

IFRS for SMEs Para 1.2

If an entity holds assets in a fiduciary capacity for a broad group of outsiders because it holds and manages financial resources entrusted to them by clients, customers or members not involved in the management of the entity and it does this for reasons incidental to a primary business, the entity is not publicly accountable.

A subsidiary whose

- Parent uses full IFRSs, or
- That is part of a consolidated group that uses full IFRSs, is not prohibited from using this IFRS in its own financial statements if that subsidiary by itself does not have public accountability

Many jurisdictions around the world have developed their own definition of SMEs for a broad range of purposes including prescribing financial reporting obligations. Often those national or regional definitions include quantified criteria based on revenue, assets, employees or other factors. However, the standard wants to focus on whether the entities publish general purpose financial statements for external users.

1.4 Arguments for and against IFRS for SMEs

Arguments for IFRS for SMEs	Arguments against IFRS for SMEs
1. IFRS for SMEs ensure comparability of the financial statements between large sector enterprises and small enterprises producing similar goods. 2. It ensures comparability of financial statements between different countries. 3. At a later point in time, when the SME grows in size and eventually gets listed on a stock exchange, then it would have to switch over to the full IFRS in any case. The transition from national GAAP to IFRS would be very difficult and resource-consuming for the enterprise. IFRS for SMEs reduced the gap so that when the SME gets listed, it will be in a better position to adopt IFRS. 4. The financial statements for SMEs are issued in public interest and are used to protect the interest of all the stakeholders of the entity.	1. Although IFRS for SMEs is a simplified version of the full IFRS, the cost involved in complying with it is relatively higher than the costs involved in complying with a particular country's national GAAP. 2. The IFRS do not provide guidance on many issues and in such cases the SMEs are allowed to take guidance from the full IFRS, but this is not compulsory. This reduces the comparability of the financial statements of the SMEs. 3. Besides the SME's investors and those directly connected with the entity, not many people require the SME's financial information.

1.5 Implications of the differences between the full IFRS and IFRS for SMEs

1. The need for separate accounting standards for SMEs

The IFRS and IAS were written to bring about a sense of uniformity in the financial statements of entities to facilitate comparability between the financial statements of different entities. It is usually the large listed corporations that follow the IFRS. However, with some countries adopting International Accounting Standards as their national GAAP, SMEs too would have to follow these standards.

There are now 117 jurisdictions which require listed companies to use the full IFRS. Out of these 117 jurisdictions, 80 require unlisted companies also to report under the full IFRS. Convergence of various local GAAPs with IFRS is thus gaining momentum worldwide. There have been increasing concerns amongst the SMEs regarding the difficulties, cost and burden for them in converging with the full IFRS.

(a) Problems in following the full IFRS

(i) **SMEs are not publicly listed**; the users of their financial statements are mainly interested in knowing the short term cash flow, liquidity and solvency of the company. Therefore applying the full IFRS is not required and their accounting needs to be governed by a separate set of standards.

(ii) The **content of many IFRS is not relevant** to SMEs.

(iii) **Cost and resources**: Streamlining their financial reporting process in accordance with IFRS requirements would only lead to the addition of a large reporting burden on them, both in terms of cost and resources.

This created the need for separate standards for SMEs. However, the entities wishing to apply these standards will need to consider the legislative requirements in their jurisdiction to determine whether and when they are permitted to apply the standards.

The standard on SME offers an excellent opportunity to create a standardised accounting framework for SMEs throughout the world. The users of financial statements will have directly comparable financial statements that are authoritative and also based on internationally recognised principles. This is a step to ensure that cross border transactions are carried out smoothly and the SMEs have access to global capital.

Moreover, this will reduce the administrative burden on privately held businesses. The disclosure requirements for SMEs would be considerably reduced.

The problems of SMEs are solved by issuing a separate standard for SMEs.

(b) The IFRS for SMEs aims at:

(i) Providing a simplified, self-contained set of standards that are appropriate for smaller, non-listed companies but still based on full IFRS.

(ii) Considering users' needs and cost-benefit considerations.

(iii) Removing choices for accounting treatment, eliminating topics that are not generally relevant to SMEs and simplifying recognition and measurement.

(iv) Providing minimum and simple disclosure requirements for SMEs, as compared to listed entities

(v) Enabling investors, lenders and others to compare SMEs' financial performance, financial position and cash flows while, at the same time, reducing the burden of preparing SMEs' financial statements.

(vi) Providing emerging economies with an internationally recognised basis for financial reporting, helping to raise the quality of financial reporting in many countries while offering entities a clear path to upgrade to full compliance with IFRS.

(vii) Ensuring that the separate IFRS for SMEs results in general purpose financial statements on which an auditor can give an opinion as to fair presentation (or true and fair view) of financial position, performance and cash flows.

(viii) Reducing the burden on SMEs by providing revisions to the IFRS once every three years

1.6 The standard is developed based on the full IFRS. However it is developed with the intention to simplify the reporting requirements of SME's, giving importance to the cost benefit consideration while doing so. The major reasons why IFRS for SME's do not address certain topics are:

1. Reporting in those areas may result in undue cost burden, which is proportionately heavier for small firms.
2. The cost burden may not be justified based on the users' needs.
3. SME's perceive that IFRS compliant financial statements are less relevant to the users of financial statements.
4. The transactions entered by SME's are less complex and therefore do not need sophisticated accounting treatment.

As a result IFRS for SME's does not address the following topics:

- Earnings per share
- Interim financial reporting
- Segment reporting
- Insurance (because entities that issue insurance contracts are not eligible to use the standard) and assets held for sale.

Apart from this, complex matters are covered in various standards. However, they are not covered by the IFRS for SME's considering that the SME's may not face such complex issues. Some examples of these matters are as follows:

Business combinations (IFRS 3): step acquisitions, a business combination achieved without the transfer of consideration, indemnification assets, re-acquired rights etc.

IFRS 10 Consolidated financial statements: loss of control, transactions with minorities etc.

Revenue: extended warranties (IAS 18), distinction between advertising and non-advertising barter transactions (SIC 31) and transfer of assets from customers (IFRIC 18).

Financial instruments: derivatives and embedded derivatives, reclassifications between categories of financial instruments, detailed guidance on de-recognition of financial assets, qualifying hedging instruments and qualifying hedged items.

1.7 Simplifications introduced by the IFRS for SME

The following are few important areas in which the IFRS for SME's has introduced certain restrictions and simplification for the reporting requirements of small and medium-sized entities.

1. Business combinations

(a) An SME that is a parent is permitted not to prepare consolidated financial statements if any of the following is applicable:

These provisions are in line with IFRS 3 before amendments in 2008.

(i) The SME itself is a subsidiary and its ultimate or any intermediate parent's financial statements comply with 'full IFRS' or 'the IFRS for SME's'.

(ii) The SME's only subsidiaries were acquired with the intention of selling or disposing them of within one year.

(b) The provision regarding the coterminous year is also applicable to parent SME's. However, there is no guidance on what might be considered an acceptable difference in reporting dates, or the treatment of transactions in the intervening period.

(c) No option of measuring non-controlling interest at fair value is available. NCI will always be valued as a share in the net assets of the subsidiary.

(d) In the case of SME's, goodwill should be calculated as the excess of the cost of the business combination over the acquirer's interest in the net fair value of net assets.

This means that it should be calculated as follows:

Cost of the business combination	X
Less: Share of parent in the fair value of net assets at acquisition date	(X)
Goodwill / gain on bargain purchase	**X**

Value of NCI is not considered.
This will always give the value of goodwill attributable to parent only (partial goodwill)

(e) Estimated amount of contingent consideration is included in the cost of a business combination if, at the acquisition date, it is probable and can be measured reliably.

However, if it is not recognised at the acquisition date but subsequently becomes probable and can be measured reliably, the additional consideration should be treated as an adjustment to the cost of the combination. As a result, the goodwill will be affected.

(f) Within 12 months after the acquisition date, the acquirer will account for any changes assets and liabilities as if they were made at the acquisition date to reflect new information obtained. Beyond 12 months after the acquisition date, adjustments to the initial accounting for a business combination shall be recognised only to correct an error in accordance with Section 10 'Accounting Policies, Estimates and Errors'.

(g) Any costs directly attributable to the business combination should be considered while calculating cost of a business combination i.e. consideration. It should not be expensed out, the same way it is done in the full IFRS (mentioned above).

(h) IFRS for SME's specifies that the acquirer recognises a separate provision for contingent liability of the acquiree only if its fair value can be measured reliably.

2. Intangible asset and goodwill

(a) Measurement of IA

Use of the revaluation model is not permitted for SME's. After initial recognition, all the intangible assets and goodwill are measured at cost less amortisation and impairment losses. The principle of measurement of IA applies to tangible non-current assets as well.

(b) Useful life

According to the new IFRS on SME's, all the goodwill and indefinite useful life intangible assets are considered to have finite useful life and are amortised accordingly. If any entity is not able to estimate the useful life reliably, it is presumed to be 10 years. SME's need to review the useful lives and residual values of intangible assets only when there are indications that they have changed. The change can happen when there is a technological advancement in the market or there are drastic changes in the prices affecting the residual value etc.

(c) Internally generated intangible asset

IFRS for SME's does not permit recognition of internally generated intangible assets. All the expenditure incurred internally including research and development expenditure is expensed out unless it forms a part of another asset meeting the recognition criteria for intangible assets.

Example

Jordan Ltd, a SME acquired a broadcasting licence that expires in five years. Thereafter the broadcasting licence is renewable every ten years, on condition that the Jordan provides at least an average level of service to its customers and complies with the relevant legislative requirements. Jordan Ltd intends to renew the licence indefinitely and historical evidence supports its ability to do so.

Because the facts and circumstances support the Jordan Ltd.'s ability to continue renewing the broadcasting licence so as to contribute to the net cash inflows indefinitely, Jordan may be unable to make a reliable estimate of the useful life of the intangible asset. However in accordance with IFRS for SME's the useful life is presumed to be 10 years and amortised accordingly.

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3. Financial instruments

The treatment of financial instruments under IFRS for SME's involves either applying:

Financial instrument sections of IFRS for SME's or

International Accounting Standard (IAS) 39, Financial Instruments: Recognition and Measurement, plus the disclosure requirements for IFRS for SME's.

IFRS 7 Financial instruments: Disclosures is not applicable to SME's under either option.

Financial instruments have been categorised under two categories (discussed below) as compared to four categories given in IAS 39. The two sections for financial instruments under IFRS for SME's are:

(a) Section 11 – for basic financial instruments and

(b) Section 12 - for more complex financial instruments.

There is no category for available-for-sale and held-to-maturity financial instruments.

(a) Section 11 – Basic financial instruments

Section 11 requires an amortised cost model for all basic financial instruments except for investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably

Initial recognition

Financial instruments within the scope of section 11 are recognised at the transaction price including transaction costs (except for those classified as fair value through profit or loss). However, if an arrangement constitutes a financing transaction, the entity shall measure the financial asset or financial liability at the present value of the future payments discounted at the market rate of interest for a similar debt instrument.

Transaction costs for the financial instruments classified as through profit or loss should be charged to the statement of profit or loss.

Example

Financial Assets

For a long-term loan made to another entity, a receivable is recognised at the present value of cash receivable (including interest payments and repayment of principal) from that entity.

For goods sold to a customer on short-term credit, a receivable is recognised at the undiscounted amount of cash receivable from that entity, which is normally the invoice price.

Financial Liabilities

For a loan received from a bank, a payable is recognised initially at the present value of cash payable to the bank (e.g. including interest payments and repayment of principal).

For goods purchased from a supplier on short-term credit, a payable is recognised at the undiscounted amount owed to the supplier, which is normally the invoice price.

Subsequent measurement

At the end of each reporting period:

Basic debt instruments are measured at amortised cost using the effective interest method

Commitments to receive a loan are measured at cost less impairment

Investments in non-convertible and non-puttable ordinary shares or preference shares are measured at fair value through profit or loss if fair value can be measured reliably, otherwise at cost less impairment

Example

Example of financial instrument falling under this section includes:

- Cash
- Demand and fixed-term deposits when the entity is the depositor, e.g. bank accounts
- Commercial paper and commercial bills held
- Accounts, notes and loans receivable and payable
- Bonds and similar debt instruments
- Investments in non-convertible preference shares and non-puttable ordinary and preference shares
- Commitments to receive a loan if the commitment cannot be settled net in cash

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Example

Examples of financial instrument that do not meet the conditions of basic financial instruments are:

- Asset-backed securities and repurchase agreements.
- Options, rights, warrants, futures, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument.
- Hedging instruments.

Commitments to make a loan to another entity.

Investments in another entity's equity instruments other than nonconvertible and non-puttable ordinary shares and preference shares. Investments in convertible debt.

Example

On 1 January 20X0, an entity acquires a bond for Tshs900 million, incurring transaction costs of Tshs50 million. Interest of Tshs40 million is receivable annually, in arrears, over the next five years (31 December 20X0–31 December 20X4). The bond has a mandatory redemption of Tshs1,100 million on 31 December 20X4. The effective rate of interest has been calculated to be 6.95%.

Year	Carrying amount at beginning of period	Interest income at 6.95%	Cash inflow	Carrying amount at end of period
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
20X0	900,000+50,000	66,000	(40,000)	976,000
20X1	976,000	68,000	(40,000)	1,004,000
20X2	1,004,000	70,000	(40,000)	1,034,000
20X3	1,034,000	72,000	(40,000)	1,066,000
20X4	1,066,000	74,000	(40,000)	1,100,000

Note: Amount rounded off

(b) Section 12 – More complex financial instruments including hedged items

Section 11 applies to basic financial instruments and is relevant to all entities. Section 12 applies to other, more complex financial instruments and transactions. If an entity enters into only basic financial instrument transactions then Section 12 is not applicable. However, even entities with only basic financial instruments shall consider the scope of Section 12 to ensure they are exempt.

Initial recognition: According to section 12, financial instruments are recognised at fair value.

Subsequent measurement: at the end of each reporting period, entity shall measure all financial instruments within the scope of section 12 at fair value and recognize any changes in profit and loss except for the following:

- Equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and
- Contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment.
- Investments in non-convertible and non-puttable ordinary shares or preference shares are measured at fair value through profit and loss if fair value can be measured reliably, otherwise at cost less impairment.

Example

Examples of financial instruments that are within the scope of Section 12 are:

- Asset-backed securities, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables.
- Options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument.

Financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in Section 12.

- Commitments to make a loan to another entity.
- Commitments to receive a loan if the commitment can be net settled in cash.

(i) Hedge accounting

Hedging risk

IFRS for SME's permits hedge accounting only for the following risks:

- Interest rate risk of a debt instrument measured at amortised cost.
- Foreign exchange or interest rate risk in a firm commitment or a **highly probable forecast transaction**.
- Price risk of a commodity that it holds or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity.
- Foreign exchange risk in net investment in a foreign operation.

Hedging instrument

IFRS for SME's permits hedge accounting only if the **hedging instrument has all of following terms and conditions:**

Only an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract or a commodity forward exchange contract are allowed to be designated as hedging instrument.

It should involve only parties external to the reporting entity.

Its notional amount should be equal to the designated amount of the hedged item.

Its specified maturity date should be no later than:

- The maturity date of the hedged item;
- The expected settlement date of the commodity purchase or sale commitment; or
- The occurrence of the highly probable forecast foreign currency or commodity transaction hedged.

It should have no prepayment, early termination or extension features.

Conditions for hedge accounting

To qualify for hedge accounting all of the following conditions need to be satisfied:

- The entity designates and documents the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified and the risk in the hedged item is the risk being hedged with the hedging instrument.

- The hedged risk is one of the risks specified above.

- The hedging instrument is as specified above.

- The entity expects the hedging instrument to be highly effective in offsetting the designated hedged risk.

4. Employee benefits

IFRS for SME provides a simplified approach for accounting of retirement benefit schemes (in particular the defined benefit schemes). Section 28 of the standard addresses employee benefit.

The projected unit credit method is applicable to SME's for measuring costs and obligations under defined benefit plan, if the necessary information is available or can be obtained without undue cost or effort.

If the entity cannot apply the projected unit method:

If an entity is not able to apply the projected unit credit method, the entity is permitted to make the following simplifications in measuring its defined benefit obligation with respect to current employees:

(a) Ignore estimated future salary increases (i.e. assume current salaries continue until current employees are expected to begin receiving post-employment benefits);

(b) Ignore future service of current employees (i.e. assume closure of the plan for existing as well as any new employees); and

(c) ignore possible in-service mortality of current employees between the reporting date and the date employees are expected to begin receiving post-employment benefits (i.e. assume all current employees will receive the post-employment benefits). However, mortality after service (i.e. life expectancy) will still need to be considered.

An entity that takes advantage of the foregoing measurement simplifications must nonetheless include both vested and unvested benefits in measuring its defined benefit obligation

Actuarial gains and losses on liabilities are recognised in full in statement of profit or loss in the period in which they occur. There is no corridor approach.

5. Exchange differences

Section 30 of the standard deals with foreign currency translations. An entity's functional currency is the currency of the primary economic environment in which it operates. This is similar to functional currency approach in "IAS 21 the effects of changes in foreign exchange rates".

Initial recognition

An entity shall record a foreign exchange transaction in the functional currency using the exchange rate at the transaction date (spot rate). Also average rates may be used if they do not fluctuate significantly. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

Reporting at the end of the subsequent reporting period

(a) At the end of each reporting period**, foreign currency monetary balances** are translated using the exchange rate at the closing rate.

(b) Non-monetary balances denominated in a foreign currency and carried:

  (i) At cost: reported using the exchange rate at the date of the transaction.
  (ii) At fair value: reported using the exchange rate at the date when the fair values were determined.

Exchange differences on monetary items are recognised in profit or loss for the period except for those differences arising on a monetary item that forms part of an entity's net investment in a foreign entity. In the consolidated financial statements, such exchange differences are recognised as a separate component in equity. Recycling through profit or loss of any cumulative exchange differences that were previously recognised in equity on disposal of a foreign operation is not permitted.

6. Associates and JVs

In the case of SME's, **in addition to the equity method**, an investor / a venturer has an **option** to account for its investments in associates / interest in a joint venture using the following:

(a) The cost model
(b) The fair value model

(a) The cost model i.e. at cost less any accumulated impairment losses

Used for other than those for which there is a published price quotation.

Initially, investment in an associate / interest in a joint venture are recognised at the transaction price excluding transaction costs.

(b) The fair value model

An investor / venturer shall measure its investment in associates / interest in joint ventures for which there is a published price quotation using the fair value model.

Subsequently, at each **reporting date**, an investor / venturer shall measure its investment in associates / interest in joint ventures at fair value, with changes in fair value recognised in statement of profit or loss.

Dividends and other distributions received from the investment shall be accounted for as income irrespective of whether the distributions are from pre-acquisition or post-acquisition profits.

IFRS for SME's does not permit proportionate method of accounting for interest in joint ventures.

7. Government grant

IFRS for SME's provide that an entity shall recognise government grants as follows:

(a) A grant that does not impose specified future performance conditions on the recipient is recognised in income when the grant proceeds are receivable.

(b) A grant that imposes specified future performance conditions on the recipient is recognised in income only when the performance conditions are met.

(c) Grants received before the revenue recognition criteria are satisfied, are recognised as a liability.

An entity should measure grants at the fair value of the asset which is received or to be receivable. Also IFRS for SME's does not cover areas such as non-monetary government grants, government assistance and repayment of government grants which are covered in IAS 20.

8. Related party

The disclosure requirements for SME's are similar to the requirements of IAS 24, except for certain relief which is provided in the case of the disclosure of certain related party transactions. The compensation of key management personnel need to be disclosed in total and the category-wise break-up as required in IAS 24 need not be given. SME's have to disclose a parent-subsidiary relationship. However, they are exempt from disclosing the amount of transactions, outstanding balances and provision for uncollectible bad debts during the year for the following entities:

(a) State government (a national, regional or local government) that has control, joint control or significant influence over the reporting entity, and

(b) Another entity that is a related party because the same state government has control, joint control or significant influence over both the reporting entity and the other entity.

9. Topic omitted by SME standard

The following topics are not covered under IFRS for SME's to reduce the reporting burden on entities:

(a) Segment reporting
(b) Earnings per share
(c) Interim financial reporting
(d) Classification under IFRS 5 i.e. held for sale

1.8 Major differences in Full IFRS and IFRS for SME's

Title	Full IFRS	IFRS for SMEs
Full set of financial statements	Statement of financial position (SOFP) Statement of profit or loss and other comprehensive income Statement of cash flows (SOCF) Statement of changes in equity (SOCE) Notes, containing summary of significant accounting policies and other information	While these statements also comprise the full set of financial statements as required by the IFRS for SMEs , a combined statement of income and retained earnings is prepared if changes to equity arise from: changes in accounting policy correction of prior period errors dividend payments profit or loss
Presentation of comparative information	Present comparative information as at the beginning of the earliest comparative period if: retrospective application of accounting policies is made retrospective restatement of financial statement items is made reclassification of items in financial statements is done	No disclosure of comparative information is required in the above cases under IFRS for SMEs

Continued on the next page

Title	Full IFRS	IFRS for SMEs
Investments in associates and jointly controlled entities	**Investments in associates:** Apart from a few exceptions, account for using the equity method **Investments in joint venture:** Apart from a few exceptions, account for using the equity method	Choice of accounting policy in accounting for investments in associates and jointly controlled entities between: equity method cost at fair value through profit or loss
Measurement of property, plant and equipment and intangible assets	**Cost model:** assets measured at cost less accumulated depreciation or amortisation and impairment losses **Revaluation model:** assets whose fair value can be reliably measured and carried at revalued amounts	Revaluation model not permitted
Research and development costs	**Research expenditure:** expense as incurred **Development expenditure:** capitalise asset if it satisfies the criteria for intangible asset in IAS 38	Expense the research and development expenses as incurred **Exception to above rule:** expenditure forms part of cost of another asset that meets the recognition criteria in the IFRS for SMEs.
Review of useful life, depreciation methods and residual values	Depreciation methods, useful lives of items of property, plant and equipment, intangible assets and residual values reviewed at end of accounting period	Review only when indication of change in useful life, residual values and depreciation methods
Useful life – intangible assets	Intangible assets can have definite as well as indefinite useful lives do not amortise intangible assets with indefinite useful lives	Consider all assets to have definite useful lives If useful life cannot be determined, then presume useful life = 10 years
Government grants	Government grants, including non-monetary grants at fair value, should not be recognised until there is reasonable assurance that: the entity will comply with the conditions attached to them; and the grants will be received	A grant that does not impose specific future performance conditions on the recipient is recognised in income when the grant proceeds are receivable. A grant that imposes specific future performance conditions on the recipient is recognised in income only when the performance conditions are met.
Measurement of inventories	Use of most recent purchase price while approximating cost of inventories not permitted	Use of most recent purchase price while approximating cost of inventories is permitted
Borrowing costs	Capitalised as part of asset	Expensed as incurred
Accounting for goodwill under business combinations	goodwill is not amortised goodwill is tested for impairment at regular intervals whether or not indication of impairment reversal of impairment losses for goodwill in subsequent periods is not permitted	goodwill considered to have finite useful life (if indeterminable amortise over 10 years) goodwill measured at cost less accumulated amortisation and impairment losses assessment at regular intervals for indications of impairment

Test Yourself 1

State how accounting recognition and measurement of financial instruments is simplified in IFRS for SME’s.

Answer to Test Yourself

Answer to TY 1

(a) IAS 39 groups financial assets into four categories. Each category has different rules for classification, recognition, subsequent accounting etc., which are complex. In IFRS for SMEs all the financial instruments are classified into two sections. One section covers only simple instruments such as receivables which are usually carried at amortised cost. Another section covers more complex instruments which are usually measured at fair value through profit or loss. As a result, there would be no need to deal with rules for held-to-maturity or available-for-sale financial instruments.

(b) Under the full IFRS, in order to be eligible for hedge accounting, quantitative effectiveness of the instruments is tested. Under IFRS for SMEs, although a limited number of risks and hedging instruments are permitted for hedge accounting, no quantitative effective test is required.

(c) There is a clear and simple principle for de-recognition i.e. if the transferor has any significant continuing involvement, do not derecognise. The complex procedures outlined in IAS 39 of 'pass-through testing' and 'control retention testing' are avoided.

Quick Quiz

1. State two advantages of IFRS for SMEs.

2. State the definition of an SME according to IFRS for SMEs.

Answers to Quick Quiz

1. Advantages

   (a) Ensures comparability

   (b) Protects interests of all stakeholders

2. Small and medium-sized entities are entities that:

   (a) Do not have public accountability, and

   (b) Publish general purpose financial statements for external users.

Self-Examination Questions

Question 1

What are the measures taken in IFRS for SMEs as against the full IFRS so as that SMEs are relatively comfortable in its implementation?

Question 2

The following information is given about a funded defined benefit plan of Smart Ltd. The present value of the obligation and the fair value of the plan assets were both Tshs2 million on 1 January 20X1.

	20X1	20X2	20X3
	Tshs'000	Tshs'000	Tshs'000
Discount rate at start of year	10.0%	9.0%	8.0%
Current service cost	260	280	300
Benefits paid	300	360	380
Contributions paid	180	200	210
Present value of obligation at 31 December	2,282	2,394	2,590
Fair value of plan assets at 31 December	2,184	2,218	2,186

In 20X2, the plan was amended to provide additional benefits with effect from 1 January 20X2.

The present value on 1 January 20X2 of additional benefits for employee service before 1 January 20X2 was Tshs100,000 for vested benefits, and Tshs60,000 for non-vested benefits.

On 1 January 20X2, the entity estimated that the average period for the non-vested benefits to become vested was three years. The entity has adopted a policy of recognising actuarial gains and losses in profit or loss.

All transactions are assumed to be made at the year-end.

Required

Prepare extracts of statement of profit or loss for the years 20X1, 20X2 and 20X3 in accordance with the SME standard.

Question 3

On 1 January 20X8, Eagle Ltd purchased a new software package to operate its production equipment for Tshs360 million, including Tshs30 million refundable purchase taxes. The purchase price was funded by taking a loan of Tshs363 million (including Tshs3 million loan origination fees). The loan is secured against the software licenses.

In January 20X8, Eagle Ltd incurred the following costs for customising the software so that it is more suited to the systems used by the entity.

Labour – Tshs72 million
Depreciation on plant and equipment used to perform the modifications – Tshs9 million

In January 20X8, Eagle's production staffs were trained in how to operate the new software. Training costs included:

Cost of an expert external instructor – Tshs4.2 million
Labour – Tshs1.8 million

In February 20X8, Eagle's production team tested the software and the information technology team made further modifications necessary to get the new software to function as intended by management. The following costs were incurred in the testing phase:

Material, net of Tshs1.8 million recovered from the sale of the scrapped output – Tshs12.6 million
Labour – Tshs6.6 million
Depreciation on plant and equipment while it was used to perform the modifications – Tshs3 million.

The new software was ready for use on 1 March 20X8. However, because of low initial order levels, the entity incurred a loss of Tshs13.8 on operating the software during March.

Required:

What is the cost of the software at initial recognition in accordance with the SME standard?

Answers to Self-Examination Questions

Answer to SEQ 1

The burden for implementation of IFRS to the SMEs is reduced in the following ways:

1. Some areas / complex topics which are expected not to relate to SMEs are not included in IFRS for SMEs such as accounting for organisations within a hyperinflationary environment, derivatives and embedded derivatives.

2. IFRS for SMEs does not include sections on topics for which IFRS for SMEs does not have a specific requirement to present such information. Those topics are:

   Segment reporting (IFRS 8)
   Earnings per share (IAS 33)
   Interim financial reporting (IAS 34)

Answer to SEQ 2

Smart Ltd – Statement of profit or loss for the year ended

	20X1	20X2	20X3
	Tshs'000	Tshs'000	Tshs'000
Current service cost	260	280	300
Interest cost	200	206	192
Return on plan assets	(304)	(194)	(128)
Actuarial (gain) loss recognised in year (W1)	122	(174)	84
*Past service cost—non-vested benefits	–	60	–
*Past service cost—vested benefits	–	50	–
Staff cost for the year ended 31 December 20X1	**278**	**228**	**448**

* **According to the SME standard**, actuarial gains and losses on liabilities are recognised in full in the statement of profit or loss in the period in which they occur. There is no corridor approach. However, in the case of Smart Ltd, the policy is to recognise actuarial gains in profit and loss.

Also under the simplified approach, future salary increases, future service and possible mortality prior to the retirement date are ignored. The resulting obligation reflects both vested and unvested benefits and should be recognised in profit and loss. Therefore both vested and non-vested benefits are charged to the profit and loss account.

W1 Changes in the present value of the obligation and in the fair value of the plan

	20X1	20X2	20X3
	Tshs'000	Tshs'000	Tshs'000
Present value of obligation on 1 January	2,000	2,282	2,394
Interest cost	200 (a)	206 (b)	192 (c)
Current service cost	260	280	300
Increases resulting from changing an existing plan			
Past service cost—non-vested benefits	-	60	-
Past service cost—vested benefits	-	100	-
Benefits paid	(300)	(360)	(380)
Actuarial (gain) loss on obligation (balancing figure)	122	(174)	84
Present value of obligation on 31 December	**2,282**	**2,394**	**2,590**
Fair value of plan assets on 1 January	2,000	2,184	2,218
Return on plan assets (balancing figure - refer d, e and f)	304 (d)	194 (e)	128 (f)
Contributions	180	200	220
Benefits paid	(300)	(360)	(380)
Fair value of plan assets on 31 December	**2,184**	**2,218**	**2,186**

Amounts in Tshs'000

(a) Tshs2,000 present value of obligation at 31 December 20X0 × 10%.

(b) Tshs2,282 present value of obligation at 31 December 20X1 × 9%.

(c) Tshs2,394 present value of obligation at 31 December 20X2 × 8%.

(d) Tshs2,184 fair value of plan assets at 31 December 20X1 + Tshs300 benefits paid - Tshs180 contributions received - Tshs2,000 fair value of plan assets at 31 December 20X0.

(e) Tshs2,218 fair value of plan assets at 31 December 20X2 + Tshs360 benefits paid - Tshs200 contributions received - Tshs2,184 fair value of plan assets at 31 December 20X1.

(f) Tshs2,186 fair value of plan assets at 31 December 20X3 + Tshs380 benefits paid - Tshs220 contributions received - Tshs2,218 fair value of plan assets at 31 December 20X2.

Answer to SEQ 3

An intangible asset is recognised at cost. The cost of intangible asset includes the following amount:

Description	Calculation / Reason	Tshs'000
Purchase price	Tshs360,000 purchase price less Tshs30,000 refundable purchase taxes	330,000
Loan raising fee	Included in the measurement of the liability	–
Preparation costs	Tshs72,000 labour + Tshs9,000 depreciation	81,000
Training costs	Recognised as expenses in profit or loss. The software is capable of operating in the manner intended by management without incurring the training costs.	–
Cost of testing	Tshs12,600 material (i.e. net of the Tshs1,800 recovered from the sale of the scrapped output) +Tshs6,600 labour + Tshs3,000 depreciation	22,200
Operating loss	Recognised as expenses in profit or loss	–
Borrowing costs	Recognised as expenses in profit or loss	–
	Cost of software	**433,200**

STUDY GUIDE B5: EXPLORATION AND EVALUATION EXPENDITURES

Get Through Intro

Imagine that you work for a mining company and you are involved in finding suitable land, assessing whether it has mineral reserves and conducting a survey to assess the quality of the reserves. There may be occasions when your company has bought land, spent a considerable amount on testing the land, only to find out that its mineral content is extremely low. In these cases, would it make sense, under IFRS, to capitalise all the expenses? If so, at which point would you start capitalising? When would you stop?

The purpose of this Study Guide is to help you understand when and how to capitalise exploration and evaluation expenditures. The figures involved are often very large and so it makes sense for you to understand and be able to apply IFRS 6!

Learning Outcomes

a) Explain the need and scope of IFRS 6.
b) Apply and discuss the treatment of costs that might be included in the initial measurement of exploration and evaluation assets.
c) Demonstrate an understanding of how exploration and evaluation assets should be classified and reclassified and also tested for impairment.

1. Explain the need and scope of IFRS 6

2. Apply and discuss the treatment of costs that might be included in the initial measurement of exploration and evaluation assets.

[Learning Outcomes a and b]

1.1 Need for an accounting standard

The need to develop an accounting standard on exploration for and evaluation of mineral resources by the IASB was for the following reasons

1. The activities related to mineral rights and mineral resources present some special issues. Therefore, they are excluded from the scope of

(a) IAS 38 Intangible Assets and
(b) IAS 16 Property, Plant and Equipment.

The activities related to mineral rights and mineral resources give rise to both tangible and intangible assets. **As such activities were excluded from the scope of both IAS 38 and IAS 16 it was essential to have a standard governing these activities.**

2. Accounting standards of **other related areas** e.g. research and development **cannot adequately cover features of exploration and evaluation assets.**

3. The **activity** and expenditure of exploration and evaluation are **important** to the entities in this business. Also, the **number of entities in this line of business is increasing.** As they would be presenting their financial statements in accordance with IFRSs, it is essential that this important aspect of their business be also governed by a standard.

The fundamental principle of capitalisation of exploration costs has not been changed by the IFRS. Forcing entities that use capitalisation to switch to expensing would not only be unjustified, but no assets would be recognized in case of those concerns which sell mineral rights after doing the initial exploration.

1.2 Scope

All entities engaged in exploration and evaluations of mineral resources are required to **apply the IFRS to the exploration and evaluation expenditures that they incur**. The IFRS does not specify accounting standards for other aspects of accounting for these entities.

The standard states the situations where an entity should

Recognise exploration and evaluation assets and
Test them for impairment in accordance with IAS 36 Impairment of Assets

It requires entities engaged in these activities to disclose

The information about these assets and
The level at which they are being assessed for impairment and
If impairment losses are being recognised

Thus, IFRS 6 treats the exploration and evaluation costs as assets even though no demonstration of probable future benefits is done. This is a deviation from the SOFP approach as exploration and evaluation costs are capitalized even though they do not meet the definition of asset under the IAS.

An entity has to apply the provisions of IFRS 6 ‘Exploration for and Evaluation of Mineral Resource’ to exploration and evaluation expenditures that it incurs.

1.3 Initial measurement

An entity has to **determine which expenses will be recognised as exploration and evaluation assets and apply the policy consistently**. While deciding this policy, it has to rely upon the degree to which these expenses can be related to the finding of mineral resources.

1.4 Expenses that can be included in the initial measurement of exploration and evaluation assets are discussed in following table.

Sr. No.	Expenses	Example
1.	Acquisition of rights to explore	Pleasure Inc. applies to the board regulating coal mines, for acquiring rights to explore land which it owns, to identify a coal mine and pays a fee of Tshs40 million. In this case Tshs40 million will be recognised as exploration and evaluation assets.
2.	Topographical, geological, geochemical and geophysical studies	Pleasure Inc. It hires an expert to conduct topographical studies to determine the site for drilling of the mine. The fees paid for this study is Tshs50 million. In this case Tshs50 million will be recognised as exploration and evaluation assets.
3.	Exploratory drilling	Pleasure Inc. decides on a site and begins its exploratory drilling. It incurs an expenditure of Tshs500 million for this job Tshs500 million will be recognised as exploration and evaluation assets.
4.	Trenching	Any amount spent by Pleasure Inc. for digging trenches at this stage of exploration will be recognised as exploration and evaluation assets.
5.	Sampling	Any amount spent by Pleasure Inc. for extracting, distributing and testing samples at this stage of exploration will be recognised as exploration and evaluation assets.
6.	Activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource	After Pleasure Inc. has extracted the first batch of coal it will incur some expenses for evaluating the technical feasibility and commercial viability of extracting the coal. All expenses incurred for this activity will be recognised as exploration and evaluation assets.

The list of expenses given above is **an indicative list**. There could be many other expenses which could qualify as exploration and evaluation assets.

What we should remember is that **until commercial viability is established** all **costs** incurred are treated as **exploration assets**.

Test Yourself 1

On 2 March 20X9 Earth Explorers Plc. has acquired some land to explore the possibility of extracting coal. The following expenses were incurred for the year to 31December 20X9.

It has paid Tshs200 million as fees to the authorities for permission to begin its activities. Holmes a topographical surveyor is hired and his fees are Tshs500 million.

The travelling expenses of Holmes were Tshs125 million and were borne by Earth Explorers Plc. The other expenses incurred were drilling expenses Tshs4,250 million, trenching Tshs2,000 million and sampling Tshs1,630 million.

After the first batch of coal was extracted it was sent for evaluation of the technical feasibility and commercial viability of extracting more coal. The cost of this was Tshs3,560 million.

Required:

Determine the expenses that can be recognised as exploration and evaluation assets.

1.5 Expenses that cannot be included are discussed in following table.

Sr. No.	Expenses	Example (Pleasure Inc.)
1.	Expenses incurred before the actual process of exploration for and evaluation of mineral resources begins	Pleasure Inc. is in the process of acquiring land for the purpose of exploration activity for evaluation of mineral resources. It is still in the process of signing the required contracts. The legal expenses incurred for signing the contract is not included under IFRS 6 as the activity of exploration and evaluation of mineral resources has not begun. It will not be treated as exploration and evaluation assets.
2.	Expenses incurred after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable	Pleasure Inc. has finished its activity of exploration and has completed the drilling of a coal mine. It has also identified the commercial viability of extracting coal. All expenses incurred after this (the technical feasibility and commercial viability of extracting coal is established) are not treated as exploration and evaluation assets. They are the normal expenses incurred by the entity in the ordinary course of their business.
3.	Expenses incurred for the development of mineral resources	Any expenses incurred by Pleasure Inc. to increase the grade of coal which they have extracted as the first sample from the mine is not treated as an exploration and evaluation asset. They are the normal expenses incurred by the entity in the ordinary course of their business.

1.6 Recognition of liability for restoration work

Sometimes an entity is required by law to **restore the excavation site** to its former condition after the mine ceases production. Under such circumstances the amount which the entity will have to spend for restoration of the site is **recognised as a liability as soon as the exploration and evacuation work starts.**

This follows the requirements of IAS 37 ‘Provisions, contingent liabilities and contingent assets’.

Example

On 1 January 20X9, Delta Ltd, a mining company signs a contract with the government in which it is given the permission to carry out its excavating operations for five years, at the end of which the mine has to be filled up again and the entire land has to be landscaped. The present value of the cost of such landscaping is expected to be Tshs2,000 million.

The liability of Tshs2,000 million has to be provided for in the first year itself, when the mining company begins its excavation work.

It cannot be provided for gradually over the five years of the mining operations, or in the fifth year (that is, at the end of the excavation work), because a liability has to be recognised as soon as the entity performs any operation affected by these environmental laws.

Tip

In the above example, note that a provision will be recognised only when the company begins the excavation work, NOT when it signs the contract. (The present obligation on the basis of a past event occurs only when the actual work starts).

Accounting treatment

The accounting treatment can be explained by reference to the same example.

Test Yourself 2

Consider the above example of Delta Ltd for the following questions

1. State the accounting entries at the time of making the provision, on 1 January 20X9 (ignore discounting).
2. Explain how amortisation will be shown in the accounts each year and
3. Show the treatment for the landscaping at the end of the 5 years.

Test Yourself 3

Midas Mine has incurred the following expenses

	Tshs million
Legal expenses to acquire land	415
Drilling expenses	525
Removing the rubble from the site (after the technical and commercial viability of extracting mineral is established)	200
Trenching	225
Travelling expenses and fees of Topographical expert	500

Required:

State with reasons the expenses that can be capitalised / cannot be capitalised as exploration and evaluation assets.

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3. Demonstrate an understanding of how exploration and evaluation assets should be classified and reclassified and also tested for impairment.

[Learning Outcome c]

3.1 Classification of exploration and evaluation assets

Exploration and evaluation assets can be classified as **tangible or intangible assets according to the nature of the asset which is acquired**. There should be consistency in the application.

Example

Tangible assets: vehicles, drilling rigs
Intangible assets: depreciation on vehicles, drilling expenses

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Using a **tangible asset** to **develop an intangible asset**

Does not change a tangible asset into an intangible asset.
Only the extent to which a **tangible asset is consumed** in developing an intangible asset is **reflected as intangible asset**.

Test Yourself 4

A vehicle is being used only to transport the persons who are engaged in the exploratory drilling of the mine. The vehicle costs Tshs12.50 million, the fuel consumed by the vehicle is Tshs0.2 million, the depreciation of the vehicle is Tshs0.6 million and the other exploratory drilling expenses are Tshs0.56 million.

Required:

Explain the accounting treatment for the above items and clarify where the items will be shown in the financial statements.

Exploration and evaluation costs that are capitalised are classified as non-current assets in the SOFP, and should be separately disclosed on the face of the statement of financial position and distinguished from production assets, where material.

Subsequent measurement

After initial recognition, an entity shall apply one of the two measurement models to exploration and evaluation assets

- The cost model or
- The revaluation model

Exploration and evaluation assets that are classified as tangible assets are measured in accordance with IAS 16. Those that are classified as intangible assets are measured in accordance with IAS 38.

3.2 Disclosure requirements

IFRS 6 requires an entity to disclose the following information about the exploration and evaluation assets recognised in its financial statements.

- Its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.
- The amount of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

Test Yourself 5

A vehicle is used only to transport persons who are engaged in extracting diamonds from a mine. These diamonds are sold in the market. The vehicle costs Tshs30 million and the depreciation and fuel expenses of the vehicle are Tshs3 million and Tshs2.5 million respectively.

State whether these expenses will be recognised as exploration and evaluation assets. If yes then classify them as tangible or intangible assets.

3.3 Impairment of exploration and evaluation assets

The exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the **carrying amount** of an exploration and evaluation asset **may exceed its recoverable amount.**

Example

The carrying amount of exploration and evaluation assets of Pleasure Inc. is Tshs45 million while its recoverable amount is Tshs39.50 million. In this case the impairment loss of exploration and evaluation assets is Tshs5.5 million (Tshs45 million - Tshs39.50 million).

The impairment loss of exploration and evaluation assets is accounted in the same manner as any other impairment loss is accounted. An impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount. Impairment of assets is explained in detail in Study Guide C1.

One or more of the following events indicate that an entity should test exploration and evaluation assets for impairment loss.

1. The period for which the entity has the right to explore in the specific area has:

(a) Expired during the period or
(b) Will expire in the near future and
(c) Is not expected to be renewed.

2. Substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.

3. Exploration for and evaluation of mineral resources in the specific area have not led to the discovery of commercially viable quantities of mineral resources and the entity has decided to discontinue such activities in the specific area.

The above list is **not an exhaustive one**.

Test Yourself 6

Nature's Treasure Plc. has exploration and evaluation assets whose carrying amount is Tshs23 million and recoverable amount is Tshs21.8 million. State the journal entry to record this transaction if it already has

(i) A revaluation surplus of Tshs2.5 million
(ii) A revaluation surplus of Tshs1 million

Answers to Test Yourself

Answer to TY 1

The expenses that are capitalised as in the books of Earth Explorers Plc exploration and evaluation assets are

		Tshs million
1	Fees to authorities for permission for exploration of coal	200
2	Fees paid to the topographical surveyor – Holmes	500
3	Travelling expenses of Holmes	125
4	Exploratory drilling	4,250
5	Trenching	2,000
6	Sampling	1,630
7	Evaluation of the technical feasibility and commercial viability of extracting coal	3,560
	Total expenses capitalised	**12,265**

Answer to TY 2

Dr Mine Account (reflected in SOFP) Tshs2,000 million
Cr Provision for landscape work Tshs2,000 million
Being provision made for the cost of landscaping work

The Mine account will be amortised over a period of five years. As the benefits to be received from the mine will flow to the entity over a period of more than one financial year, it is reflected as an asset in the SOFP.

The journal entry made every year for amortisation of mine account is

Dr Mine Amortisation Expense (Reflected in SOPL) Tshs400 million
Cr Mine Account Tshs400 million
Being the amortisation for the year (Tshs2,000 million / 5 years)

When actual landscape work is done:

Dr Provision for landscape work Tshs2,000 million
Cr Bank Tshs2,000 million
Being provision made for the cost of landscaping work

Answer to TY 3

All expenses incurred before the actual process of exploration for and evaluation of mineral resources begins up to the technical feasibility and commercial viability of extracting a mineral resource are demonstrable are recognised as exploration and evaluation assets.

The expenses that **can** be **capitalised** are

	Tshs million
Drilling Expenses	525
Trenching	225
Travelling expenses and fees of Topographical expert	500
Total	**1250**

The expenses that **cannot** be **capitalised** are:

	Tshs million
Legal expenses to acquire the land (incurred before the actual process of exploration and evaluation of mineral resources begins)	415
Removing the rubble (After the technical feasibility and commercial viability of extracting a mineral resource has been established)	200
Total	**615**

Answer to TY 4

In this case

The **vehicle** is a **tangible** exploration and evaluation asset if it is used for no other purpose.
The **expenses incurred for the exploratory drilling of the mine** are **intangible exploration and evaluation assets.**

However, the vehicle does not become an intangible exploration and evaluation asset just because it is used in connection with the exploratory drilling of the mine. The fuel consumed by the vehicle Tshs0.2 million and the depreciation of the vehicle Tshs0.6 million form part of the intangible assets they are the extent to which a tangible asset is consumed in developing an intangible asset. Hence the split between tangible and intangible exploration and evaluation assets is

	Tshs'000	Tshs'000
Tangible exploration and evaluation assets		
Vehicle	12,500	
Less: Depreciation	(600)	11,900
Intangible exploration and evaluation assets		
Other expenses	560	
Depreciation of vehicle	600	
Fuel consumed	200	1,360

Answer to TY 5

The vehicle is used for activities after the technical feasibility and the commercial viability of extracting diamonds has been established. This is evident from the fact that the diamonds are sold in the market. All expenses incurred after the technical feasibility and commercial viability of extracting a mineral resource are established **cannot** be included as exploration and evaluation assets. Hence these expenses **will not be recognised as exploration and evaluation assets.**

Answer to TY 6

There is an impairment loss of Tshs1.2 million (W1). This will be recorded as follows

(i) When there already exists a revaluation surplus of Tshs2.5 million

Dr Revaluation surplus Tshs1.2 million
Cr Exploration and evaluation asset Tshs1.2 million
Being the loss on impairment transferred to the revaluation reserve

(ii) When there already exists a revaluation surplus of Tshs1 million

Dr Loss on impairment Tshs0.2 million
Dr Loss on impairment Tshs1 million
Cr Exploration and evaluation asset Tshs1.2 million
Being loss on impairment transferred to revaluation reserve and balance transferred to the statement of profit or loss

Working

W1 Impairment loss on exploration and evaluation assets

	Tshs'000
Carrying amount	23,000
Less: Recoverable amount	(21,800)
Impairment loss	**1,200**

Quick Quiz

1. The expenses which cannot be included as exploration and evaluation assets.

2. State the expenses that can be included as exploration and evaluation assets.

3. Exploration and evaluation assets are always tangible assets. True or False?

4. Fill in the blanks

   Using a tangible asset to develop an intangible asset

   Does not change____________________.
   _________________________in developing an intangible asset is reflected as an intangible asset.

Answers to Quick Quiz

1. The expenses which **cannot be included** as exploration and evaluation assets are

   (a) Expenditures incurred before obtaining legal rights to explore a specific area.
   (b) Expenditures incurred after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.
   (c) Expenditure incurred to develop a mineral resource.

2. The expenses that **can be included** as exploration and evaluation asset

   - Acquisition of rights to explore
   - Topographical, geological, geochemical and geophysical studies
   - Exploratory drilling
   - Trenching
   - Sampling
   - Activities in relation to evaluating the technical feasibility and commercial
   - Viability of extracting a mineral resource

3. **False**: exploration and evaluation assets are **split into tangible and intangible assets**. Examples of tangible exploration and evaluation assets are vehicles, drilling rigs and of intangible exploration and evaluation assets are vehicle expenses, drilling expenses.

4. Using a **tangible asset** to **develop an intangible asset**

   Does not change **a tangible asset into an intangible asset.**
   Only the extent to which a tangible asset is consumed in developing an intangible asset is reflected as an intangible asset.

Self-Examination Questions

Question 1

Precious Gems Ltd is a newly set up entity and has bought land for prospecting for diamonds. It has paid Tshs1.2 million for permission from the authorities to do so. The legal expenses to acquire the land were Tshs0.5 million.

A topographical expert was appointed whose consultation fees are Tshs2.3 million. His travelling expenses (Which include his food and hotel expenses) amounting to Tshs0.25 million are borne by Precious Gems Ltd.

The other expenses incurred are digging trenches Tshs5 million, samples sent for testing Tshs3.25 million, drilling expenses Tshs0.6 million and commercial expenses (to ensure that the extraction of diamonds is commercially viable) Tshs1.7 million. They have hired an expert to advise them how to cut the diamonds in order to increase their commercial value. His fees are Tshs24 million.

Required:

State with reasons the expenses that can be capitalised / cannot be capitalised as exploration and evaluation assets.

Question 2

How are exploration and evaluation assets classified and how are they measured after recognition?

Question 3

Gold Mine Ltd is a newly set up entity and has bought land for gold mining. It has paid Tshs2.4 million to receive permission from the authorities to do so. The legal expenses to acquire the land are Tshs2,04 million.

A topographical expert is appointed whose consultation fees are Tshs3.4 million. His travelling and living expenses amounting to Tshs0.35 million are borne by Gold Mine Ltd. The other expenses incurred are: digging trenches Tshs8 million, samples sent for testing Tshs3.75 million, drilling expenses Tshs0.9 million and commercial expenses (to ensure that the extraction of gold is commercially viable) Tshs1.7 million.

Vehicle A is used to transport persons engaged in the exploratory drilling of the mine. The vehicle costs Tshs20 million. The fuel consumed by vehicle a costs Tshs2.1 million and the depreciation charge of vehicle A is Tshs1 million. The expenses incurred for removing the rubble from the site (after the technical and commercial viability of extracting the gold is established) are Tshs0.25 million.

Vehicle B is used to transport miners who work in the gold mine. The gold is then sold in the market. The vehicle costs Tshs42 million and the depreciation charge and fuel expenses of the vehicle are Tshs4.2 million and Tshs2.5 million respectively.

Required:

Determine (with reasons) the expenses that can be recognised as exploration and evaluation assets. Classify these assets as required by the standards.

Answers to Self-Examination Questions

Answer to SEQ 1

All expenses incurred before the actual process of exploration for and evaluation of mineral resources begins up to the technical feasibility and commercial viability of extracting a mineral resource are established are recognised as exploration and evaluation assets.

The expenses that can be capitalised are

	Tshs'000
The expenses that can be capitalised are	
Fees to acquire rights to explore the land	1,200
Fees of topographical expert	2,300
Travelling, lodging and boarding expenses of topographical expert	250
Fees of samples sent for testing	3,250
Digging trenches	5,000
Drilling expenses	600
Fees paid to ensure commercial viability of extracting diamonds	1,700
Total	**14,300**
The expenses that cannot be capitalised are	
Legal expenses to acquire land (incurred before the actual process of exploration and evaluation of mineral resources begins)	500
Fees of expert (development of mineral resources)	24,000
Total	**24,500**

Answer to SEQ 2

Exploration and evaluation assets are classified as tangible or intangible assets according to the nature of the assets acquired. Exploration and evaluation assets such as drilling rights are classified as intangible asset and assets like vehicles and drilling rigs are classified as tangible.

The part of cost consumed by a tangible asset in developing an intangible asset is considered to be the part of intangible asset. However, that does not mean that a tangible asset can be classified into an intangible asset.

This means that if a vehicle is recognised as an exploration and evaluation asset then it is classified as a tangible asset. The fuel charges of the vehicle and its depreciation is classified as an intangible asset.

After initial recognition as with most assets, an entity shall apply either

(a) The cost model or
(b) The revaluation model

Under the revaluation model the exploration and evaluation assets shall be assessed for impairment, when facts and circumstances suggest that the **carrying amount** of an exploration and evaluation asset **may exceed its recoverable amount.**

Answer to SEQ 3

All expenses incurred after the actual process of exploration for and evaluation of mineral resources begins up to the stage where the technical feasibility and commercial viability of extracting a mineral resource are demonstrable are recognised as exploration and evaluation assets.

The expenses that can be capitalised in the books of Gold Mine are

Intangible exploration and evaluation assets

	Tshs'000	**Tshs'000**
Fees to acquire rights to explore the land		2,400
Fees of topographical expert		3,400
Expenses incurred by topographical expert		350
Fees of samples sent for testing		3,750
Digging trenches		8,000
Drilling expenses		900
Ensuring commercial viability of extracting gold		1,700
Depreciation of vehicle (Vehicle A)	1,000	
Fuel consumed (Vehicle A)	2,100	3,100
Total		**23,600**
Tangible exploration and evaluation assets		
Vehicle A	20,000	
Less: Depreciation	(1,000)	19,000

The expenses that cannot be capitalised are

	Tshs'000	**Tshs'000**
Legal expenses to acquire land (incurred before the actual process of exploration and evaluation of mineral resources begins)		2,040
Removing the rubble (After the technical feasibility and commercial viability of extracting a mineral resource has been established)		250
Vehicle B (This is a non-current asset – not an expense)		42,000
Depreciation of vehicle B	4,200	
Fuel consumed by vehicle B	2,500	6,700
(Vehicle B has been used for activities after the technical feasibility and commercial viability has been established)		
Total		**50,990**

SECTION B

REPORTING THE FINANCIAL PERFORMANCE OF ENTITIES

B6

STUDY GUIDE B6: PREPARATION OF FINANCIAL PERFORMANCE AND POSITION OF ENTITIES

Get Through Intro

Companies communicate details of their corporate performance to internal and external stakeholders by issuing reports. Internal stakeholders have access to more details as they operate within the company. However, external stakeholders have to rely primarily on corporate reports to assess corporate performance.

For example: Warthogs Co needs funds for its expansion program. It approaches two potential lenders- a bank and its Vice President (Production) for a loan of Tshs500,000. While its Vice President (Production) (an internal stakeholder) has access to all documents regarding the expansion program, the bank (an external stakeholder) has to rely on the financial statements and project reports submitted to it.

Hence, the objective of corporate reports should be to provide external stakeholders with a better insight into the company which should enable them to better assess the position, performance and potential of the company. The financial statements are the main indicators of the financial health of any company.

The revised IAS 1 Presentation of financial statements (applicable from 2009) has introduced the concept of 'Comprehensive income'. The idea was to bring together in one statement all changes that affect the statement of financial position apart from equity introduced and dividends withdrawn which are shown in the changes in equity.

Traditional external corporate reporting, based nearly exclusively on financial statements, needs to be expanded into a more comprehensive business-reporting framework in order to be of more use to external stakeholders. With this in mind the IASB proposes to make management commentary an integral part of corporate reporting. Of all the tasks in the lead up to "results day", writing the management commentary is one of the most challenging and demanding one. Management commentary is expected to enable external stakeholders to see the company through the eyes of management.

Understanding this Study Guide will help you prepare corporate reports which are so useful to the external stakeholders of your company.

Learning Outcomes

a) Prepare and present financial statements and extracts from the financial statements of a single entity undertaking a variety of transactions on the basis of chosen accounting policies and in accordance with IFRSs and local regulations.
b) Prepare notes/disclosures that meet the disclosure requirements of the IFRSs and local standards, including disclosures under IAS 33 and other specific standards.
c) Prepare appropriate interim reports from a given scenario.
d) Identify and explain the extent of distributable profits of an entity based on Companies Act.
e) Prepare and comment upon a Directors report as per the TFRS 1.
f) Discuss and apply the principles of IAS 18 to record revenue.
g) Explain the reporting requirements for a first time adopter under IFRS.

1. **Prepare and present financial statements and extracts from the financial statements of a single entity undertaking a variety of transactions on the basis of chosen accounting policies and in accordance with IFRSs and local regulations.**
2. **Prepare notes/disclosures that meet the disclosure requirements of the IFRSs and local standards, including disclosures under IAS 33 and other specific standards.**
3. **Prepare appropriate interim reports from a given scenario.**
4. **Identify and explain the extent of distributable profits of an entity based on Companies Act.**

[Learning Outcomes a, b, c and d]

1.1 Who are the external stakeholders?

The major categories external stakeholders are
1. Investors / potential investors
2. Lenders
3. Suppliers
4. Customers
5. Government
6. General public

1.2 Importance of the financial reports relating to corporate performance and position for external stakeholders

Financial reports help the users of financial statements to

1. Assess potential changes in the economic resources likely to be available on the disposal of an entity
2. Assess variability of performance
3. Predict the capacity of an entity to generate cash flows from its existing resource base and form judgements about the effectiveness with which the entity might employ additional resources
4. Assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise these cash flows
5. Predict future financial position and performance and other matters, such as dividend and wage payments, security price movements and the ability of the entity to meet its commitments as they fall due
6. Assess taxes that can be levied

1.3 Financial information to the stakeholders

1. Information to be presented in the statement of financial position

(a) After studying the methods of classification, it is now essential to see which items must be disclosed in the statement of financial position. It is to be noted that these items can be classified by using either of the methods discussed above.

Definition

As a minimum, the face of the statement of financial position should include line items that present the following amounts

Property, plant and equipment;
Investment property;
Intangible assets;
Financial assets (excluding amounts shown under (e), (h) and (i));
Investments accounted for using the equity method;
Biological assets;
Inventories;
Trade and other receivables;
Cash and cash equivalents;
Total assets classified as held for sale in accordance with IFRS 5
Trade and other payables;
Provisions;
Financial liabilities (excluding amounts shown under (j) and (k));
Liabilities and assets for current tax, as defined in IAS 12 Income Taxes;
Deferred tax liabilities and deferred tax assets, as defined in IAS 12;
Non-controlling interest, presented within equity; and
Issued capital and reserves attributable to owners of the parent.

IAS 1 Para 54

(b) Held for sale and disposal groups: the following items are also to be disclosed in the statement of financial position

(i) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5;
(ii) Liabilities included in disposal groups classified as held for sale in accordance with IFRS 5.

(c) Additional line items, headings and subtotals: when relevant to an understanding of the entity's financial position, additional line items, headings and subtotals may be presented in the statement of financial position.

A Proforma of the Statement of financial position with imaginary figures is given below

XYZ Group – Statement of financial position as at 31 December 20X7 (in thousands of currency units)

Assets	20X7 Tshs'000	20X6 Tshs'000
Non-current assets		
Property, plant and equipment	1,000	900
Goodwill	200	200
Other intangible assets	300	250
Investments in associates	150	150
Available-for-sale financial assets	50	100
Total Non-current Assets	**1,700**	**1,600**
Current assets		
Inventories	500	450
Trade receivables	600	500
Other current assets	200	250
Cash and cash equivalents	100	50
Total Current Assets	**1,400**	**1,250**
Total assets	**3,100**	**2,850**

Equity and Liabilities	20X7 Tshs'000	20X6 Tshs'000
Equity attributable to owners of the parent		
Share capital	500	400
Retained earnings	350	300
Other components of equity	125	50
Non-controlling interest	325	250
Total equity	**1,300**	**1,000**
Non-current liabilities		
Long-term borrowings	600	650
Deferred tax	150	170
Long-term provisions	50	80
Total non-current liabilities	**800**	**900**
Current liabilities		
Trade and other payables	500	400
Short-term borrowings	250	300
Current portion of long-term borrowings	120	80
Current tax payable	80	100
Short-term provisions	50	70
Total current liabilities	**1,000**	**950**
Total liabilities	**1,800**	**1,850**
Total equity and liabilities	**3,100**	**2,850**

2. **Information to be presented either in the statement of financial position or in the notes**

Definition

As a minimum, the face of the statement of financial position should include line items that present the following amounts

(a) For each class of share capital

(i) The number of shares authorised;
(ii) The number of shares issued and fully paid, and issued but not fully paid;
(iii) par value per share, or that the shares have no par value;
(iv) A reconciliation of the number of shares outstanding at the beginning and at the end of the period;
(v) The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
(vi) Shares in the entity held by its subsidiaries or associates; and
(vii) Shares reserved for issue under options, including terms and amounts.

(b) Nature and purpose of each reserve in the equity.

IAS 1 Para 79

The sub classification of line item should be classified in a manner appropriate to the entity's operations. This sub classification can be either disclosed in statement of financial position or in the notes. For example

(a) Classification of items of property, plant and equipment according to IAS 16;
(b) Classification of receivables into trade receivables, related party receivables, prepayments and other amounts;
(c) Classification of inventories according to IAS 2, such as merchandise, production supplies, materials, work in progress and finished goods;
(d) Classification of provisions for employee benefits and other items; and
(e) Classification of equity capital and reserves disaggregated into various classes, such as paid-in capital, share premium and reserves.

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

Figures for assets and liabilities, as well as income and expenses, are disclosed separately.

Example

The trade payables control account shows a balance of Tshs100 million. There are credit balances in the accounts of individual parties totalling Tshs115 million , and debit balances of Tshs15 million representing advances given to suppliers. The two are disclosed separately as assets (Tshs15 million) and liabilities (Tshs115 million) respectively.

3. **Statement of profit or loss and other comprehensive income (IAS 1)**

Profit is widely used as a measure of performance. It is also used as the basis for other performance measures such as earnings per share and return on capital employed.

On 16 June 2011 the International Accounting Standards Board (IASB) issued Presentation of Items of Other Comprehensive Income (amendments to IAS 1) to align the presentation of items of other comprehensive income (OCI) in financial statements prepared in accordance with International Financial Reporting Standards (IFRSs) and those prepared in accordance with US GAAP. The amendment to IAS 1 suggests changes in the title of 'income statement' and 'statement of comprehensive income''. The revised titles are as follows:

Old term	New term
Income statement	Statement of profit or loss
Statement of comprehensive income	Statement of profit or loss and other comprehensive income

Note: This change is not mandatory as IAS 1 still permits entities to use other titles.

IAS 1 gives a choice to entities to present profit or loss and other comprehensive income in either

(i) A single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections or

(ii) Two separate statements comprising of 'statement of profit or loss' and 'statement of profit or loss and other comprehensive income'

Further IAS 1 has given the option to entities to use titles for the statements other than those used in the standard. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'.

Important

Profit or loss is the total of income less expenses, excluding the components of other comprehensive income.

Other comprehensive income comprises items of income and expenses that are not recognised in profit or loss as required or permitted by other IFRSs.

(a) Information to be presented in the statement of profit or loss or the profit or loss section

In addition to items required by other IFRSs, the profit or loss section shall include line items that present the following amounts for the period

(i) Revenue;
(ii) Finance costs;
(iii) Share of the profit or loss of associates and joint ventures accounted for using the equity method;
(iv) Tax expense;
(v) A single amount for the total of discontinued operations (see IFRS 5);

(b) Information to be presented in the other comprehensive income section

The other comprehensive income section shall present line items for amounts of other comprehensive income in the period, classified by nature (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method) and grouped into those that, in accordance with other IFRSs:

(i) Will not be reclassified subsequently to profit or loss; and
(ii) Will be reclassified subsequently to profit or loss when specific conditions are met.

OCI items that can be reclassified into profit or loss

Foreign exchange gains or losses arising from translating the financial statements of a foreign operation (See IAS 21 the Effects of Changes in Foreign Exchange Rates);
Effective portion of gains and losses on hedging instruments in a cash flow hedge (see IAS 39 Financial Instruments: Recognition and Measurement);

OCI items that cannot be reclassified into profit or loss include:

- Changes in revaluation surplus (see IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets);
- Measurements of plan assets and defined benefit obligations under IAS 19 Employee benefits
- Gains and losses from equity instruments measured at fair value through other comprehensive income for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of IFRS 9)

An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period

Profit or loss for the period attributable to:

- non-controlling interests, and
- Owners of the parent.

Comprehensive income for the period attributable to

- Non-controlling interests, and
- Owners of the parent

An entity may present additional line items, headings and subtotals in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

IAS 1 Para 7, 81A, 81B 82, 82A, 85

The formats of the statement of profit or loss and other comprehensive income are given below

The presentation of comprehensive income in one statement and the classification of expenses within profit by function

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7		
	20X7 Tshs	**20X6 Tshs**
Revenue	**X**	**X**
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	X	X
Administrative expenses	X	X
Other expenses	X	X
Finance costs	X	X
Share of profit of associates	X	X
Profit before tax	**X**	**X**
Income tax expense	(X)	(X)
Profit for the year from continuing operations	X	X
Loss for the year from discontinued operations	-	(X)
PROFIT FOR THE YEAR	**X**	**X**
Other comprehensive income		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	X	X
Actuarial gains (losses) on defined benefit pension plans	(X)	X
Gain on investment in Equity instruments	X	X
Share of other comprehensive income of associates	X	(X)
Income tax relating to items that will not be reclassified	(X)	(X)
Items that may be reclassified to profit or loss		
Exchange differences on translating foreign operations	X	X
Cash flow hedges	(X)	(X)
Income tax relating to items that will may be reclassified	(X)	(X)
Other comprehensive income for the year, net of tax	**(X)**	**X**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**X**	**X**
Profit attributable to		
Owners of the parent	X	X
Minority interest	X	X
	X	**X**
Total comprehensive income attributable to		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	**X**
Earnings per share (in currency units)		
Basic and diluted	**X**	**X**

The presentation of comprehensive income in two statements and classification of expenses within profit by nature

XYZ Group – Statement of profit or loss for the year ended 31 December 20X7		
	20X7 Tshs	**20X6 Tshs**
Revenue	**X**	**X**
Other income	X	X
Changes in inventories of finished goods and work in progress	(X)	(X)
Work performed by the entity and capitalised	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense Depreciation	(X)	(X)
and amortisation expense Impairment of	(X)	(X)
property, plant and equipment Other	(X)	-
expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	**X**	**X**
Income tax expense	(X)	(X)
Profit for the year from continuing operations	**X**	**X**
Loss for the year from discontinued operations	-	(X)
PROFIT FOR THE YEAR	**X**	**X**
Profit attributable to		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	**X**
Earnings per share (in currency units)		
Basic and diluted	**X**	**X**

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7		
	20X7 Tshs	**20X6 Tshs**
Profit for the year	**X**	**X**
Other comprehensive income		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	X	X
Actuarial gains (losses) on defined benefit pension plans	(X)	X
Gain on investment in equity instruments	X	X
Share of other comprehensive income of associates	X	(X)
Income tax relating to items that will not be reclassified	(X)	(X)
Items that may be reclassified to profit or loss		
Exchange differences on translating foreign operations	X	X
Cash flow hedges	(X)	(X)
Income tax relating to items that will may be reclassified	(X)	(X)
Other comprehensive income for the year, net of tax	**(X)**	**X**
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	**X**	**X**
Total comprehensive income attributable to		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	**X**

4. Statement of changes in equity

The statement of changes in equity presents all changes in all components of equity. IAS 1 stipulates that certain details are to be disclosed in the statement of changes in equity, whereas others are to be disclosed either in the statement of changes in equity or in the notes.

Important

An entity shall show the following in the statement of changes in equity

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

(b) For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with IAS 8.

(c) For each component of equity, reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from

- (i) Profit or loss;
- (ii) Each item of other comprehensive income and
- (iii) Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control

IAS 1 Para 106

The statement of changes in equity presents all changes in all components of equity.

Components of equity include each class of contributed equity, the accumulated balance of each class of other comprehensive income and retained earnings.

Changes in equity include

changes resulting from the transactions with owners in their capacity as owners (such as equity contributions, reacquisition of the entity's own equity instruments and dividends).

The total amount of income and expense, including gains and losses, generated by the entity's activities during that period.

IAS 1 requires an entity to present dividends recognised as distributions to owners during the period and related amounts per share in the statement of changes in equity or in the notes.

Possible reasons for changes in equity are

Profit or loss for the period;

Other comprehensive income during the period; and

Other transactions between the entity and the shareholders or owners (for example, equity contributions and withdrawals, buyback of shares, dividends distributed, and the transaction costs directly related to such transactions).

A pro forma with imaginary figures (based on the format presented at the end of revised IAS 1)

(All figures in Tshs'000)

XYZ group- Statement of changes in equity for the year ended 31 December 20X7									
	Equity shares	**Retained earnings**	**Translation of foreign operations**	**Financial asset through OCI**	**Cash flow hedges**	**Revaluation Surplus**	**Total**	**NCI**	**Total equity**
Balance at 01/01/20X6	600,000	118,100	(4,000)	1,600	2,000		717,700	29,800	747,500
Changes in accounting policy	-	400	-	-	-	-	400	100	500
Restated balance	**600,000**	**118,500**	**(4,000)**	**1,600**	**2,000**		**718,100**	**29,900**	**748,000**
Changes in equity for 20X6									
Dividends	-	(10,000)	-	-	-	-	(10,000)	-	(10,000)
Total CI for the year	-	53,200	6,400	16,000	(2,400)	1,600	74,800	18,700	93,500
Balance at 31/12/20X6	**600,000**	**161,700**	**2,400**	**17,600**	**(400)**	**1,600**	**782,900**	**48,600**	**831,500**
Changes in equity for 20X7									
Issue of share capital	50,000	-	-	-	-	-	50,00		50,000
Dividends		(15,000)	-	-	-	-	0	-	(15,000)
Total CI for the year	-	96,600	3,200	(14,400)	(400)	800	(15,000	21,450	107,250
Transfer to retained earnings	-	200	-	-	-	(200)	)	-	-
Balance at 31/12/20X7	**650,000**	**243,500**	**5,600**	**3,200**	**(800)**	**2,200**	**903,700**	**70,050**	**973,750**

Test Yourself 1

Ramco earned profit of Tshs1.6 million during 20X7, and distributed dividends of Tshs0.4m. During the year, it issued 500 shares of Tshs1,000 each at a premium of 25%.

It revalued property of Tshs2.4 million to Tshs3.0 million. The difference between depreciation on original cost and depreciation on the revalued amount was Tshs30,000, which was transferred to realised profit.

Balances at 01/01/20X7	**Tshs'000**
Retained profits	2,100
Revaluation surplus	400
Ordinary shares	1,000
Share premium	50

Required:

Present a statement of changes in equity for Ramco for the year ended 31 December 20X7.

5. Statement of cash flows

In Paper B2 you must have already studied preparation of statement of cash flow for a single entity. Also group statement of cash flows has been discussed in detail in Study Guide E1.

6. Other important information presented along with corporate reports (including disclosures)

(a) Earnings per share (IAS 33)

Earnings per share are one of the important measures of performance. Earnings per share are required to be reported on the face of the statement of profit or loss. EPS has already been covered in detail in Paper B2. Let us have a quick revision of basic EPS and diluted EPS.

(i) Basic earnings per share

Calculation of basic earnings per share

Definition

Basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.

IAS 33 Para 10

If we put this into equation form, we get

$$EPS = \frac{\text{Profit or loss attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding}}$$

(ii) Diluted earnings per share

Definition

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

IAS 33 Para 5

Diluted EPS means an EPS that is reduced or diluted due to increase in the number of shares (the denominator) without a proportionate increase in the earnings (the numerator).

(iii) Potential ordinary shares

While determining the number of shares for calculating simple EPS, we consider only the shares which entitle the shareholders for a share in the earnings at present. However, there are some financial instruments or other contracts that may entitle their holders to ordinary shares in the company in the future.

Definition

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares.

IAS 33 Para 5

If earnings per share are going to be reduced (or loss per share increased) as a result of potential shares being converted into ordinary shares, the potential shares are said to be dilutive.

The presentation of basic EPS is insufficient information to take decisions about the future; **information on diluted EPS is more relevant for decisions about the future for the existing as well as the potential investors**.

Existing shareholders will know what the EPS could be in the future, on shares held by them. Based on market expectations, they can check whether the expected returns are sufficient for their needs. Accordingly, they can decide whether to hold the shares or to sell them.

Potential shareholders can decide whether to buy the shares or not, using a similar analysis.

Both the numerator and denominator need to be adjusted when calculating the diluted EPS.

Example

Gander Wander is a juice manufacturing entity and is calculating its weighted average number of shares to do this it needs to determine the order in which to include its dilutive instruments. The following details are relevant:

1. Earnings

	Tshs
Profit from continuing operations attributable to the parent entity	13,120,000
Less: Dividends on preference shares	(5,120,000)
Profit from continuing operations attributable to ordinary equity holders of the parent entity	8,000,000
Loss from discontinued operations attributable to the parent entity	(3,200,000)
Profit attributable to ordinary equity holders of the parent entity	**4,800,000**

Ordinary shares outstanding	1,600,000
Average market price of one ordinary share during year	Tshs600

2. Potential ordinary shares

There are 80,000 options with exercise price of Tshs480 each. There are also 640,000 convertible preference shares with a par value of Tshs1,000 each entitled to a cumulative dividend of 8% on par or Tshs80 per share. Each preference share is convertible into two ordinary shares.

3. Convertible bonds

5% convertible bonds worth nominal amount of Tshs80,000,000 are in issue. Each Tshs1,000 bond is convertible to 20 ordinary shares. There is no amortisation of premium or discount affecting the determination of interest expense.

4. Tax rate 40%

Increase in earnings attributable to ordinary equity holders on conversion of potential ordinary shares

		Increase in earnings	Increase in number of shares	Incremental EPS	Rank
		Tshs		Tshs	
Options					
Increase in earnings Incremental shares issued for no consideration	80,000 x (Tshs600 – Tshs480)/Tshs600	-	16,000	-	1
Convertible preference shares					
Increase in profit Incremental shares	Tshs640,000 x 100 x 0.08 2 × 640,000	5,120,000	1,280,000	4.00	3
5% convertible bonds					
Increase in profit Incremental shares	Tshs80,000,000 x 0.05 x (1 – 0.40) 80,000 x 20	2,400,000	1,600,000	1.50	2

Continued on the next page

Calculation of diluted earnings per share

	Profit attributable to ordinary equity holders	Ordinary shares	Per share
	Tshs		Tshs
As reported	8,000,000	1,600,000	5.00
Options	–	16,000	
	8,000,000	1,616,000	4.95 dilutive
5% convertible bonds	2,400,000	1,600,000	
	10,400,000	3,216,000	3.23 dilutive
Convertible preference shares	5,120,000	1,280,000	
	15,520,000	**4,496,000**	**3.45 anti-dilutive**

The convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share as diluted earnings per share are increased when the convertible preference shares are taken into account (from Tshs3.23 to Tshs3.45). Therefore, diluted earnings per share for profit from continuing operations are Tshs3.23.

	Basic EPS	Diluted EPS
	Tshs	Tshs
Profit attributable from continuing operations to ordinary equity holders	5.00[(e)]	3.23[(f)]
Loss from discontinued operations attributable to ordinary equity holders	(2.00)[(a)]	(0.99)[(b)]
Profit attributable to ordinary equity holders of parent entity	3.00[(c)]	2.24[(d)]

(a) (Tshs3,200,000) / 1,600,000 = (Tshs2.00)
(b) (Tshs3,200,000) / 3,216,000 = (Tshs0.99)
(c) 4,800,000 / 1,600,000 = Tshs3.00
(d) (Tshs4,800,000 + Tshs2,400,000) / 3,216,000 = Tshs2.24
(e) 8,000,000 / 1,600,000
(f) 10,400,000 / 3,216,000

(b) Interim financial reporting (IAS 34)

In addition to annual financial statements, interim financial reports are often prepared by entities whose debt or equity securities are publicly traded due to the requirements laid down by governments, securities regulators, stock exchanges and accountancy bodies. Timely and reliable interim financial reporting improves the ability of investors, trade payables and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

The interim financial reports may contain a complete set of financial statements prepared according to IAS 1 or a condensed financial statement containing headings and subtotals.

Minimum contents of an interim report

An interim financial report shall include, at a minimum, the following components

(i) Condensed statement of financial position;
(ii) Condensed statement of profit or loss and other comprehensive income
(iii) Condensed statement of changes in equity
(iv) Condensed statement of cash flows; and
(v) Selected explanatory notes.

Periods to be covered in the interim reports

(i) Statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding financial year;

(ii) Statements of comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative statements of comprehensive income for the comparable interim periods (current and year to date) of the immediately preceding financial year;

(iii) Statement showing changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year to date period of the immediately preceding financial year; and

(iv) Statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year to date period of the immediately preceding financial year.

Materiality

Like any other financial statements, materiality is relevant for the interim financial statements also. For this purpose, **materiality shall be assessed in relation to the interim period financial data (and not the annual data).** Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Materiality is considered in deciding how to recognise measure, classify, or disclose an item for interim financial reporting purposes.

Example

The following are the examples of the material items that may need separate disclosure

Results of discontinued operations

Changes in accounting estimates and errors

Use of estimates

Generally, estimates form the part of any financial statements; however, **the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports**.

Examples of use of estimates

	Item	Use of estimates for interim periods
1	Inventories	At the year end, full inventory taking and valuation is done. However, for interim statements, it is sufficient to make estimates based on sales margins.
2	Pensions	At the year-end a professionally qualified actuary is involved in measurement of the obligations. For the interim periods, extrapolation of the latest actuarial valuation is sufficient.
3	Contingencies	The measurement of contingencies may involve the opinions of legal experts or other advisers. Such opinions may or may not also be needed at interim dates.

(c) Segment information (IFRS 8)

Information about segments also enables the users of financial statements to assess the performance of an entity. This topic is dealt with in Study Guide D1 of this Study Text.

(d) Related party information

Related party information is relevant for the assessment of performance. Therefore, IAS 24, Related Party makes it mandatory to disclose the relationships with the related parties. The existence of a relationship indicates the possibility of the transactions between the parties not being at arm’s length. This topic is dealt with in Study Guide D2 of this Study Text.

(e) Directors’ report

Discussed in detail in Learning Outcome 2

7. Information in specific situations

(a) Non-current assets held for sale and discontinued operations (IFRS 5)
(b) Reporting in hyperinflationary situations (IAS 29 Financial reporting in hyperinflationary economy)

These are discussed later in this Study Guide.

Test Yourself 2

Decibels has three divisions called Mercy Bell, Jerky Bell and Crazy Bell.

During 20X5 the following restructuring were carried out by it

Jerky Bell which represents the major line of business of Decibels was discontinued during the year. At the end of the reporting date the assets and liabilities were not yet disposed of. However, it was expected to be disposed of in a single deal. The profits of Jerky Bell was Tshs50 million, assets Tshs300 million and liabilities, Tshs100 million

Crazy Bell has a machine which is secured under a loan and a plant which is sold in a single transaction. The business of Crazy Bell is continued from an alternative location and it recognised a loss of Tshs40 million on measurement of the assets.

Required:

Explain how these will be presented in the financial statements.

1.4 Information about performance which is derived from the analysis of the financial statements

Financial analysts analyse the financial statements to find indications of future performance. Mostly, this analysis involves calculation of ratios and trends. Ratio and trend analysis is a useful tool for assessing the performance of an entity. This is **not an essential part of the preparation of corporate reports**. However, some entities include a few important ratios in their corporate reports. This topic is discussed in detail in **Section G** of this Study Text**.** Accounting treatment of most transactions affects the amount of profit or loss. Various accounting standards lay down the accounting treatment of various items e.g. impairment losses, provisions and contingencies. Many of these transactions affect the amount of profit and therefore, the performance of an entity.

1.5 Reporting in hyperinflationary economies

A hyperinflationary economy is an economy suffering from a very high rate of inflation i.e. the purchasing power of money is lost very quickly. In this kind of an economy, because of material changes in the real value of assets and liabilities caused by the falling value of money, transactions that occurred at different points of time, including those that occurred during the same accounting year, cannot be easily compared to one another.

In a hyperinflationary economy, entities preparing their financial statements should account for the fall in the purchasing power of money over time. IAS 29 Financial Reporting in Hyperinflationary Economies deals with the financial statements of those entities whose functional currency is the currency of a hyperinflationary economy.

A hyperinflationary economy is one which has the following characteristics

1. Generally, individuals prefer to keep their wealth in non-monetary assets or in a stable foreign currency. Any local currency held would be immediately invested to maintain purchasing power.
2. Prices are quoted in a stable foreign currency and not in terms of the local currency.
3. Credit sales and purchases take place at prices that compensate for the expected loss in purchasing power.
4. Interest rates, wages and prices are linked to a price index.
5. The cumulative inflation rate over three years is approaching or exceeds 100%.

In a hyperinflationary economy, money loses purchasing power at such a rate that comparison of amounts from transactions and other events that have occurred at different times is misleading. This even applies to transactions within the same accounting period. In such a situation, reporting of operating results and financial position in the local currency without restatement is not useful.

The financial statements of an entity, whose functional currency is the currency of a hyperinflationary economy, shall be stated in terms of the measuring unit current at the reporting date. This is to be done irrespective of whether the financial statements are based on a historical cost approach or a current cost approach. Not only are the figures at the reporting date restated; the corresponding figures for the previous period required by IAS 1 Presentation of Financial Statements and any information in respect of earlier periods shall also be restated in terms of the measuring unit current at the reporting date.

Statement of financial position amounts not already expressed in terms of the measuring unit current at the reporting date are restated by applying a general price index. Monetary items (i.e. money held and items to be received or paid in money e.g. trade receivables and payables) are not restated because they are already expressed in terms of the monetary unit current at the reporting date.

Some non-monetary items are carried at amounts current at the reporting date, such as net realisable value and market value, so they are not restated. E.g. investment properties accounted for using the fair value model are valued at fair value. All other non-monetary assets and liabilities are restated.

Example

A property was purchased for Tshs100 million on 31 December 20X5, when the general price index was 250. The index was at 350 and 460 respectively at 31 December 20X6 and 31 December 20X7. This is a hyperinflationary situation. IAS 29 does not define an absolute percentage at which hyperinflation is deemed to arise. However, one of the characteristics laid down is that the cumulative inflation rate over three years is approaching, or exceeds, 100%.

In the statement of financial position at 31 December 20X6, the asset is restated at Tshs140 million (i.e. Tshs100 million x 350/250). Similarly, in the statement of financial position at 31 December 20X7, the asset is restated at Tshs184 million (i.e. Tshs100 million x 460/250). In the statement of financial position at this date, even the previous year's figure (i.e. at 31 December 20X6,) is restated at Tshs184 million.

Test Yourself 3

A Zimbabwean company prepares it financial statements in the Zimbabwe Dollar. Since Zimbabwe is a hyperinflationary economy, the financial statements for the year were restated in accordance with IAS 29. Its parent company is located in Pakistan and prepares it consolidated financial statements in Pakistani Rupees.

Required:

List the steps that the Pakistani parent company would take when consolidating the financial statements with the Zimbabwean company.

Important

We have discussed the preparation of financial statement extracts and appropriate disclosures based on the accounting policy chosen in various Study Guides under Section C so far.

For example:

In Study Guide C1 Tangible Non-current Assets, we discussed the preparation of financial statements based on the accounting policy chosen to measure tangible non-current assets (i.e. when the asset is measured under cost model or revaluation model, or when an asset is a held for sale asset or an investment property).

In Study Guide C2 Financial Instruments, we discussed the various classifications of financial assets and financial liabilities and their impact on the financial statements.

In Study Guide C3 Leases, we discussed the preparation of financial statements in the books of the lessor and lessee based on the accounting policy chosen to account for leases (operating lease or a finance lease).

IAS 10 Events after Reporting Date has already been covered in detail in Paper B2. Students are advised to refer Paper B2 to understand the impact of adjusting and non-adjusting events in the preparation of corporate reports.

1.6 Distributable profits

Definition

The profits available for the distribution among the shareholders of a company as dividends are called divisible or the distributable profits.

In accordance with Companies Act 2002, the company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the directors. The directors may from time to time pay to the members such interim dividends as appear to the directors to be justified by the profits of the company.

No dividend shall be paid otherwise than out of profits. The directors may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as a reserve or reserves which shall, at the discretion of the directors, be applicable for meeting contingencies, or for equalising dividends, or for any other purpose of which the profits of the company may be properly applied, and pending such application may, at the like discretion, either be employed in the business of the company or be invested in such investments (other than shares of the company) as the directors may from time to time think fit.

The Companies Act does not lay down detailed rules on what is and what is not a realised pro t. Further it also does not even refer specifically to 'accounting principles' while determining distributable profits. Therefore it would be ideal to determine distributable profits based on generally accepted accounting principles i.e. IFRSs in case of Tanzanian companies.

Dividends declared after the reporting date

If dividends are declared after the reporting period but before the financial statements are authorised for issue, the dividends are not recognised as a liability at the end of the reporting period because no obligation exists at that time. Such dividends are disclosed in the notes in accordance with IAS 1 Presentation of Financial Statements. In other words this is treated as a non-adjusting event.

1.7 Timelines for reporting

The directors of every company shall at some date not later than 18 months after the incorporation of the company and subsequently once at least in every calendar year lay before the company in a general meeting a profit and loss account

This period of 18 months can be extended by the Minister, if for any special reason he thinks fit so to do.

5. Prepare and comment upon a Directors report as per the TFRS 1.
[Learning Outcome e]

2.1 Directors Report

In accordance with Section 133 of the Companies Act 2002, every company in its annual general meeting lays before the members of the company a directors' report. It will be the duty of the directors of the company to prepare the directors' report.

Further, a copy of the directors' report is required to be delivered to the Registrar which shall be signed on behalf of the Board by a Director or the Secretary of the company. In Tanzania, TFRS 1 provides guidance on the contents to include in the directors' report.

2.2 Features of Directors Report

In accordance with TFRS1 Directors' Report, the Directors' Report is expected to have the following features in general

(i) It should refer to comments made in the previous periods Directors' Reports where these have not been borne out by events;
(ii) It should contain analytical discussion rather than merely numerical analysis;
(iii) It should follow 'top-down' structure discussing individual aspects of the business in the context of a discussion of the business as a whole;

(iv) It should make it clear how any ratio or other numerical information given relate to the financial statements;
(v) It should include discussion of
(vi) Trends and factors underlying the business that have affected the results but are not expected in the future; and
(vii) Known events and uncertainties that are expected to have an impact on the business in the future.

2.3 Scope of TFRS 1

TFRS 1 is applicable to all entities. Entities are urged to follow the spirit of this Standard and use their best endeavours to adapt the detailed guidance to their own circumstances.

Contents of Directors Report

A report which may be called a Directors' Report or by any other name as appropriate, shall be included in and constitute an integral part of the financial statements. This report shall contain the information provided in TFRS 1 and such other statutory legislation relevant to the entity.

The directors should primarily include the following information

Principal activities of the company
Composition of the Board of Directors
Report on corporate governance
Capital structure of the company
Management structure
Analysis of the shareholdings
Future development plans
Dividends during the year
Risk management and internal control
Employee welfare
Related party transaction
Political and charitable donation
Environmental reporting
Corporate social reporting
Statement of directors' responsibility

2.4 Specimen Directors Report

ILLUSTRATIVE EXAMPLE ON THE DIRECTORS' REPORT

This appendix accompanies, but is not part of TFRS 1. It is just an illustrative example and it is not necessary that entities should follow the illustrative example word by word when preparing directors report.

**XYZ COMPANY LIMITED REPORT
OF THE DIRECTORS FOR THE
YEAR ENDED …………**

The Directors present this report and the audited financial statements for the financial year ended ………….., which disclose the state of affairs of the Company.

Incorporation

The company is incorporated in Tanzania under Companies Act as a private company limited by share/public limited company.

Company's vision
…………………………………….

Company's mission
…………………………………….

Principal activities

The principal activities of the Company are:…………………………….

Composition of the board of directors

The directors of the Company at the date of this report and who have served since ………., except where otherwise stated, are

	Name	Position	Age	Qualifications / Discipline	Nationality	Appointed / Registered	Date of appointment / Resignation
1.							
2.							
3.							
4.							
5.							

The Company secretary as at ……………. was ………………..

Corporate governance

The Board of…………………consists of …………..Directors, apart from the Managing Director, no other directors hold executive positions in the Company. The Board takes overall responsibility for the Company, including responsibility for identifying key risk areas, considering and monitoring investment decisions, considering significant financial matters, and reviewing the performance of management business plans and budgets. The Board is also responsible for ensuring that a comprehensive system of internal control policies and procedures is operative, and for compliance with sound corporate governance principles.

The Board is required to meet at least four times a year. The Board delegates the day to day management of the business to Managing Director assisted by senior management. Senior Management is invited to attend board meetings and facilitates the effective control of all the Company's operational activities, acting as a medium of communication and coordination between all the various business units.

The company is committed to the principles of effective corporate governance .The directors also recognize the importance of integrity, transparency and accountability. During the year the Board of …………………………….company has the following board sub-committees to ensure a high standard of corporate governance throughout the company.

……….. Committee (1st committee)

	Name	Position	Qualifications / Discipline	Nationality	Remarks
1.					
2.					
3.					
4.					

The ……………. Committee reports to………………………
The ……………….. Committee met ………….. times during the year.

Audit Committee (2nd committee)

	Name	Position	Qualifications / Discipline	Nationality	Remarks
1.					
2.					
3.					
4.					

The ……………. Committee reports to………………………
The ……………….. Committee met ………….. times during the year.

Mention any other specific committees.

The Board met ……. times during the year.

Capital structure

The company capital structure for the year under review is shown below.

Management

The Management of the Company is under the Managing Director and is organized in the following departments.

Finance and administration department.
Operations department
Marketing department
………………………. (etc as appropriate)

Shareholders of the company

The total number of shareholders during the year….. is………..shareholders (previous year:…. shareholders)

Directors holding shares are listed below

S/N	Name	Nationality	Number of Ordinary Shares	Number of Preference Shares

The shares of the company are held as follows

S/N	Shareholder	Current Year Number of shares		Previous Year Number of shares	
		Ordinary	Preference	Ordinary	Preference
	Total				

Stock Exchange Information

In …… (year) the Company was listed with ……….(mention the stock exchange). The share price during the year was Tshs. …….. In …… (year) the performance of the Company's shares in the secondary market was as follows: Market capitalization as at (date) ….. was Tshs………(previous year - Tshs…..)

Future Development Plans

The company will continue to improve its profitability through the introduction of innovative products, focusing on value-added customer services and selective expansion of its branches while carefully managing both costs and risks. The company will continue to focus on improving productivity and introducing new products to the market.

Results and Dividend

During the year the company had a net profit for the year of Tshs ……………. (previous year - Tshs …………)
The Board of Directors is proposing a dividend of Tshs ………………….relating to ….(current year) profit (previous year TShs……………………)

Performance for the Year

Discuss on the company's performance for the year under review in comparison with that of the previous. Include explanations involving both the statement of financial position and income statement items.

Risk Management and Internal Control

The Board accepts final responsibility for the risk management and internal control systems of the Company. It is the task of management to ensure that adequate internal financial and operational control systems are developed and maintained on an on-going basis in order to provide reasonable assurance regarding

The effectiveness and efficiency of operations;
The safeguarding of the Company's assets;
Compliance with applicable laws and regulations;
The reliability of accounting records;
Business sustainability under normal as well as adverse conditions; and
Responsible behaviours towards all stakeholders.

The efficiency of any internal control system is dependent on the strict observance of prescribed measures. There is always a risk of non-compliance of such measures by staff. Whilst no system, of internal control can provide absolute assurance against misstatement or losses, the company system is designed to provide the Board with reasonable assurance that the procedures in place are operating effectively. The Board assessed the internal control systems throughout the financial year ended …… (year) and is of the opinion that they met accepted criteria.

The Board carries risk and internal control assessment through…………Committee (mention Committee e.g. Audit committee etc)

Solvency

The Board of directors confirms that applicable accounting standards have been followed and that the financial statements have been prepared on a going concern basis. The Board of directors has reasonable expectation that XYZ Company has adequate resources to continue in operational existence for the foreseeable future.

Employees' welfare

Management and Employees' Relationship

There were continued good relation between employees and management for the year ….. There were no unresolved complaints received by Management from the employees during the year. A healthy relationship continues to exist between management and trade union.

The company is equal opportunity employer. It gives equal access to employment opportunities and ensures that the best available person is appointed to any given position free from discrimination of any kind and without regard to factors like gender, marital status, tribes, religion and disability which does not impair ability to discharge duties.

Training Facilities

When presenting its annual budget for the year …… (year), the company put aside a sum of TShs. …….. for staff training in order to improve employee's technical skills and hence effectiveness (previous year TShs. …..). Training programs has been and are continually being developed to ensure employees are adequately trained at all levels, all employees have some form of annual training to upgrade skills and enhance development.

Medical Assistance

All members of staff with a maximum number of four beneficiaries (dependants) for each employee were availed medical insurance guaranteed by the Board. Currently these services are provided by ………..

Health and Safety

The company has a strong health and safety department which ensure that a strong culture of safety prevails at all times. A safe working environment is ensured for all employees and contractors by providing adequate and proper personal protective equipment, training and supervision as necessary.

Financial Assistance to Staff

Loans are available to all confirmed employees depending on the assessment of and the discretion of management as to the need and circumstances. Management has established a Revolving Fund and has influenced staff to established and join Company Savings and Credit Co- operative Society (SACCOS) to assist in promoting the welfare of its employees.

Persons with Disabilities

Applications for employment by disabled persons are always considered, bearing in mind the aptitudes of the applicant concerned. In the event of members of staff becoming disabled, every effort is made to ensure that their employment with the company continues and appropriate training is arranged. It is the policy of the company that training, career development and promotion of disabled persons should, as far as possible, be identical to that of other employees.

Employees Benefit Plan

The company pays contributions to a publicly administered pension plans on mandatory basis which qualifies to be a defined contribution plan.

The average number of employees during the year was ….. (previous year: …..)

Gender Parity

The company had ….. employees, out of which ….. were female and …. were male. (Previous year: …..)

Related Party Transactions

All related party transactions and balances are disclosed in note……… to these financial statements.

Political and Charitable Donations

The company did not make any political donations during the year. Donations made to charitable organizations during the year amounted to TShs ………….. (TShs ………. (previous year)).

Environmental Control Programme

Discuss on the environmental control program in place.

Corporate Social Responsibility

Discuss issues on corporate social responsibility performed by the company during the year under review.

Statement of Directors' Responsibilities

The Companies Act, 2002 requires the directors to prepare financial statements for each financial year that gives a true and fair view of the state of affairs of the company as at the end of the financial year and of its profit or loss for that year. It also requires the directors to ensure that the company maintains proper accounting records that disclose, with reasonable accuracy, the financial position of the company. The directors are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud, error and other irregularities.

The directors accept responsibility for the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Auditors

The auditors ABC & Co have expressed their willingness to continue in office and are eligible for reappointment. A resolution proposing the re-appointment as auditor of the Company for the year …. will be put to the Annual General Meeting.

Approved by the board of directors on ………………………and signed on its behalf by

CHAIRMAN **DATE**

DIRECTOR **DATE**

(Source: TFRS1 Director's Report, Appendix A)

6. Discuss and apply the principles of IAS 18 to record revenue.
[Learning Outcome f]

3.1 Revenue recognition

The amount and timing of revenue recognition is one of the most crucial factors in accounting as it determines the amount of profit or loss that will be disclosed by the financial statements. Revenue recognition is dealt with by IAS 18, Revenue.

Revenue could arise from the following transactions and events

the sale of goods;
the rendering of services; or
the use by others of entity assets yielding interest, royalties and dividends.

Definition

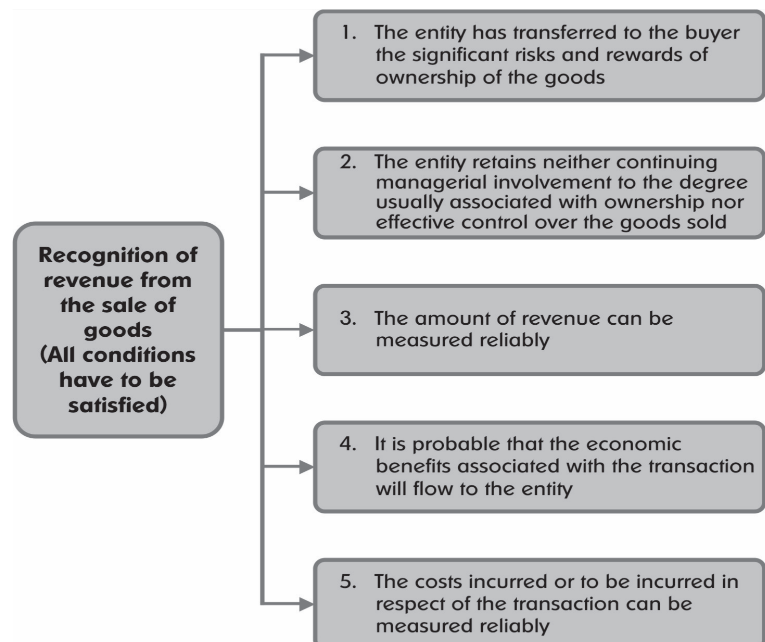
Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

IAS 18 Para 7

Simply put, when an entity receives cash or other non-monetary assets in return for their activities (whether making something or providing a service), this is termed revenue. However the definition excludes any contributions received from shareholders for shares.

1. Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied

Diagram 1: Recognition of revenue from the sale of goods



Going through each of these conditions in turn

(a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.

However, an entity may retain the significant risks and rewards of ownership in the following circumstances

(i) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
(ii) when the receipt of revenue from a particular sale is contingent on the receiving of revenue by the buyer from its sale further on of the goods;
(iii) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity;
(iv) when the buyer has the right to cancel the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

If an entity retains only an insignificant risk of ownership the transaction is a sale and revenue is recognised.

(b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.

(c) The amount of revenue can be measured reliably.

(d) It is probable that the economic benefits associated with the transaction will flow to the entity.

(e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

Example

Quebec Heavy Machinery Inc, an international manufacturer of cranes and mining equipment, has sold a piece of mining equipment to Antonnia Mines Ltd on 30 June 20X5 for Tshs2 million for use in its operations in Alaska. Since Alaska is an upcoming mining location,

Antonnia purchases the mining equipment on condition that if Antonnia communicates in writing to Quebec that a suitable quantity of minerals are not extracted within the next one year, i.e. by 30 June 20X6, Quebec would repurchase the mining equipment from Antonnia.

Quebec prepares its financial statements as on 31 December every year. By 30 June 20X6, Antonnia had not yet conveyed its mining results as positive or negative.

Required

How would Quebec report this transaction in

(a) Its 20X5 financial statements
(b) Its 20X6 financial statements

Answer

In Quebec's financial statements for the year ended 31 December 20X5

This transaction would not be reflected as a sale in this year as the risks and rewards incidental to ownership have not yet been transferred to Antonnia Mines from Quebec Heavy Machinery as on 31 December 20X5.

This can be reflected from the fact that Antonnia still reserves the right to return the machinery if a suitable quantity of minerals is not extracted. As a result, the equipment sold would be recorded as a Deposit received from Antonnia and not a sale. The entry would be as follows

Dr	Bank (current assets in Quebec's SOFP)	Tshs2 million	
Cr	Deposit received from Antonnia Mines ltd (Current liability in Quebec's SOFP)		Tshs2 million

Continued on the next page

In Quebec's financial statements for the year ended 31 December 20X6

Antonnia Mines had not conveyed its satisfaction / dissatisfaction on 31 June 20X6, hence losing its right to do so, with the risks and rewards incidental to ownership transferred to Antonnia Mines. As a result, Quebec Heavy Equipment would not have any claim or control in the ownership of the equipment.

Now this transaction would be recorded as revenue and Quebec can reliably measure the costs associated with the sale of the equipment.

The accounting entry would be as follows

Dr	Deposit received from Antonnia Mines Ltd (Current liabilities in Quebec's SOFP)	Tshs2 million	
Cr	Sales (SOPL)		Tshs2 million

Tip

In the above example, the sale of the equipment, in Quebec's accounts would be reflected as a general sale and not a sale of a non-current asset. This is because Quebec is in the business of manufacturing and selling mining equipment and would reflect this equipment as trade receivables and not non-current assets.

The matching of revenues and expenses requires that revenues and expenses that relate to the same transaction or event are recognised simultaneously

If it is not possible to measure expenses reliably, then any consideration received for the sale of goods is recognised as a liability.

Example

Machine Tools Ltd has sold a plant worth Tshs25 million to Significant Co and has received the amount. The sales contract requires Machines Tools to bear the installation expenses, which are expected to be of a considerable value.

However as on the reporting date, neither the plant has been installed, nor is it possible to reliably estimate these expenses.

In this case the amount received (Tshs25 million) will be not be reflected as revenue but as a current liability, advance received from Significant Co.

After the reporting date, the company has to either perform the services or repay the amount. There would be an outflow of economic benefits and hence it is a liability.

2. Revenue from services

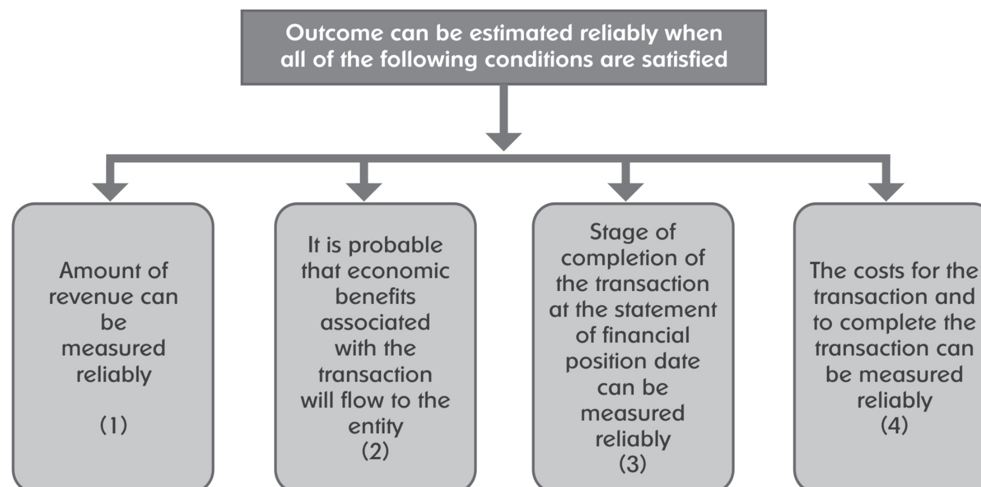
Recognition of revenue depends upon whether the outcome a transaction involving the rendering of services can be estimated reliably

(a) If outcome can be estimated reliably, revenue from services rendered is recognised using the stage of completion method.

(b) If outcome cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.

In order to estimate the outcome reliably, all of the necessary conditions – outlined in the following diagram - must be satisfied.

Diagram 2: Criteria to measure whether outcome can be reliably estimated



Reliable estimates of revenue can be made when both the parties to the contract agree about

Each party's enforceable rights about the services to be provided / received.
The consideration to be exchanged.
The manner and the terms of settlement.

Example

Calcio Treatments is a multinational pharmaceutical company with operating divisions in eight countries. Since each of these countries has its own legislative requirements, on 1 January 20X7, Calcio has employed the services of Miller, Martinez and Ichikawa (MMI), an international management consultancy firm to study and recommend ways to streamline their operation through corporate restructuring.

For this, the Calcio would provide MMI with all the necessary resources to complete the process. The entire process is agreed to be completed within six months, at the end of which MMI would present its findings to Calcio's management. For its services, MMI would be paid Tshs5 million after three months and another Tshs5 million at the end of six months. The stage of completion is expected to be in the same proportion.

If MMI breach any of the terms of the agreement or are not able to come up with specific recommendations, then Calcio would not pay MMI for its services.

On which dates would MMI recognise the revenue?

MMI as well as Calcio have agreed upon the following conditions

1. Calcio would provide all the necessary resources to MMI.
2. The consideration of Tshs10 million to be paid and the manner of settlement of the consideration.

As a result, MMI would recognise the revenue in the following manner

On 31 March 20X7, Tshs5 million would be recognised as revenue.
On 30 June 20X7, the remaining Tshs5 million would be recognised as revenue.

It would also depend on whether there was a chance that the terms would not be met.

(i) It is probable that the **economic benefits associated with the transaction will flow to the entity.**

If after the revenue is recognised, there is uncertainty about the probability of receiving the monies, then it is simply accounted for as a bad debt.

(ii) The **stage of completion of the transaction** at the reporting date can be **measured reliably.**

Generally, the seller's performance under service contracts is not immediate and often takes place over several reporting periods. Therefore, revenue is recognised depending on the stage of completion of a transaction.

Tip

Revenue recognition with reference to the stage of completion of a transaction is called the **percentage of completion method.** The stage of completion of a transaction can be determined in a number of ways e.g. based on past experience, percentage of work completed, surveys of work performed etc.

Other points

If services are performed continuously over a period of time, revenue is recognised on a straight line basis over the period.

Example

Terence & Western (T&W) is an insurance firm. For this purpose of marketing, its in-house marketing and advertising department has created an advertisement to be aired on a 24-hour news channel, World for You. T&W has entered into a contract with World For You to air its advertisement over the next two years. During his period, T&W would pay World for You a sum of Tshs40 million.

How would World for You account for the Tshs40 million over the two year period?

Service revenue in this case should be recognised on a straight-line basis. In this case, the customer (T&W) contracted for the on-going activity. It is evident that the services specified in the arrangement are performed continuously over the contractual term of the arrangement. Therefore, World for You should recognise Tshs40 million/2 years i.e. Tshs20 million every year as revenue.

If a specific act is extremely important for completing any service then the revenue is recognised only after that specific act is performed.

Example

Dr. Rao who is a cardiac surgeon charges a normal rate of Tshs20 million for an operation. The pre-operative checks cost Tshs5 million. A patient has to pay Tshs12.5 million before the operation and Tshs12.5 million after the operation.

In this case, Dr Rao can recognise the revenue only **after** he has conducted the operation, as the **operation** is the **significant act** in this service. The amount received before the operation will be recognised as a liability (Advance received from the patient) until the operation is performed

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(iii) The **costs incurred** for the transaction and the costs to complete the transaction **can be measured reliably.**

In the early stages of rendering services when the **outcome of a transaction is not certain, revenue will be recognised only to the extent of costs incurred that can be recovered.**

Example

Jay Co has asked Zara Co to write a computer programme to help Jay Co track sales and margins on individual customers. They have agreed a timetable, where Zara Co starts writing the programme in November 20X6, but the majority of the programme will be written in December 20X6 and January 20X6. Zara's year end is 30 November 20X6.

In the accounts ending November 20X6, Zara Co will recognise any expenses incurred for rendering this service as revenue e.g. petrol expenses for coming to Jay Co's offices, any administrative costs incurred on the project etc. This is because Zara Co assumes that Jay Co will definitely pay for the expenses Zara Co incurs for rendering its services.

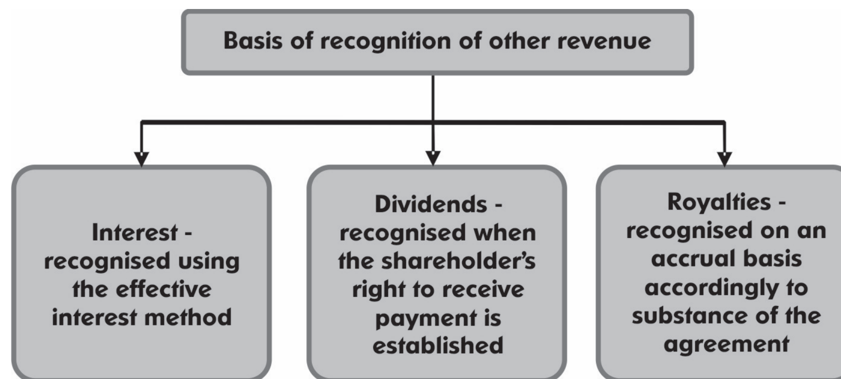
If it is not probable that the costs will be recovered, no revenue is recognised and all costs are immediately expensed.

As soon as the uncertainty of the outcome is removed, revenue will be recognised according to the procedure explained above.

3. **Revenue received on account of use by others of entity assets (yielding interest, royalties and dividends) are recognised when all the following conditions are satisfied**

   It is probable that the economic benefits associated with the transaction will flow to the entity; and
   The amount of the revenue can be measured reliably.

Diagram 3: Basis of recognition of revenue



(a) Interest

Interest shall be recognised using the effective interest method.

Definition

The **effective interest method** is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

IAS 39 Para 9

Definition

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

IAS 39 Para 9

Definition

The **amortised cost of a financial asset or financial liability** is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

IAS 39 Para 9

Example

On 1 January 20Y1, M-dok Co purchased a bond worth Tshs10 million. The bond attracts interest at 5% every year. On 31 December 20Y3, it will be redeemed for Tshs11.66 million. The effective interest rate is 10%.

In this case, the total revenue is not only from interest but also from premium on redemption. The total amount receivable as interest and premium on this bond is

	Tshs'000
On account of interest (10,000 x 5%) x 3 years)	1,500
On account of premium on redemption (11,660 – 10,000)	1,660
Total amount receivable	**3,160**

M-dok Co must allocate the amount receivable over the life of the bond at a constant rate on the carrying amount of the bond. The effective interest rate it has to apply in order to allocate the amount receivable over three years is 10%.

Year	Amortised cost at beginning of year (1)	Amount receivable at effective rate of 10% (2)	Amount actually received during year (3)	Amortised cost at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
20Y1	10,000	1000	(500)	10,500
20Y2	10,500	1050	(500)	11,050
20Y3	11,050	*1110	(11,660 + 500)	-

* - rounding adjustment at end

Amortised cost at the end of the year = Amortised cost at the beginning of the year (1)
+ Amount receivable at effective rate of 10% (2)
- Amount actually received during the year (3)

Thus, the effective rate is that rate which helps allocate the estimated future cash payments or receipts through the expected life of the financial instrument.

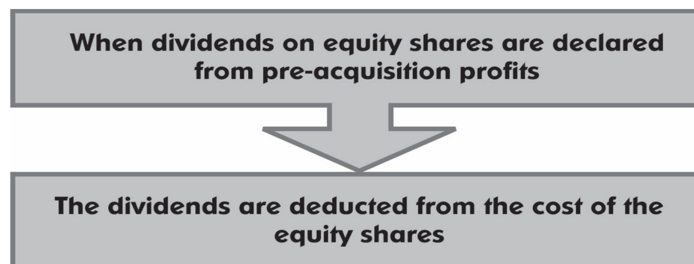
(b) Royalty

Revenue from royalty is recognised on an accruals basis according to the substance of the agreement.

(c) Dividend

Dividends are recognised when the shareholder's right to receive payment is established.

Diagram 4: Treatment of dividends in the first year after acquisition of a subsidiary



Tip

When it is difficult to determine whether the dividend declared is out of pre-acquisition profits or post acquisition profits, remember that dividends are generally considered to be revenue i.e. out of post-acquisition profits.

4. Measurement of revenue

Measurement of revenue shall be at the fair value of consideration received or receivable.

For cash sales, revenue is the cash received for the sale.
For credit sales, revenue is the anticipated cash receivable. Where the proceeds are to be received in the future and the time value of money is material, the revenue is to be discounted to present value.
Taxes and duties are not included in revenue since they are collected on behalf of the government and they are not the economic benefits to the entity.

Guidance in IAS 18 Revenue in the specific situations

Appendix to IAS 18 gives guidance on accounting to be performed in specific situations. The important point is when the risks and rewards pass to the buyer. Depending upon the local laws this may happen at slightly different times in different places. Some important situations are shown in the following paragraphs:

(a) Bill and hold arrangements

When delivery is delayed at the buyer's request but the buyer takes title and accepts billing, revenue is recognised when

(i) It is probable that delivery will be made;
(ii) The item is on hand, identified and ready for delivery;
(iii) The buyer specifically acknowledges the deferred delivery instructions; and
(iv) The usual payment terms apply.

(b) Goods shipped subject to installation and inspection

Revenue is normally recognised when the buyer accepts delivery, and installation and inspection are complete.

However, in the following situations, revenue is recognised immediately upon the buyer's acceptance of delivery

(i) The installation process is simple in nature, e.g. television sets; or
(ii) The inspection is performed only for purposes of final determination of contract prices, e.g. shipments of iron ore.

(c) Subscriptions to publications and similar items

(i) When the items involved, for example magazines, are of similar value in each time period, revenue is recognised on a straight line basis over the period in which the items are despatched.

(ii) When the items vary in value from period to period, revenue is recognised on the basis of the sales value of the item despatched in relation to the total estimated sales value of all items covered by the subscription.

Example

A publishing company receives annual subscription of Tshs100,000 for a journal to be dispatched every month. Usually the sales value of each issue of the journal would be the same. Hence it would be appropriate to recognise revenue on straight line basis.

However, if all the issues were not of uniform value, then the revenue will be recognised proportionately. If the value of a journal of a particular month is expected to be 15% of the total annual amount, then Tshs15,000 will be recognised as revenue for that month.

(d) Advertising commissions

Commissions are recognised when the related advertisement or commercial appears before the public e.g. when the advertisements are printed in newspapers or displayed on televisions.

Test Yourself 4

Omega Inc prepares its accounts up to 31 March each year. On 30 March 20X7, Omega Inc sold a consignment of products for Tshs45 million. This sale is debited to trade receivables and credited to revenue.

The terms of sale of the products were that Omega would provide an after sales service which required Omega to correct any defects that became apparent in the products for a one year period from the date of sale. The estimated cost of correcting defects would be Tshs1.5 million. The gross profit margin for corrective work would be 20%. Revenue as recorded in Trail balance as at 31 March 20X7 is Tshs360 million.

Required:

Determine the revenue to be recognised in the statement of profit or loss according to IAS 18.

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7. Explain the reporting requirements for a first time adopter under IFRS.
[Learning Outcome g]

Prior to the introduction of International Accounting Standards, later known as International Financial Reporting Standards, there was no uniformity in the accounting principles followed internationally. IASB designed these international standards to bring about homogeneity in the standards being followed all over the world.

However, changing over from the existing system to the IFRS has to be done methodically, so as to ensure that the readers are not misled and sufficient information is given. IFRS 1, First-time adoption of international financial reporting standards was issued by IASB to address these concerns. These are discussed in the following paragraphs.

3.1 First IFRS financial statements

Definition

An entity's **first IFRS financial statements** are the first annual financial statements in which the entity adopts IFRSs, by an explicit and unreserved statement in those financial statements of compliance with IFRSs.

IFRS 1 Para 3

3.2 Opening IFRS Statement of financial position

At the date of transition, an entity shall prepare an opening IFRS statement of financial position. This serves as a starting point for transition to IFRS.

In the opening financial statements the entity should

1. Recognise all assets and liabilities which are required to be recognised under IFRS.
2. Derecognise items as assets or liabilities if IFRS does not permit such recognition.
3. Reclassify items of assets, liability or components of equity that it recognised under previous GAAP, which are recognised differently under IFRS.
4. Apply IFRS while measuring the above recognised assets and liabilities.

According to Para 7 of IFRS 1, an entity shall use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the reporting date for its first IFRS financial statements.

It is likely that the accounting policies that were applied earlier to the opening statement of financial position were different from those required so as to comply with the IFRS. Some amounts reflecting events and transactions of an earlier date may have to be restated so as to comply with IFRS. These adjustments are recognised directly in the retained earnings or another category of equity at the date of transition to IFRS.

Example

An asset is valued at Tshs50 million according to the earlier accounting policy. According to IFRS, its value is Tshs40 million only. Tshs10 million (Tshs50 million - Tshs40 million) will be reduced from the value of the asset as well as retained earnings in the opening IFRS statement of financial position.

3.3 Exemptions from other IFRSs

As stated above, the opening statement of financial position should follow all the IFRSs that are effective on that date. In effect, it means that there should be a retrospective application of the IFRSs. However, IAS 1 provides for number of exemptions where the general rule should not be applied (or need not be applied). Some of the main exemptions are discussed below:

1. Business combinations

(a) A first-time adopter may opt not to apply IFRS 3 Business Combinations retrospectively to past business combinations (those that occurred before the date of transition to IFRSs).

(b) However, if a first-time adopter opts to restate any business combination to comply with IFRS 3, it shall restate all later business combinations. It shall also apply revised IAS 36 Impairment of Assets (as revised in 2004) and IAS 38 Intangible Assets (as revised in 2004) from that same date. The exemption for business combinations is also applicable to acquisitions of investments in associates and interests in joint ventures.

Example

A company adopts IFRS for the first time for a reporting date of 31 December 2007. It elects to restate the business combination that occurred on 1 July 2004. All the business combinations after 1 July 2004 must be restated and the provisions of IAS 36 (as revised in 2004) and 38 (as revised in 2004) applied.

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2. Fair value or revaluation as deemed cost

(a) Instead of at actual cost, a first-time adopter can elect to measure an item of property, plant and equipment at the date of transition to IFRSs at its fair value and use that fair value as its deemed cost at that date.

(b) Previous GAAP revaluation may be retained if it is broadly comparable to fair value or cost / depreciated cost as per IFRS.

(c) These exemptions are also available for investment properties and intangible assets. In the case of intangible assets the option is available only if there is an active market for such assets.

(d) In some jurisdictions, local law requires revaluation of assets and liabilities to fair value for a privatisation or initial public offering (IPO) and treats the revalued amounts as deemed cost for the entity's previous GAAP. In such a case, first-time adopters are allowed to use event-driven fair value as deemed cost, even if the event occurs after the date of transition, but before the first IFRS financial statements are issued.

Note the difference between IAS 16 and IFRS 1.

Under IAS 16, the entire class has to be revalued, whereas under IFRS 1 exemption can be applied to individual items.
Application of IFRS 1 is a one-time affair whereas revaluation of assets under revaluation model is to be performed regularly.

3. Employee benefits

IFRS 1 allows an exemption whereby all the cumulative actuarial gains and losses can be recognised at the date of transition to IFRSs in the statement of profit or loss. Thus all the cumulative actuarial gains and losses can be deemed to be zero.

4. Cumulative translation differences

IAS 21 - The Effects of Changes in Foreign Exchange Rates requires an entity to classify some translation differences as a part of equity. IAS further requires that, on disposal of a foreign operation, the entity shall transfer the cumulative translation difference related to that foreign operation to the statement of profit or loss as part of the gain or loss on disposal.

However, a first-time adopter can apply this exemption and treat the cumulative translation differences for all foreign operations to be zero (deemed cost) at the date of transition to IFRSs.

5. Compound financial instruments

IAS 32 Financial Instruments: Presentation requires an entity to split a compound financial instrument at inception into separate liability and equity components. Retrospective application of IAS 32, when the liability component is no longer outstanding, involves separating two components of equity. The part representing cumulative interest accreted on the liability component is the part of retained earnings. The other part represents the original equity component. If the liability component is no longer outstanding, under this IFRS, a first-time adopter need not separate these two portions at the date of transition to IFRSs.

6. Assets and liabilities of subsidiaries, associates and joint ventures

If the subsidiary, associates or a joint venture adopts IFRS later than the parent company, it measures its assets and liabilities

(a) Either at the amount that would be included in the parents financial statements based on the transition date of the parent or

(b) At the amounts based on the subsidiary, associate or joint ventures date of transition

7. Borrowing costs

A first-time adopter can elect to apply the requirements of IAS 23 from the date of transition or from an earlier date as permitted by IAS 23. From the date an entity that applied this exemption begins to apply IAS 23, the entity

(a) Shall not restate the borrowing cost component that was capitalised under previous GAAP and that was included in the carrying amount of assets at that date; and

(b) Shall account for borrowing costs incurred on or after that date in accordance with IAS 23, including those borrowing costs incurred on or after that date on qualifying assets already under construction.

3.4 Mandatory exemptions – Exemption from retrospective application of other IFRSs

IFRS 1 prohibits retrospective application of certain aspects of other IFRS. These relate to

1. Derecognition of financial assets and financial liabilities

If an entity derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP before 1st January 2001, it should not recognise those assets and liabilities under IFRSs unless they qualify for recognition as a result of a later transaction or event.

However, a first-time adopter should recognise all derivatives and other interests retained after derecognition and still existing, and consolidate all special-purpose entities (SPE) that it controls at the date of transition to IFRSs.

2. Hedge accounting

An entity is required, at the date of transition to IFRSs, to measure all derivatives at fair value and eliminate all deferred losses and gains on derivatives that were reported under its previous GAAP.

However, the entity should not reflect a hedging relationship in its opening IFRS statement of financial position if it does not qualify for hedge accounting under IAS 39. Transitional provisions of IAS 39 apply to hedging relationships of a first-time adopter at the date of transition to IFRSs.

3. Estimates

An entity's estimates under IFRS at the date of transition to IFRSs should be consistent with estimates made for the same date under its previous GAAP, unless there is objective evidence that those estimates were in error, as that term is defined under IFRS.

Any information an entity receives after the date of transition to IFRS about estimates it made under previous GAAP should be treated by it as a non-adjusting event after the date of the statement of financial position, and accorded the treatment prescribed by IAS 10 (i.e. by making a disclosure in the footnotes as opposed to an actual adjustment of items in the financial statements).

4. Non-controlling interests

This exception applies for entities that adopt amendments to IAS 27 in their first IFRS financial statements. The exception requires that a first-time adopter should apply the following requirements of IAS 27 prospectively from the date of transition

(a) Total comprehensive income shall be attributed to the owners of the parent and to the non-controlling interests even if this results in a deficit balance for the non-controlling interests;

(b) Requirements regarding accounting for changes in a parent's ownership interest in a subsidiary that do not result in a loss of control; and

(c) Requirements regarding accounting for a loss of control over a subsidiary, and the related requirements of IFRS 5.

However, if a first-time adopter opts to apply IFRS 3 (revised) retrospectively, it shall restate all the later business combinations.

3.5 Temporary exemption from the requirement to restate comparative information for IFRS 9

In its first IFRS financial statements, an entity that adopts IFRSs for annual periods beginning before 1 January 2012, and which applies IFRS 9, shall present at least one year of comparative information. However, this comparative information need not comply with IFRS 9 or IFRS 7 Financial Instruments: Disclosures, to the extent that the disclosures required by IFRS 7 relate to items within the scope of IFRS 9.

For such entities, references to the 'date of transition to IFRSs' shall mean, in the case of IFRS 9 and IFRS 7 only, the beginning of the first IFRS reporting period.

3.6 Accounting policies in the first IFRS statements

The accounting policies followed in the first IFRS statements shall follow each IFRS effective at the reporting date, except where exemptions are provided for specifically.

However, if a first-time adopter changes its accounting policies or its use of the exemptions in IFRS 1 from those used in its published interim financial report prepared in accordance with IAS 34, it needs to explain those changes and update the reconciliations between the previous GAAP and IFRS.

3.7 Estimates

According to Para 31 of IFRS 1, an entity's estimates under IFRSs at the date of transition to IFRSs shall be consistent with estimates made for the same date under previous GAAP (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

Example

A company had estimated a net realisable value of an inventory at Tshs10 million according to earlier GAAP. There is no difference in accounting policy while making transition to IFRS. The company will retain the value of Tshs10 million.

3.8 Comparative information

An entity's first financial statements shall include at least one year of comparative information under IFRS, so as to comply with IAS 1 Presentation of Financial Statements.

3.9 Reconciliations (Explanation of transition to IFRSs)

It is likely that the transition from previous GAAP to IFRS will affect its financial position, performance and cash flows. An entity has to provide for reconciliations as follows

1. a reconciliation of its equity reported under previous GAAP to its equity under IFRSs at the date of transition as well as the date of most recent annual financial statements under previous GAAP

2. a reconciliation of the profit or loss reported under previous GAAP for the latest period in the entity's most recent annual financial statements to its total comprehensive income under IFRSs for the same period; and

3. if the entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS statement of financial position, the disclosures that IAS 36 Impairment of Assets would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRSs.

3.10 Interim financial reports

The provisions of IFRS 1 apply to the interim financial reports of the entity presented under IAS 34. While presenting the interim financial reports, the entity is required to provide the reconciliations and material adjustments to the SOCF similar to full financial statements.

Test Yourself 5

Royale Paint Ltd is preparing it financial statements for the year ended 31 March 2012. The management of the company decided to adopt IFRSs and comply with IFRSs completely going forward. In accordance with the local legislation Royale Ltd has to give comparative figures for one year while presenting its financial statements.

According to IFRS1 which IFRSs should be used when preparing the opening IFRS statement of financial position and the comparative figures for the year ended 31 March 2012.

A IFRS in existence at 31 March 2011
B IFRS in existence at 31 March 2012
C IFRS in existence at 31 March 2011 for comparative SOFP and IFRS in existence at 31 March 2012 for the current year SOFP
D IFRS in existence at 1 April 2011

Test Yourself 6

Greenwood decided to publish IFRS statements for 2008 with comparatives for the last two years.

The accountant produced an interim financial report for January to June 2008. The company has made an explicit and unreserved statement of compliance with IFRSs.

Is it necessary to apply IFRS 1 First-time adoption of International Financial Reporting Standards to the interim financial report?

A Yes
B No
C You have an option to do either
D Interim financial statements are not published under IFRS

Answers to Test Yourself

Answer to TY 1

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

	Share Capital	Share Premium	Retained Earnings	Revaluation Surplus	Total
	Tshs'000	**Tshs'000**	**Tshs'000**	**Tshs'000**	**Tshs'000**
Balance at 01/01/20X7	1,000	50	2100	400	3,550
Dividends	-	-	(400)	-	(400)
Issue of Share Capital	500	125	-	-	625
Total Comprehensive Income for year	-	-	1600	*600	2,200
Transfer to retained earnings	-	-	30	(30)	-
Balance at 31/12/20X7	**1,500**	**175**	**3,330**	**970**	**5,975**

* This is on account of revaluation of property

Answer to TY 2

1. **Jerky Bell** satisfies the definition of discontinued operations. Therefore, the profit of Tshs50 million is included in results from discontinued operations, along with the details of revenue, expense, pre-tax profits, tax and post-tax profits. The assets and liabilities satisfy the definitions of a disposal group held for sale. They are re-measured and the gain / loss on re-measurement is also disclosed along with the income tax expense related to the gain / loss in results from discontinued operations. The assets and liabilities are disclosed separately in the statement of financial position as a disposal group held for sale.

2. **Crazy Bell:** the assets satisfy the criteria for recognition as a disposal group held for sale and are disclosed separately in the statement of financial position. However, the measurement loss of Tshs40 million is not presented under discontinued operations, since the assets do not meet the criteria. Instead, it is included in the profit or loss from continuing operations.

Answer to TY 3

The Pakistani parent company would first prepare the financial statements using the Zimbabwe Dollar. Next it would restate the financial statements according to IAS 29. Finally, before consolidating the financial statements, the Zimbabwe financial statements would be translated into Pakistani Rupees.

Answer to TY 4

IAS 18 'Revenue' requires that where sale of the product includes terms for after sales service then a portion of revenue is deferred and amortised over the period of performance of the service. The amount deferred should cover expected cost of service plus reasonable profit on these services.

Revenue to be recognised in the statement of profit or loss according to IAS 18 as at 31 March 20X7 is:

	Tshs'000
Revenue as shown in trial balance	360,000
Less: Revenue deferred (1500 x 100/80)	(1,875)
Revenue to be recognised	**358,125**

Answer to TY 5

The correct option is **B.**

In accordance with IFRS1 First time adoption of International Financial Reporting Standards, the IFRSs that are effective at the reporting date should be used for the whole period.

Answer to TY 6

The correct option is **A.**
If an entity presents an interim financial report in accordance with IAS 34 for part of the period covered by its first IFRS financial statements, the entity shall have to satisfy certain requirements of IFRS1.

Quick Quiz

1. What is the relationship between management commentary and financial statements?

2. What are the possible reasons for changes in equity?

3. What is dilution?

4. State the periods to be covered in the interim reports.

5. State the other benefits the project of IASB and FASB of reporting financial performance will provide once implemented in addition to cohesiveness.

Answers to Quick Quiz

1. To supplement and complement the financial statements. The management commentary explains certain figures in the financial statements and provides additional information not contained in them.

2. The possible reasons for changes in equity are
   (a) **income and expenses recognised** during the period; and
   (b) **other transactions** between the entity and the shareholders (for example, equity contributions and withdrawals, buyback of shares, dividends distributed and the transaction costs directly related to such transactions).

3. According to IAS 33 Para 5, dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised or that ordinary shares are issued upon the satisfaction of specified conditions.

4. The periods to be covered in interim reports are

   (a) Statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding financial year;

   (b) Statements of comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative statements of comprehensive income for the comparable interim periods (current and year to date) of the immediately preceding financial year;

   (c) Statement showing changes in equity cumulatively for the current financial year-to-date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year; and

   (d) Statement of cash flows cumulatively for the current financial year-to-date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

5. Other benefits the project would provide are

   (a) It will separate an entity's financing activities from its business and other activities.

   (b) It will also separate financing activities into transactions with owners in their capacity as owners and all other financing activities.

   (c) It will help a user to assess an entity's ability to meet its financial commitments as they come due and to invest in business opportunities.

   (d) It will help a user to understand

   (i) The basis on which assets and liabilities are measured
   (ii) The uncertainty in measurements of individual assets and liabilities
   (iii) What causes a change in reported amounts of individual assets and liabilities
   (iv) It will help investors, trade payables and others to assess:

   - An entity's ability to generate future cash inflows
   - An entity's ability to meet its obligations, its ability to pay dividends and its need for external financing
   - The difference between cash transactions and accrual accounting
   - The effects of non-cash activities during the period on an entity's financial position

Self-Examination Questions

Question 1

Cobweb Broadband issued 1000 fully convertible bonds on 1 January 20X4 at par with face value of Tshs600 per bond. The term period of the bond is three years. The rate of interest is 4% paid annually. The bond can be converted at any time up to maturity into 150 ordinary shares. Cobweb has an option to settle the loan amount in ordinary shares or cash.

A market survey of a similar bond for that date shows an interest rate of 9%, without the conversion option. The market price of an ordinary share on the issue date is Tshs1.8, excluding income tax. The net profit in 20X4 is Tshs600,000, the ordinary shares' balance is 1,200,000, convertible bonds 1,000.

Required:

Calculate the EPS, diluted EPS and show how the bonds are settled by Cobweb.

Question 2

Earnings per share is one of the most quoted statistics in financial analysis, coming into prominence because of the widespread use of the price earnings ratio as an investment decision making yardstick.

Until the IASC issued E52 'Earnings per Share', there had been no international guidance on the subject from the IASC. Subsequently in 1997, IAS 33 'Earnings per Share' was issued to provide principles for its determination and presentation.

Required:

Explain why there is a need to disclose diluted earnings per share in financial statements.

Question 3

Goldfish Fisheries is a fishing company which has entered into the following transactions for the year to 31 December 20X6. State with reasons, which of the following transactions can be recognised as revenue.

(a) Goldfish Fisheries sold one of its ships to Shark Plc for Tshs200 million on the condition that it will repurchase the ship from Shark Plc after one year on a payment of Tshs250 million.

(b) It sold one of its boats and nets to Guppy Ltd on 1 August 20X6 for Tshs25 million. A condition of sale states that Guppy Ltd should sell it fish worth more than Tshs1.7 million per month for one year of sale. If it fails to do so then Goldfish Fisheries will retake possession of the boat. Guppy Ltd complies with this condition during December 20X6.

(c) It sends goods worth Tshs17 million to Dollarfish Ltd. Dollar Fish Ltd is an intermediary and does not have storage facility. Therefore the insurance and warehouse costs are borne by Goldfish Fisheries. On 1 September 20X6 Dollarfish sells these goods to a third party.

(d) Goldfish has taken an advance of Tshs15 million from Rola Gola soft drinks for advertising their product by painting them on 3 of their ships and 5 of their boats. The agreed price is Tshs1.5 million for each boat and Tshs2.5 million for each ship. Till the statement of financial position date five boats are painted. The three ships have not been painted till the statement of financial position date.

Question 4

The following is the trial balance of Mandarin Ltd as at 31 December 20X7.

Trial balance	Tshs'000	Tshs'000
Ordinary shares each Tshs1,000 (fully paid)		1,400
Retained profit 01/01/20X7		968
General reserves 01/01/20X7		684
10 % debentures (issued in 20X4)		800
Freehold land & buildings 01/01/20X7 (cost)	1,720	
Plant and machinery 01/01/20X7 (cost)	3,320	
Provision for depreciation:		
Freehold buildings 01/01/20X7		80
Plant and machinery 01/01/20X7		888
Inventory 01/01/20X7	760	-
Sales		10,780
Purchases	8,608	
Wages and salaries	1,016	
Ordinary dividend (interim)	32	
Debenture interest	40	
Receivables	716	
Light and heat	124	
Sundry expenses	452	
Suspense account		540
Cash	132	
Payables		780
	16,920	**16,920**

Notes:

1. The amount of sundry expenses includes Tshs36,000 paid in respect of insurance for the year ending 1 September 20X8.

2. An invoice of Tshs12,000 for electricity for the three months ending 31 December 20X7, which was paid in February 20X8 was omitted to be recorded in light and heat expenses.

3. The suspense account balance consists of the following:

	Tshs'000
Proceeds from the issue of 200 ordinary shares	480
Proceeds from the sale of plant	1,200
	1,680
Less: Investment in the shares of companies	(1,140)
	540

4. The freehold property was acquired a few years ago. The building element of the cost was estimated at Tshs400,000 and the estimated useful life of the assets was fifty years at the time of purchase. As at 31 December 20X7, the property is revalued at Tshs3,200,000.

5. The plant which was sold was initially purchased at a cost of Tshs1,400,000 and had a net book value of Tshs1,096,000 as at 1 January 20X7.

6. The applicable tax rate is 30%.

7. Tshs144,000 depreciation is to be charged on plant and machinery for 20X7.

8. The directors decided to provide for the following
   (a) Audit fees of Tshs16,000
   (b) Debenture interest due
   (c) A transfer to the general reserve of Tshs64,000

9. Inventory as at 31 December 20X7 was valued at Tshs880,000 (cost)

Required:

Prepare the financial statements of Mandarin Ltd in a form suitable for internal purposes.

Answers to Self-Examination Questions

Answer to SEQ 1

The liabilities are Tshs524,060, the equity is Tshs75,940 (refer W1)

Present value of bond (W1)	Tshs463,310
Interest at 4% per year for 3 years on Tshs600,000	Tshs24,000

Liability and equity are determined according to IAS 32. They are recognised at initial carrying amounts of the liability and equity as shown in the statement of financial position. The bonds converted into equity are permanent and cannot be adjusted.

Basic earnings per share in 20X4

600,000/1,200,000 = Tshs0.5 per ordinary share

Diluted earnings per share 20X4

Assume that Cobweb will settle the bonds by issue of its ordinary shares.

600,000 + Interest on liability component (524,060 x 9%)	Tshs647,165
1,200,000 + 150,000 (150 x 100)	1,350,000

Therefore EPS is Tshs647,165 / 1,350,000 shares = Tshs0.48

Workings

W1 Present value discounted at 9%

Principal amount of bond payable after three years = Tshs600,000/$(1.09)^3$
=Tshs463,310

Interest payable annually for three years

		Tshs
Present value for year 1	Tshs24,000/1.09	22,018
Present value for year 2	Tshs24,000/$(1.09)^2$	20,200
Present value for year 3	(Tshs24,000 + Tshs600,000)/$(1.09)^3$	481,842
Liability component		**Tshs524,060**

Equity component is calculated as follows: Tshs600,000 - Tshs524,060 = Tshs75,940

Answer to SEQ 2

Basic EPS accounts is calculated only for those shares which are in issue and do not account for obligations that could dilute the EPS in future. A company could have convertible stock options or warrants. Also company may enter into deferred consideration agreements under which additional shares may be issued at a future date. Investors are more interested in the future earnings per share of a company than the past performance. This may result in dilution of basic earnings per share. Therefore the effect of any dilution in the future should be disclosed. Growth in basic EPS can be achieved by many companies by using convertible stocks.

The securities normally carry a low rate of interest due to the fact that they can be converted into shares, where convertible loan stock and shares are used to finance expansion. EPS can be increased by sustaining current performance and covering the incremental finance cost. The true growth in earnings can be revealed by diluted EPS as an attempt is made to show the true cost of using convertible stock to finance growth in earnings.

The disclosure is intended to help users assess the potential variability of future EPS and the risk attached to it. It is an indicator to users that the current level of basic EPS may not be sustainable in future. However, the objectives of the basic and diluted EPS should be the same and act as a performance measure. The diluted EPS is a theoretical measure of the effect of dilution on basic EPS. Due to its hypothetical nature, analysts do not use this measure as much as basic EPS. The diluted EPS can be used as a warning device to equity shareholders that future earnings will be affected by diluting factors.

Answer to SEQ 3

(a) It will not recognise Tshs200 million as revenue from sale of ship. The substance of the transaction shows that Goldfish Fisheries has taken a loan from Shark Plc. It has pledged one of its ships as mortgage and the increase in the re-purchase price shows the element of interest in the transaction.

(b) The Tshs25 million is a receipt from the sale of non-current assets. Goldfish Fisheries will recognise Tshs25 million in December 20X6 as the condition of the sale has been fulfilled. If there is any condition in the sale agreement, then revenue is recognised when the condition is fulfilled.

(c) Goldfish Fisheries will recognise Tshs17 million as revenue in September 20X6 as the risks and rewards of ownership are retained by Goldfish Fisheries as it bears the insurance and warehouse expenses of the goods. Revenue will be recognised when the goods are sold to a third party on 1 September 20X6.

(d) Gold fish will recognise Tshs7.5 million as revenue as it has painted only five boats till the statement of financial position date at Tshs1.5 million each. The advance taken for the rest of the ships cannot be recognised as revenue as the assignment has not been completed. Therefore it is recognised in the statement of financial position as liability on a percentage of completion basis.

Answer to SEQ 4

Mandarin Ltd - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

	Tshs'000	Tshs'000
Revenue	-	10,780
Less: Cost of goods sold	-	-
Opening inventory	760	-
Purchases	8,608	-
	9,368	-
Less: Closing inventory	(880)	(8,488)
Gross profit	**-**	**2,292**
Other income	-	
Profit on disposal of plant (W7)		104
Wages, salaries and commission	(1,016)	-
Sundry expenses (452 – 24 Prepaid insurance)	(428)	-
Light and heat (124 + 12)	(136)	-
Depreciation (W4)	-	-
Freehold buildings	(8)	-
Plant	(144)	-
Audit fees	(16)	-
Debenture interest	(80)	(1,828)
Profit before tax	-	568
Income tax expense (30% of 568)	-	(170)
Profit for the year	**-**	**398**
Other comprehensive income – Not reclassified to profit or loss	**-**	**-**
Gains on property revaluation (W6)	1,568	-
Income tax relating to components of other comprehensive income (30% of 1,568)	(470)	(1,098)
Total comprehensive income for the year		**1,496**

Mandarin Ltd - Statement of changes in equity for the year ended 31 December 20X7

	Share capital	Share premium account	Retained earnings	Revaluation surplus	General reserve	Total
	Tshs'000					
Balance at 01/01/20X7	1,400		968		684	3,052
Issue of share capital (W10)	200	280				480
Dividends paid			(32)			(32)
Total comprehensive income for the year			398	1,098		1,496
Transferred to general reserve			(64)		64	-
Balance as at 31/12/20X7	**1,600**	**280**	**1,270**	**1,098**	**748**	**4,996**

Mandarin Ltd - Statement of financial position as at 31 December 20X7

	Tshs'000	Tshs'000
Non-current assets		
Tangible assets		
Freehold property	3,200	
Plant and machinery (W4)	1,192	
Investments	1,140	5,532
Current assets		
Inventory	880	
Receivables	716	
Pre-paid expenses (Insurance: 36 x 9/12)	24	
Cash	132	1,752
		7,284
Capital and reserves		
Share capital – Tshs1,000 par value of each ordinary shares		1,600
Reserves Share premium	280	
Revaluation surplus	1,098	
General reserve	748	
Retained earnings	1,270	3,396
Non-current liabilities		
10% debentures (secured)		800
Current liabilities		
Income tax provision (170 + 470)	640	
Payables	780	
Accrued expenses	68	1,488
		7,284

Workings

W1 Accrued interest on 10% debentures

	Tshs'000
Interest expense on 10% debentures (10% of Tshs800,000)	80
Amount already paid as shown in trial balance	(40)
Accrued interest payable	40

W2 Accrued expenses shown in SOFP

	Tshs'000
Debenture interest (Tshs800 x 10% -40) (W1)	40
Light & heat	12
Audit fees	16
	68

W3 Plant and machinery

	Tshs'000
According to trial balance Cost of the plant sold Accumulated depreciation (W9)	3,320 (1,400) (728)
	1,192

W4 Depreciation on the building portion of freehold property

Depreciation = Cost / Useful life of the asset

$$= \frac{4,00,000}{8,000} = 50$$

W5 Reduced down value of the freehold property

	Tshs'000
Freehold land & building on 01/01/20X7 **Less:** Accumulated depreciation **Less:** Depreciation for the year (W4)	1,720 (80) (8)
	1,632

W6 Revaluation surplus

	Tshs'000
The property is revalued at **Less:** Carrying value (Tshs1,720 – Tshs80 - Tshs8) (W5)	3,200 (1,632)
Revaluation surplus	**1,568**

W7 Profit on disposal of plants

	Tshs'000
Proceeds from the disposal of plants **Less:** Reduced down value	1,200 (1,096)
Profit on disposal of plants	**104**

W8 Cost of remaining plant

	Tshs'000
Cost of the remaining plant is (Tshs3,320, - Tshs1,400)	1,920

W9 Accumulated depreciation on plant

	Tshs'000
According to trial balance Charge for the year 20X7 **Less:** Depreciation on disposals (Tshs,400 – Tshs1,096)	888 144 (304)
	728

W10 Share premium

	Tshs'000
Proceeds from ordinary shares **Less:** Nominal value of shares issued (200 x Tshs1,000)	480 (200)
Excess consideration over the nominal value	**280**

SECTION C

PRESENTATION OF ACCOUNTS AND DISCLOSURES

C1

STUDY GUIDE C1: OPERATING SEGMENTS

Get Through Intro

In today's global economy, most entities produce and market a variety of products and services and also operate in many geographical areas of the world. Each of the products and geographical areas are naturally subject to different rates of profitability, risks, and opportunities and so on. It is therefore essential for key management personnel to be aware of the risks and returns involved in each geographical area and for each product / service. This information will enable key management personnel to make appropriate decisions regarding the utilisation of the entity's resources.

IFRS 8 deals with providing segment information. The objective of this IFRS is to establish principles for reporting financial information by segment. That is, information regarding the different types of products and services an entity produces and the different geographical areas in which it operates. This information will enable users of financial statements to

- Understand the entity's past performance better
- Assess the entity's risks and returns better
- Make more informed judgements about the entity as a whole

E.g. The GE Group has the following businesses

- GE commercial finance
- GE Healthcare
- GE Industrial
- GE Money
- GE infrastructure
- NBC Universal

For each of the operations, the risk and returns will be different. Therefore, preparation of the financial statements in accordance with the IFRS will enable the group to determine the amount of resources to be utilised for each of the services; so that optimum return on investment can be ensured.

This Study Guide explains the concepts relating to operating segments. Studying this Study Guide will enable you to prepare financial statements in accordance with the IFRS in your professional assignments.

Learning Outcomes

a) Define an operating segment and understand the problems faced by companies in reporting segment information.
b) Identify and apply the knowledge of IFRS 8 Operating Segments to report segments.

1. Define an operating segment and understand the problems faced by companies in reporting segment information.

[Learning Outcome a]

1.1 Operating segment

The term operating segment has been defined in IFRS 8 as follows

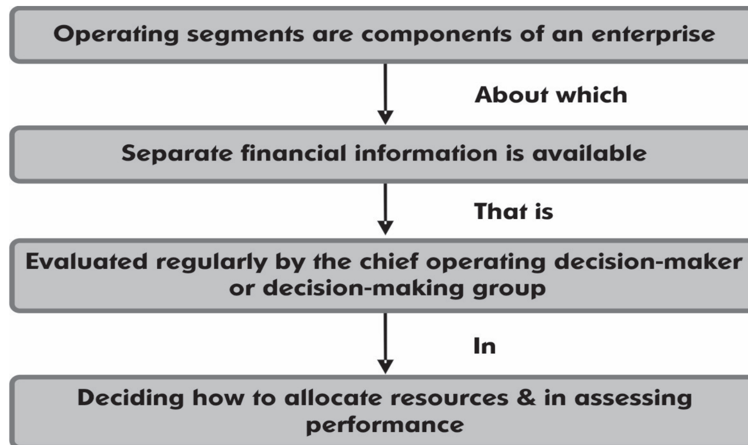
Definition

An **operating segment** is a component of an entity:

- That **engages in business activities** from which it **may earn revenues and incur expenses** (including revenues and expenses relating to transactions with other components of the same entity);
- Whose **operating results** are **reviewed** regularly by the entity's **chief operating decision maker** to make **Decisions about resources** to be allocated to the segment and assess its performance; and for which discrete **financial information** is available.

IFRS 8 Para 5

Diagram 1: Operating segments



Example

Real InfoTech is a company engaged in various activities related to information technology.

The major operations comprise of:

- Software segment
- Business service segment
- Hardware product segment
- Financing segment
- Technology service segment

Financial information regarding revenue, profit / loss, assets and liabilities are available for each of the segments mentioned above.

These segments represent the various components of the company**.**
Financial information for the various operations **is available to the company.**
The **financial information is reviewed regularly by the key management personnel (KMP).**
The **financial information is used to decide the allocation of the company's resources.**
Hence the segment information mentioned above meets the requirements of operating segments.

According to IFRS 8, **operating segments may include segments for which the entity has still to earn revenue.**

Example

Electronics Ltd manufactures and markets electronic items. It has recently entered into the internet business. This segment has not started generating revenue as at the reporting date. However, the company wishes to highlight it as a start-up activity that incurs cost but does not generate revenue. Therefore the segment is treated as an operating segment.

The management approach to segment reporting requires companies to report segment financial information consistent with the way they manage their businesses. This definition includes reporting separately segments that sell their products or services primarily or exclusively to other operating segments of the enterprise, if management reports these segments separately for decision-making purposes.

Test Yourself 1

Quality Ltd manufactures and markets air conditioners: room air conditioners, split air conditioners and central air conditioners. Room air conditioner and split air conditioner divisions have similar:

(i) Products
(ii) Production processes
(iii) Customers; and
(iv) Distribution system for the products

Financial information on all these products is compiled and made available to the key management personnel for making decisions regarding the utilisation of resources.

Required:

Determine the reportable segments.

1.2 Usefulness of segment information

The following are the uses of segment information

1. Comparative assessment of segmental risk and returns

Segment information helps in reporting the different types of products and services that an entity provides and the different geographical areas in which it operates. It offers **critical yardsticks for comparison** of performance across divisions and is a very useful tool for making investment decisions.

2. Enables more informed judgements about the entity as a whole

Segment information enables users of financial statements to make better judgements as a whole. From the information given above, we can derive the profitability and assets employed segment-wise. Therefore, segment-wise data can be analysed to make a judgement about the performance of the entity.

3. Investors are aided in forecasting consolidated sales and net income

Segment reporting gives retail investors the opportunity to track the performance of a company across various divisions. Investors can make investment decisions on the basis of the future growth of the company. Investors can find out the most profitable segment of the company and the future prospects of the product and the company. This will help them to make correct investment decisions.

4. Comparative analysis of the company with its competitors

Segment reporting creates an opportunity for companies to add value to the information they disclose about their industry and geographical operations. The disclosures with respect to segment information will enable the compilation of industry data. This is useful in analysing past performance and forecasting the future of the industry as a whole. This also enables the entity to compare its performance with the performance of its competitors. This would not be possible if the segment information was not disclosed in the financial statements.

5. Enables better understanding of the entity's past performance

Segment reporting helps in understanding the entity's past performance segment-wise. Management can assess the current performance of the segment with its own past performance and decide whether the particular segment is running profitably and needs extra attention. Management can also make a detailed analysis of a less profitable segment and hence take corrective measures.

Example

Shoe Co has been in the shoe business for the last ten years and markets its products in Yorkshire, London and France. Till recently, the business had done well. However, over the last three years there has been a decline in the profitability of the company. The company is unable to find the exact reason for the decline in profit, as it has always made a consolidated cost and profit analysis.

The company now decides to make a profitability analysis of the company, segment-wise. To achieve this, the company is divided into three geographical segments (Yorkshire, London and France) and a detailed profit / cost analysis is made segment-wise. It is found that sales in France have been declining for the last three years and this has affected the overall profitability of the company. The company can now take the necessary corrective action.

1.3 Problems with segment reporting

The following are the problems associated with segment reporting

1. Risk of information being passed on to competitors

Management faces increased competitive risk as a result of competitors knowing more about the company. Most companies guard information on the profitability of segments carefully. If too much information is revealed in the financial statements, the company could lose its negotiating advantage in an acquisition.

2. Inconsistency in the determination of segments

The determination of a segment is a subjective decision. Not all companies in the industry follow a similar method of determining segments. In other words, there is no consistency in the determination of operating segments. Some entities classify the whole of Europe, the Middle East and Africa as one segment; while other entities separate them into different segments.

Example

The segment information of three companies from the pharmaceutical industry was compared. All three are involved in more or less the same business categories - bulk drugs, formulations and drug discovery (or research and development).

The first company had provided segment information across these categories,

The second company had classified its business into `pharmaceuticals' and `others'.

The third company had classified its activities as a single segment.

Therefore there is no consistency in determining the reportable segment.

---

3. Burden for smaller companies

Segment information is a burden for smaller companies as it may be expensive and time-consuming for them to compile the segment information which is prescribed by the IFRS.

4. Problem faced by the auditors

Auditors, sometimes, face the risk of not knowing how the regulatory authorities will respond to disclosures on which the auditor has rendered an opinion. If the auditor discloses too much information, the client faces a competitive disadvantage. Disclosing too little might raise the ire of the regulatory authorities.

5. Difficulty in allocating revenue expenses to different segments

Revenue expenses which are not directly attributable to a segment need to be allocated between the different segments on a reasonable basis. However, the IFRS has not explained how this is to be done. The basis for allocation which is chosen can have a material effect on the segment result. Furthermore, the IFRS also does not require a disclosure about the basis of allocation of revenue expenses. Therefore the financial statements of different entities may not be comparable.

2. Identify and apply the knowledge of IFRS 8 Operating Segments to report segments. [Learning Outcome b]

2.1 Determination of reportable segment

1. According to the IFRS, reportable segments are determined as follows

Definition

An **operating segment** is a component of an entity

That **engages in business activities** from which it **may earn revenues and incur expenses** (including revenues and expenses relating to transactions with other components of the same entity); whose **operating results** are **reviewed** regularly by the entity's **chief operating decision maker** to make **decisions about resources** to be allocated to the segment and assess its performance; and for which discrete financial information is available.

IFRS 8

In order to establish whether a segment is a reportable segment, the standard suggests using either a quantitative threshold (as explained in paragraph 2 below) or basing the segment split on the aggregation criteria (as explained in paragraph 2.2 below).

2. Quantitative threshold (QT)

Segments must be reported on separately if they meet any of these criteria

(a) Reported revenues (internal and external) are more than 10% of the combined revenues (internal and external) of all the segments.

(b) The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of
The combined reported profit of all the operating segments that did not report a loss, and
The combined reported loss of all the operating segments that reported a

loss. (c) Assets are more than 10% of the combined assets of all the segments.

Example

Saturn Ltd has identified the following segments: (All amounts in Tshs millions)

	Iron	Cement	Steel	Aluminium	Copper	Limestone	Total
Segment revenue							
External sales	25	2	6	20	23	23	99
Inter-segment sales	12	6	8	2		1	29
Total revenue	**37**	**8**	**14**	**22**	**23**	**24**	**128**
Segment result (profit / loss)	9	16	(3)	(1)	6	8	35
Segment assets	81	51	16	16	27	5	196

Continued on the next page

Using the quantitative threshold mentioned above, reportable segments can be identified as follows

Step 1	**Calculate which segments are reportable based on 10% of revenue** Segments iron, steel, aluminium, copper and limestone have revenue from sales to external customers and from transactions with other segments of more than 10% of the total revenue (external and internal), of all segments (W1)
Step 2	**Calculate which segments are reportable based on 10% of combined profit / loss** Segments iron, cement, copper and limestone have segment results, whether profit or loss, at 10% or more of the combined profit of all segments in profit or the combined loss of all segments in loss, whichever is the greater in absolute amount
Step 3	**Calculate which segments are reportable based on 10% of total assets** Segments iron, cement and copper have assets which are 10% or more of the total assets of all segments

Therefore segments iron; cement, steel, aluminium, copper and limestone are the reportable segments.

Workings (All amounts in Tshs million)

		Iron	Cement	Steel	Aluminium	Copper	Limestone	Total
W1	**Segment revenue**							
	External sales	25	2	6	20	23	23	99
	Inter-segment sales	12	6	8	2		1	29
	Total revenue	**37**	**8**	**14**	**22**	**23**	**24**	**128**
W2	Total revenue of each segment as a percentage of total revenue of all segments (W1)	29 (37/128x100)	6	11	17	18	19	
W3	Segment result (profit / loss)	9	16	(3)	(1)	6	8	35
W4	Combined result of all segments in profit	9	16			6	8	39
W5	Combined result of all segments in loss			3	1			(4)
W6	Segment result as a percentage of the greater of the totals in 4 and 5 above in absolute amounts (W2)	23 (9/39x100)	41	8 (3/39x100)	3	15	21	
W7	Segment assets	81	5	16	16	27	5	196
W8	Segment assets as a percentage of total assets of all segments (W3)	41 (81/196x100)	26	8	8	14	3	

Alternative method

There is another alternative available for performing above calculations to identify reportable segments.

Here instead of calculating percentages for each segment, a quantitative threshold (i.e. 10% of total) is calculated. Then actual figures are compared with the threshold calculated to identify reporting segments.

Continued on the next page

Using the quantitative threshold mentioned above, reportable segments can be identified as follows

Step 1	**Calculate which segments are reportable based on 10% of revenue** The revenue threshold is 12.8. Segments Iron, Steel, Aluminium, Copper and Limestone have revenue from sales to external customers and from transactions with other segments of more than 10% of the total revenue (external and internal), of all segments (W1)
Step 2	**Calculate which segments are reportable based on 10% of combined profit / loss** The threshold is 3.9. (Segments Iron, Cement, Copper and Limestone have segment results, whether profit or loss, at 10% or more of the combined profit of all segments in profit or the combined loss of all segments in loss, whichever is the greater in absolute amount (W2, W3 and W4)
Step 3	Calculate **which segments are reportable based on 10% of total assets** The asset threshold is 19.6. Segments Iron, Cement and Copper have assets which are 10% or more of the total assets of all segments (W5)

Therefore segments Iron, Cement, Steel, Aluminium, Copper and Limestone are reportable segments.

Workings

(All figures in Tshs million)

		Iron	Cement	Steel	Aluminium	Copper	Limestone	Total
W1	Segment revenue							
	External sales Inter-segment sales	25 12	2 6	6 8	20 2	23	23 1	99 29
	Total revenue	**37**	8	**14**	**22**	**23**	**24**	**128**
W2	Segment result (profit / loss)	9	16	(3)	(1)	6	8	35
W3	Combined result of all segments in profit	9	16			6	8	39
W4	Combined result of all segments in loss			**3**	**1**			**(4)**
W5	Segment assets	**81**	**51**	**16**	**16**	**27**	**5**	**196**

Test Yourself 2

The following is segment information for Fancy Motors: (All amounts in Tshs million)

	Asia	Europe	Australia	Africa	N. America	L. America	Total
Segment revenue							
External sales	25	95	89	50	69	18	346
Inter-segment sales	53	15	8	42		25	143
Total revenue	**78**	**110**	**97**	**92**	**69**	**43**	**489**
Segment result (profit / loss)	(7)	12	(6)	7	2	1	9
Segment assets	1,020	720	160	160	270	50	2,380

Required:

Determine the reportable segments.

3. The **reportable segments** should report at least **75% of the entity's revenue**.

If the total external revenue reported by operating segments is less than 75% of total entity revenue. Then the entity shall identify additional segments (even though they do not meet the criteria of quantitative thresholds) until at least 75% of the entity's revenue is included in the reportable segments.

IFRS 8 has not defined the term 'total entity revenue'. However, the total entity revenue should be interpreted as the total entity's external revenue. If the total external revenue of identified reportable segments is less than 75% of the entity's external revenue, then additional segments are required to be reported until the 75% criteria is fulfilled.

Example

Segment information of Gamma Limited is shown below and is divided into segments: iron, copper, aluminium and limestone with revenue from sales to external customers and from transactions with other segments.

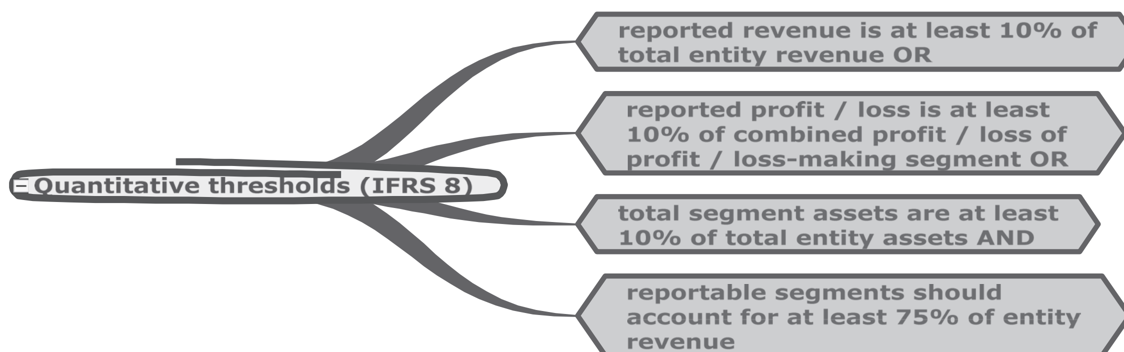
(All amounts in Tshs million)

	Iron	Cement	Steel	Aluminium	Copper	Limestone	Total
Segment revenue							
External sales	15	5	7	3	12	16	58
Inter-segment sales	12	6	8	2	9	1	38
Total revenue	**27**	**11**	**15**	**5**	**21**	**17**	**96**
Total revenue of each segment as a percentage of total revenue of all segments	28	11	16	5	22	18	

Iron, Cement, Steel, Copper, Limestone are reportable segments as they fetch more than 10% revenue individually of total revenue of the entity.

Revenue from sales to external customers of reportable segments is (Tshs15 million + Tshs5 million + Tshs7 million + Tshs12 million + Tshs16 million) = Tshs55 million i.e. 95% of the entity's revenue (100 x 55/58)

SUMMARY



Test Yourself 3

The following is the segment information of Royal Motors

(All amounts in Tshs million)

	Cars	Bikes	Tractors	Cranes	Forklifts	Cycles	Total
Segment revenue							
External sales	12	6	5	13	6	0	42
Inter-segment sales	25	1	8	2	2	7	45
Total revenue	**37**	**7**	**13**	**15**	**8**	**7**	**87**

Required:

Determine the reportable segments.

2.2 Aggregation criteria

Two or more operating segments may be aggregated into a single operating segment if the segments have similar economic characteristics and the segments are similar in each of the following respects

1. The nature of the products and services;
2. The nature of the production processes;
3. The type or class of customer for their products and services;
4. The methods used to distribute their products or provide their services; and
5. If applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities

The criteria for applying the aggregation criteria

If there are more operating segments than can be reported, then some segments may be aggregated.

Example

Quality insurance provides insurance services in Germany, France, Scotland, India, China, Japan and USA.

Segments Germany, France, India and China meet the threshold limits. So information about these segments has to be given in separate columns in the financial statements.

However segments Scotland, China Japan and USA do not meet the threshold limits. Hence information about these segments can be aggregated (provided they fulfil the other criteria for aggregation explained below).

The procedure is as follows
Segments that do not individually exceed the 10% threshold limit, may be aggregated

if the operating segments have similar economic characteristics; and
share a majority of the features of the aggregation criteria mentioned above (i.e. have similar production processes, customers, distribution systems and regulatory authority).

Test Yourself 4

Quality International provides insurance services in Germany, France, Scotland, India, China, Japan and the USA. Based on the quantitative threshold, India and China are identified as reportable segments.

However, Germany and France do not individually exceed the 10% threshold limits. Both the locations face similar risk and returns.

Required:

Can the two businesses be aggregated and reported as a reportable entity?

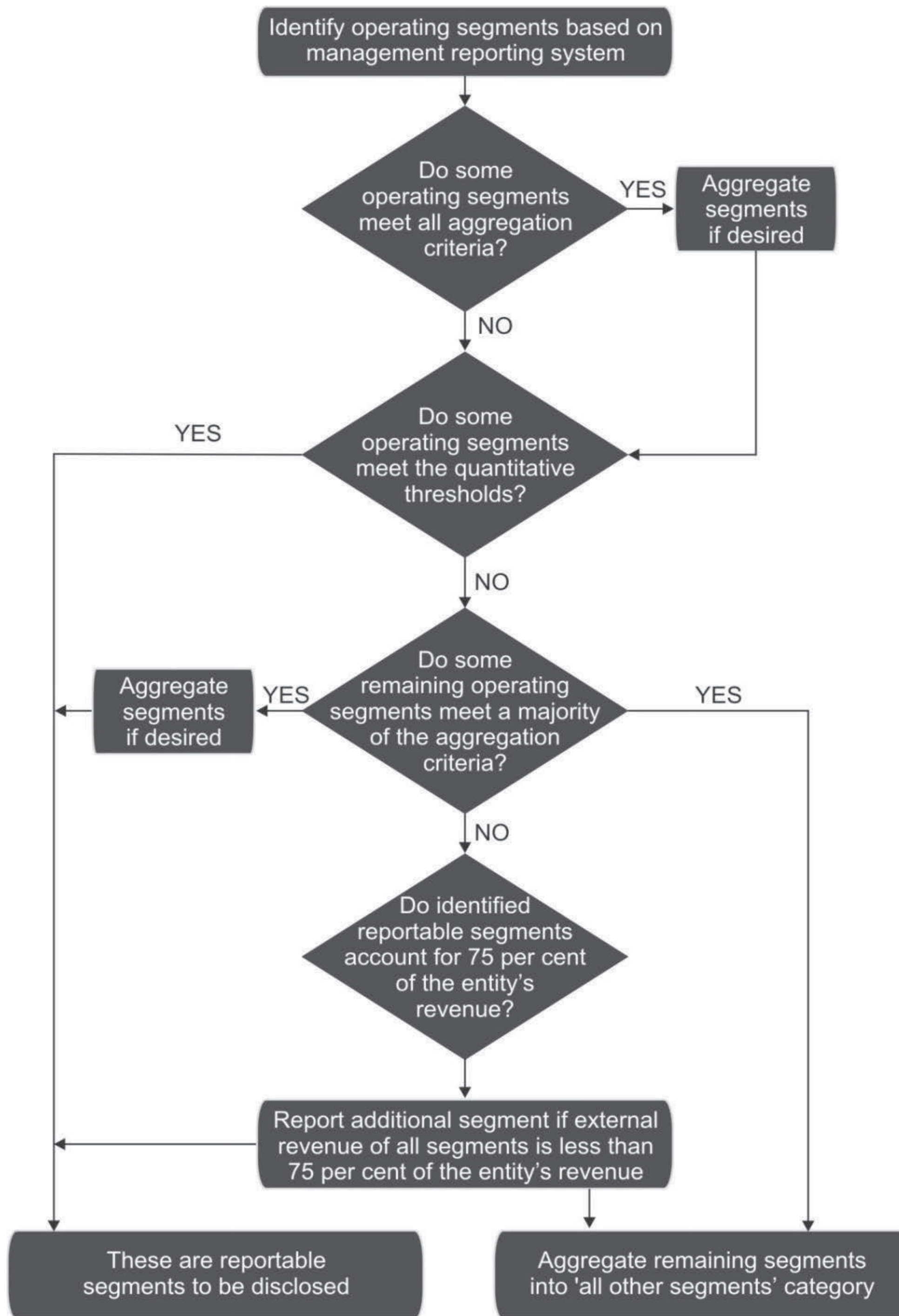
If the total external revenue reported by operating segments is less than 75% of the entity’s revenue, then a lower threshold than 10% is applied in order to identify additional operating segments until at least 75% of the entity’s revenue is reported.

2.3 Maximum number of segments

IFRS 8 does not prescribe the maximum limit for the number of operating segments to be reported.

However IFRS 8 has advised that, if the number of reportable segments increases above ten, the entity should consider whether a practical limit has been reached.

Diagram 2: Identifying reportable segments



2.4 Segment information prepared should contain the following

1. **General Information**- This should contain

   The various factors used to identify the reportable segments.

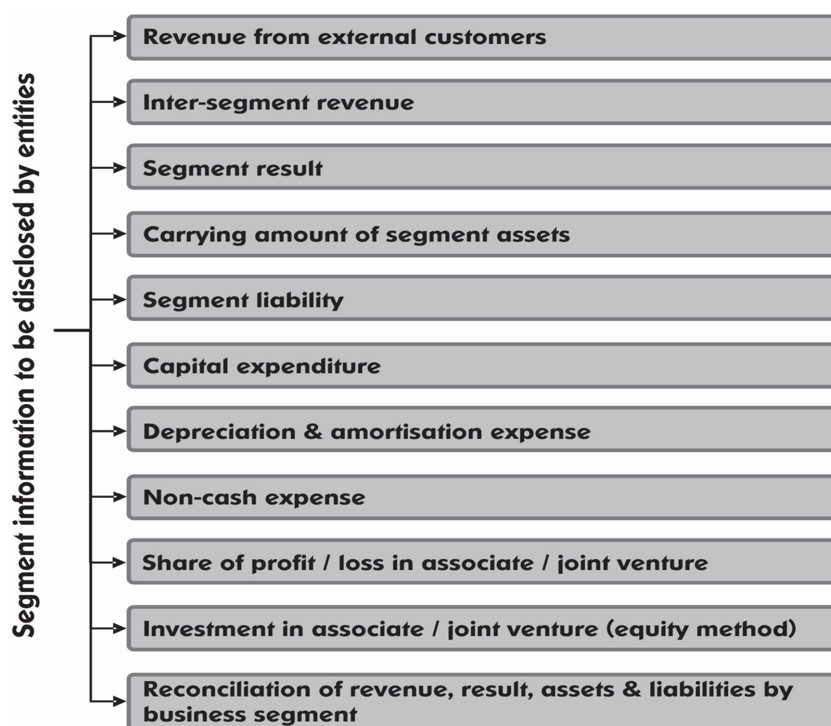
For example, the basis for selection of a segment can be based on geographical areas or differences in products.

   The types of products from which the segment derives revenue

2. **Information about segment revenue, profit / loss, segment assets, segment liabilities and the method of measurement.**

The following diagram indicates the segment information relating to the profit or loss and the assets and liabilities which are to be disclosed by entities.

Diagram 3: Reporting related to profit and loss and assets and liabilities



Answers to Test Yourself

Answer to TY 1

The activities of room air conditioner and split air conditioner division meet the requirements of reportable segments since both are engaged in providing product / services and are subject to similar risk and returns. Financial information is available and is used by the key management to determine the utilisation of revenue.

Answer to TY 2

Step 1	**Calculate which segments are reportable based on 10% of revenue** Segments Asia, Europe, Australia, Africa and N. America have revenue from sales to external customers and from transactions with other segments which is 10% or more of the total revenue (external and internal), of all segments.
Step 2	**Calculate which segments are reportable based on 10% of combined profit / loss** Segments Asia, Europe, Australia and Africa have segment results, whether profit or loss, which are 10% or more of the combined profit of all segments in profit or the combined loss of all segments in loss, whichever is the greater in absolute amount.
Step 3	**Calculate which segments are reportable based on 10% of total assets** Segments Asia, Europe and N. America have assets which are 10% or more of the total assets of all segments.

Therefore segments Asia, Europe, Australia, Africa and N. America are reportable segments.

Workings

(All amounts in Tshs million)

		Asia	Europe	Australia	Africa	N. America	L. America	Total
1	Segment revenue							
	External sales	25	95	89	50	69	18	346
	Inter-segment sales	53	15	8	42		25	143
	Total revenue	**78**	**110**	**97**	**92**	**69**	**43**	**489**
2	Total revenue of each segment as a percentage of total revenue of all segments	16 (78/489 x100)	22	20	19	14	9	
3	Segment result (profit / loss)	(7)	12	(6)	7	2	1	9
4	Combined result of all segments in profit		12		7	2	1	22
5	Combined result of all segments in loss	7		6				13
6	Segment result as a percentage of the greater of totals arrived at 4 and 5 above in absolute amounts	32 (7/22 x 100)	55	27 (6/22 x100)	32	9	5	
7	Segment assets	1,020	720	160	160	270	50	2,380
8	Segment assets as a percentage of total assets of all segments	43 (1,020/2380 x 100)	30	7	7	11	2	

Answer to TY 3

Step 1: The segments viz. Cars, Tractors and Cranes have revenue of more than 10%.

However, the total revenue from these segments through external sales is Tshs30 million i.e. only 72% of the total external revenue of the entity. According to IFRS, the reportable segments need at least 75% of the entity's revenue.

Therefore the entity must also consider either the Bikes segment or the Forklift segment as a reportable segment.

If the entity chooses the Bikes segment as a reportable segment, the external revenue from this segment is 14%, therefore the total revenue will be 86%.

If the entity chooses the Forklift segment as a reportable segment, the revenue from this segment is also 14%, therefore the total revenue will be 86%.

Therefore the reportable segments would be the

Car segment
Tractor segment
Crane segment

AND

Bikes segment OR
Forklift segment.

(All amounts in Tshs million)

	Cars	Bikes	Tractors	Cranes	Forklifts	Cycles	Total
Segment revenue							
External sales	12	6	5	13	6	-	42
Inter-segment sales	25	1	8	2	2	7	45
Total revenue	37	7	13	15	8	7	87
External revenue of each segment as a percentage of entity's revenue of all segments	29	14	12	31	14		100

Answer to TY 4

Germany and France face similar currency risks as they have a common currency. Furthermore, the returns are also similar for these segments. Hence the two businesses can be merged and reported as a separate reportable segment. The following are the reportable segments according to the IFRS: Germany and France aggregated as one segment, India and China.

Quick Quiz

1. Give two reasons why segment information is useful.

2. Explain the quantitative threshold based on which reportable segments are determined.

3. Explain in brief the information relating to major customers?

Answers to Quick Quiz

1. Segment information

   Enables a better understanding of the entity's past performance
   Enables a better assessment of the entity's risks and returns

2. Segments must be reported on separately if they meet any of these criteria

   Reported revenues (internal and external) are more than 10% of the combined revenues (internal and external) of all the segments.
   Reported profit or loss is 10% or more of the combined profit of all segments in profit or the combined loss of all segments in loss, whichever is the greater in absolute amount.
   Assets are more than 10% of the combined assets of all the segments.

3. Entities which generate revenue from any single customer amounting to more than 10% of the entity's revenue need to disclose the details of such customers. The disclosure is to be made about the total amount of revenue from each such customer and the identity of the segment reporting the revenue. However, the identity of the major customer need not be disclosed.

Self-Examination Questions

Question 1

The following is the segment information of Medicare Ltd for 20X6. Determine the reportable segments.

(All amounts in Tshs million)

	India	Japan	China	Russia	USA	UK	Total
Segment revenue							
External sales	75	2	25	40	16	10	168
Inter-segment sales	15	6	8	22	39	1	91
Total revenue	**90**	**8**	**33**	**62**	**55**	**11**	**259**
Segment result (profit / loss)	17	(2)	(3)	27	15	(5)	49
Segment assets	81	51	16	16	27	5	196

Required:

Determine the reportable segments.

Question 2

A multinational enterprise by the name of Mars International has business activities located in three segments. The relevant details are as follows

Allocation of net income and net assets

Location	Relevant Percentages for Allocation of	
	*Revenue & Costs	Assets & Liabilities (see note 2)
	Tshs million	Tshs million
Europe	60	40
North America	20	40
Asia	20	20

* The allocation percentage to be applied to revenues and cost for net of inter-group revenue (see note 3)

1. Details relating to head office

The head office procures all necessary finance for the enterprise's activities and allocates this finance to operating units through current accounts. Some costs, assets and liabilities relate solely to head office and cannot be allocated to segments on a rational basis. These amounts are as follows

Operating costs of Tshs8,000 million at 31 March 20X4
Non-current financial assets
Bank balances of Head Office is Tshs14,000 million at 31 March 20X4
All liabilities except trade payables

2. Inter-Group revenues - year to 31 March 20X4

Selling Segment	Inter-Group Sales	Inter-Group Sales made to		
		Europe	North America	Asia
	Tshs million	Tshs million	Tshs million	Tshs million
Europe	16,000		11,200	4,800
North America	12,800	8,800		4,000
Asia	10,400	5,600	4,800	
Total		**14,400**	**16,000**	**8,800**

Extracts from the consolidated financial statements of Mars International for the year ended 31 March 20X4

Statement of profit or loss for the year to 31 March 20X4

	Tshs million
Revenue Cost of	532,000
sales Gross profit	(249,600)
Distribution costs	282,400
Administrative expenses	(79,200)
Profit from operations	(94,400)
Income from investments	**108,800**
Finance costs	4,800
Profit before tax	(20,000)
Income tax expenses	**93,600**
Profit after tax	(22,400)
Non-controlling interest	**71,200**
Net profit for the period	(6,400)
	64,800

Statement of financial position as at 31 March 20X4

	Tshs million	Tshs million
Assets		
Non-current assets		
Property, plant & equipment	272,000	
Financial assets	40,000	**312,000**
Current assets		
Inventories	60,000	
Trade receivables	83,200	
Bank balances	19,200	**162,400**
		474,400
Equity and liabilities		
Capital and reserves		
Issued capital	120,000	
Accumulated profits	144,000	**264,000**
Non-current liabilities		
Interest-bearing borrowings	112,000	
Deferred tax	28,800	**140,800**
Current liabilities		
Trade and other payables	56,000	
Short-term borrowings	13,600	**69,600**
		474,400

Required:

Prepare a segment report for Mars International for the year ended 31 March 20X4 that complies with IAS 14. You need not address disclosures required by IAS 14 that cannot be given from the information available.

Answers to Self-Examination Questions

Answer to SEQ 1

Step 1	**Calculate which segments are reportable based on 10% of revenue** Segments India, China and Russia and the USA have revenue from sales to external customers and from transactions with other segments of 10% or more of the total revenue (external and internal), of all segments.
Step 2	**Calculate which segments are reportable based on 10% of combined profit / loss** Segments India, the USA and Russia have a segment result, whether profit or loss, which is 10% or more of the combined result of all segments in profit or the combined result of all segments in loss, whichever is the greater in absolute amount. (W2)
Step 3	**Calculate which segments are reportable based on 10% of total assets** Segments India, Japan and the USA have assets which are 10% or more of the total assets of all segments

Therefore segments India, Japan, China and Russia and the USA are the reportable segments.

Workings

(All amounts in Tshs million)

		India	Japan	China	Russia	USA	UK	Total
1	Segment revenue							
	External sales	75	2	25	40	16	10	168
	Inter-segment sales	15	6	8	22	39	1	91
	Total revenue	**90**	**8**	**33**	**62**	**55**	**11**	**259**
2	Total revenue of each segment as a percentage of total revenue of all segments (W1)	35	3	13	24	21	4	
3	Segment result (profit / loss)	17	(2)	(3)	27	15	(5)	49
4	Combined result of all segments in profit	17			27	15		59
5	Combined result of all segments in loss		2	3			5	10
6	Segment result as a percentage of the greater of totals in 4 and 5 above in absolute amounts (W2)	29	3	5	46	25	8	
7	Segment assets	81	51	16	16	27	5	196
6	Segment assets as a percentage of total assets of all segments	41	26	8	8	14	3	

Answer to SEQ 2

Segment report for Mars international

(Amount in Tshs million)

	Europe	North America	Asia	Total
Revenue				
External sales (60:20:20)	319,200	106,400	106,400	532,000
Inter-segment sales	16,000	12,800	10,400	39,200
Total revenue	**335,200**	**119,200**	**116,800**	**571,200**
Result				
Segment result (W1)	**71,680**	**20,160**	**24,960**	**116,800**
Unallocated corporate expenses (H O operating cost)				(8,000)
Profit from operations				108,800
Investment income				4,800
Finance cost				(20,000)
Income taxes				(22,400)
Non-controlling interest				(6,400)
Net profit				**64,800**
Other information				
Segment assets (W2)	171,680	171,680	85,840	429,200
Unallocated corporate assets (40,000 + 5,200*)				45,200
Consolidated assets				**474,400**
Segment liabilities (W3)	22,400	22,400	11,200	56,000
Unallocated corporate liabilities (140,800 + 13,600)				154,400
Consolidated liabilities				**210,400**

* Total bank balance – amount allocated to segments = Tshs19,200 – Tshs14,000 = Tshs5200

Workings (all figures in Tshs million)

W1 Segment result

	Europe	North America	Asia	Total
Segment revenue	335,200	119,200	116,800	571,200
Segment costs	(249,120)	(83,040)	(83,040)	(415,200)
External*				
Inter-Group (Note 2 to question)	(14,400)	(16,000)	(8,800)	(39,200)
Segment result	**71,680**	**20,160**	**24,960**	**116,800**

* Total operating costs (excluding inter-group items) are 423,200 (249,600 + 79,200 + 94,400)

Head office costs are 8,000
So costs to be allocated are 415,200 in the ratio (60:20:20)

W2 Segment assets all allocated 40:40:20

	Europe	North America	Asia
Property, plant & equipment (272,000)	108,800	108,800	54,400
Inventories (60,000)	24,000	24,000	12,000
Trade receivables (83,200)	33,280	33,280	16,640
Bank balances (14,000)	5,600	5,600	2,800
	171,680	**171,680**	**85,840**

W3 Segment liabilities all allocated 40:40:20

	Europe	North America	Asia
Trade Payables (56,000)	22,400	22,400	11,200

STUDY GUIDE C2: RELATED PARTY DISCLOSURES

Get Through Intro

In today's global economy, group and associated companies normally carry out transactions among each other. These transactions can have an important effect on the statement of profit or loss and the financial position of the businesses concerned. The definition of related parties includes the members of a group company; therefore, transactions between related parties are a common characteristic of business.

For example, Rogers Limited may sell engines to Dina Limited, which is a member of the Roger Limited Group, at a lower rate compared to the rate at which it sells the same type of engine to Bila Limited, which is not a part of the Rogers Limited Group. Transactions with a group company will therefore affect the statement of profit or loss and the financial position of the group company, as Rogers will be showing sales at below fair value and Dina will be showing purchases at below fair value in their individual financial statements.

Therefore the IAS 24, Related Party Disclosures requires that a disclosure of such transactions needs to be made in the financial statements of the company. This will enable the readers of the financial statements to understand what is actually happening in each of the companies.

Transactions, which take place between related parties, are known as related party transactions. A variety of stakeholders have different interests in an entity. There is a risk that some of these relationships will lead to a conflict of interests. Examples include transaction with entities under common control or transactions between an entity and its directors. In order to aid transparency IAS 24 'Related Parties' requires disclosure of such transactions between related parties to be disclosed in the financial statements.

In this Study Guide we will examine the concept of related parties and the disclosures in the financial statements in this connection, which are required according to IAS 24.

Learning Outcomes

a) Apply the principles of IAS 24 Related Party Disclosures, to identify related party relationships.
b) Describe the disclosures pertaining to related party transactions.

1. Apply the principles of IAS 24 Related Party Disclosures, to identify related party relationships.

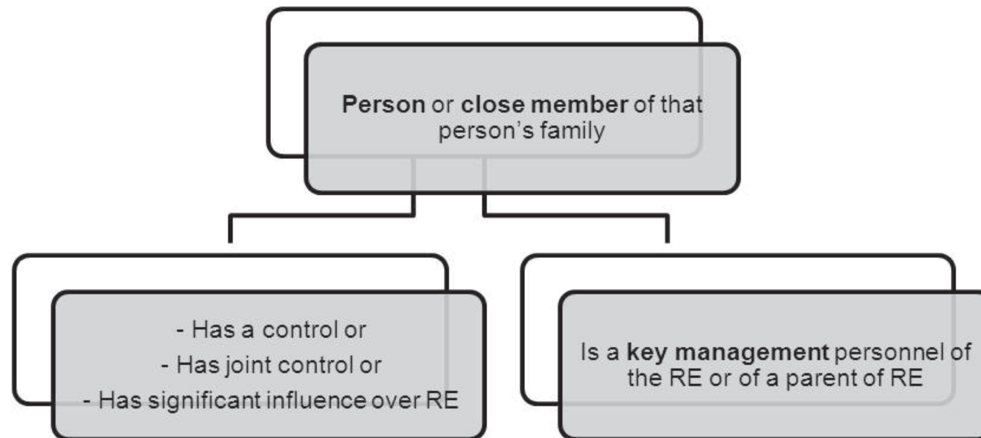
[Learning Outcome a]

1.1 What is a related party?

IAS 24, in its definition of related party, lists all scenarios where a party can be said to be related to another. First let us understand what is meant by a related party and then what constitutes related party relationships.

A person is related party of the reporting entity if

Diagram 1: Related party



RE – Reporting Entity

1. Close family members

Definition

Close family members of the family of the individual refers to "those family members who may be expected to influence or be influenced by that individual in their dealings with that entity".

IAS 24 Para 9

They may include

(a) The individual's domestic partner and children or
(b) Children of the individual's domestic partner or
(c) Dependants of the individual or the individual's domestic partner

The above list is not exhaustive. It could include other family members such as brothers, sisters, parents and so on if the family member has an influence in their dealings with the entity**.**

Example

Mr Patman owns 65% of the shares of Valley Plastics and Mrs Patman (the wife of Mr Patman) own 100% of the shares of City Plastics.

Mrs Patman is a close family member of Mr Patman and she has control over City Plastics, so in the financial statements of Valley Plastics, City Plastics is a related party.

Similarly, as Mrs Patman is a close family member of Mr Patman, and Mr Patman owns 65% of the shares of Valley Plastics, in the financial statements of City Plastics, Valley Plastics is a related party.

If Mrs Patman were to own only 10% shares in City Plastics she would not have had a significant influence over City Plastics.

Example

Sam and Tanya are married and therefore, are defined as close family members. Regardless of whether Zen or Yen is the reporting entity, Sam and Tanya are related parties.

If entity Zen is the reporting entity, entity Yen is a related party.
If entity Yen is the reporting entity, entity Zen is a related party.

Test Yourself 1

Mr. David is a director of Glassworks and Mrs David owns 25% shares of Metalworks.

Required:

State the related parties if Glassworks is the reporting entity.

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2. Key Management personnel

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

1.2 Related parties

Definition

An entity is related to a reporting entity if any of the following conditions applies

(a) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

(b) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

(c) Both entities are joint ventures of the same third party.

(d) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

(e) The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

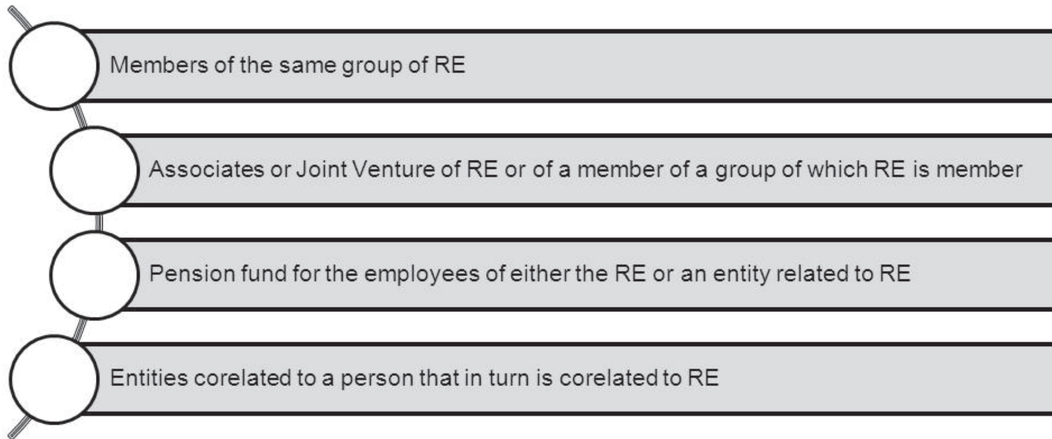
(f) The entity is controlled or jointly controlled by a person identified in (a).

(g) A person identified in (a) (i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

(IAS 24 Para 9 (b))

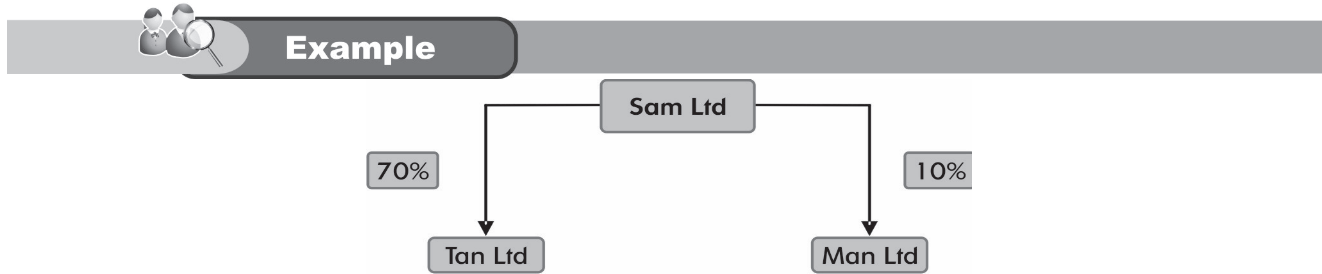
The above definition may seem a bit confusing. To conceptually understand the definition of related party transactions, let us now summarise it in the form of a diagram.

Diagram 2: Related party transactions



RE – Reporting Entity

Example



The following table will explain the concept of related parties

Reporting entity	Sam Ltd	Tan Ltd	Man Ltd
Related parties	Tan Ltd (subsidiary)	Sam Ltd (parent)	None

1.3 Exclusion from related party disclosures

The following are not deemed to be related in accordance with IAS 24

(a) Two entities simply because they have a director or key manager in common

(b) Two ventures who share joint control over a joint venture

(c) providers of finance, trade unions, public utilities, and departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity, simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process)

(d) a single customer, supplier, franchiser, distributor, or general agent with whom an entity transacts a significant volume of business merely by virtue of the resulting economic dependence.

Test Yourself 2

Limca Co owns nominal share capital of Tshs1 million in Fanta Co out of its total share capital of Tshs10 million. Limca Co also owns shares worth Tshs15 million in Rose Co and Tshs27.5 million in Wine Co. The share capital of Wine Co is Tshs50 million and that of Rose Co is Tshs15 million.

Required:

If Limca Co is the reporting entity, determine the related parties.

Test Yourself 3

State the related parties in the following table

Reporting Entity	Sam Ltd	Ran Ltd	Set Ltd
Related Parties			

Tip

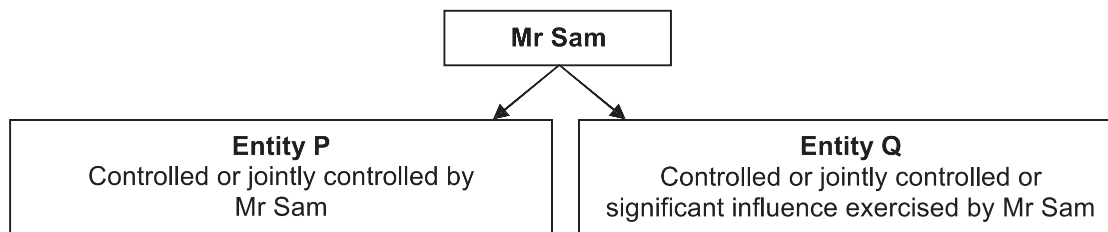
Remember, while determining whether a party is related or not, substance of the relationship should be considered and not merely the legal form. This means that to become a related party, the party should be in a position to influence the decision making power of the reporting entity.

1.4 Practical examples

The following are some examples of related party relationship under the revised standard:

1. An associate of a subsidiary's controlling investor

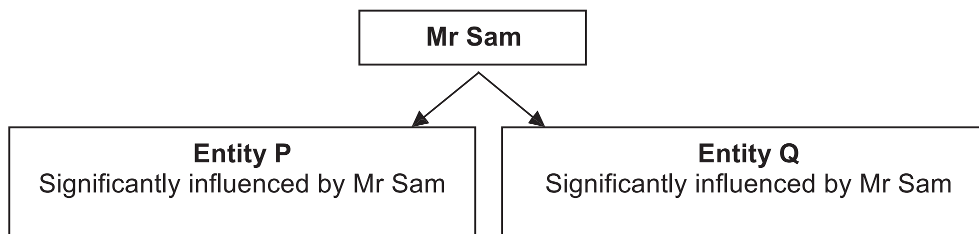
Assume that Mr Sam has control, joint control or significant influence over entities P and Q.



Entities P and Q are related party for the purpose of the financial statements under IAS 24.

2. Two associates of a person

Assume that Mr Sam has significant influence over entities P and Q.



Entities P and Q are not related parties for the purpose of the financial statements under IAS 24.

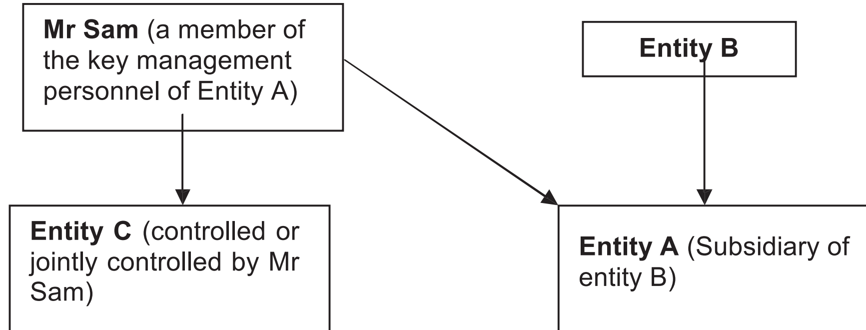
According to BC 25 of IAS 24R – **Earlier, IAS 24 did not define associates as related to each other if the investor was an entity.** This is because there is insufficient influence through the common investment in two associates.

However, the Board noted a discrepancy in the earlier version of IAS 24 that if a person significantly influences one entity and a close member of that person's family significantly influences another entity; those entities were treated as related parties of each other. Therefore the Board amended the definition to exclude entities described in the latter scenario, to be treated as related party**.**

3. Investments of members of key management personnel

Consider the following relationship

Mr Sam (who is key management personnel of entity A) controls or jointly control entity C. Entity A is a subsidiary of entity B.



Under IAS 24R for the purposes of the financial statements of entity C, entity A is a related party.

Per BC 26 of IAS 24R – IAS 24 treats some investees of the key management personnel of a reporting entity as related to that entity.

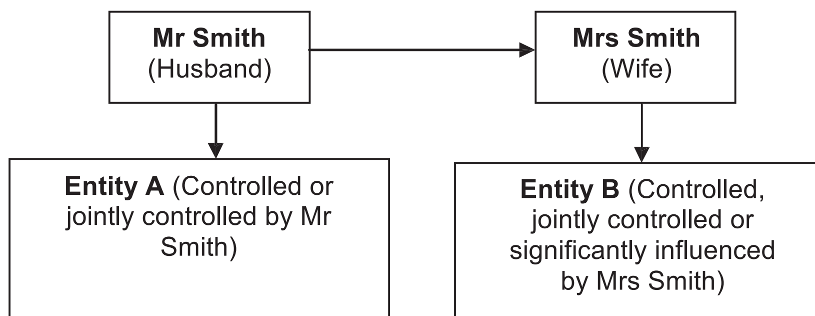
However, the definition in the 2003 version of IAS 24 did not include the reciprocal of this - i.e. for the financial statements of the investee, the other entity managed by the key management personnel was not a related party. To eliminate this inconsistency, the Board amended the definition so that for both sets of financial statements the entities are related parties.

Note: the outcome will be the same if Mr Sam is a member of the key management personnel of entity B and not entity A.

4. Joint control

Consider the following relationship

Mr Smith and Mrs Smith are husband and wife. Mr Smith has control or joint control over entity A while Mrs Smith has control, joint control or significant influence over entity B.



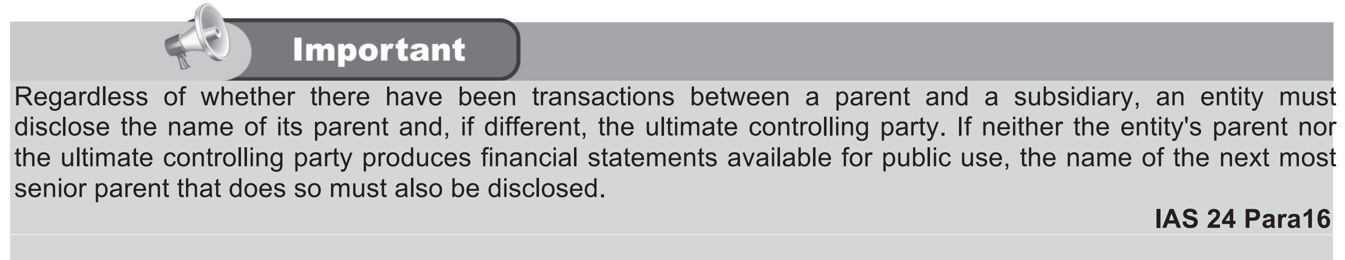
In accordance with IAS 24R, entity A and entity B are related parties for the purpose of the financial statements of both entities.

Whenever a person or an entity has both joint control over a second entity and joint control or significant influence over a third entity, the revised IAS 24 treats the second and third entities as related to each other.

2. Describe the disclosures pertaining to related party transactions.

[Learning Outcome b]

2.1 Disclosure requirements



Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party. If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so must also be disclosed.

IAS 24 Para16

According to IAS 24, relationships between parents and subsidiaries shall be disclosed irrespective of whether there have been transactions between those related parties.

1. The accounting standard requires the following disclosures

(a) The **name of the reporting entity's parent**

(b) The **ultimate controlling party** (if different from the name of the reporting entity's parent)

(c) If neither the entity's parent nor the ultimate controlling party produces financial statements available for public use, **the name of the next most senior parent that does so**

(d) The **related party relationship** when control exists irrespective of whether there have been transactions with those related parties.

(e) The **identification of related party relationships** between parents and subsidiaries in addition to the disclosure requirements in IAS 27, IAS 28 and IAS 31

(f) **Key management personnel compensation** in total for each of the following categories

(i) Short-term employee benefits;
(ii) Post-employment benefits;
(iii) Other long-term benefits;
(iv) termination benefits; and
(v) Share-based payments.

JD Enterprises is a subsidiary company of SR Enterprises. The disclosures in the financial statements of JD Enterprises for 20X6 would be as follows

Related party disclosures

Sr. No.		Name	Designation
1	Holding Company	SR Enterprises	
2	Subsidiary Companies	Sun Ltd	
		Mars Ltd	
3	Key management personnel	Dr A J Morgan	Chairman and managing director
		Mr S Kyle	Director

In the above example, disclosures have been made with respect to the names of the parent company, subsidiary companies, identification of relationships and the names of the key management personnel.

These disclosures are required by the accounting standard.

2. If there have been transactions between related parties, a reporting entity shall disclose

(a) The **nature of the related party relationship**

(b) Information about the **transactions**

(c) The **amount** of the transactions

(d) The amount of **outstanding balances, including commitments and**
(i) Their terms and conditions i.e. whether secured and the consideration to be provided at settlement
(ii) Details of any guarantees given or received

(e) **Provisions for doubtful debts** related to the amount of outstanding balances

(f) The **expense** recognised during the period with regard to **bad or doubtful debts due from related parties**

Example

In the above example, disclosures with respect to transactions need to be made in the financial statements of JD Enterprises as follows

Disclosure of transactions between the company and related parties and the status of outstanding balances as at 31 December 20X6

		Nature of transaction	During the year	Outstanding as on 31 December 20X6
			(Tshs million)	(Tshs million)
1	Holding Co	Interest paid Funds	33	
		borrowed	225	365
2	Subsidiaries	Investment in shares	36	25
		Sale of goods	275	185
3	Key management personnel	Funds borrowed	20	70
		Remuneration paid	147	

Therefore, disclosures have been made in accordance with the accounting standard with respect to the nature of the transaction, the amount of the transaction and the amount of outstanding balances.

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3. The disclosures required by paragraph 2 above shall be made separately for each of the following

(a) The **parent**;
(b) Entities with **joint control or significant influence** over the entity;
(c) subsidiaries;
(d) **Associates**;
(e) **Joint ventures** in which the entity is a venturer;
(f) **Key management personnel** of the entity or its parent; and
(g) **Other related parties.**

4. The above example makes disclosures with respect to each of the entities and individuals mentioned above.

(a) Disclosures that related party transactions were made on terms equivalent to those that occur in arm's length transactions are made only if such terms can be substantiated.

(b) The following are examples of transactions that are disclosed if they are with a related party

(i) Purchases or sales of goods (finished or unfinished)
(ii) Purchases or sales of property and other assets
(iii) Rendering or receiving of services
(iv) Leases
(v) Transfers for research and development
(vi) Transfers under licence agreements
(vii) Transfers under finance arrangements (including loans and equity contributions in cash or in kind)
(viii) Provision of guarantees or collateral
(ix) settlement of liabilities on behalf of the entity or by the entity on behalf of another party

(c) The previous version of IAS 24 did not specify exemption for government-related entities. Many entities, particularly in an environment where government control is pervasive, found it problematic in practice to identify all government-related entities, and to quantify all related party transactions and balances with those entities. The revised IAS 24 exempts a reporting entity from disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with

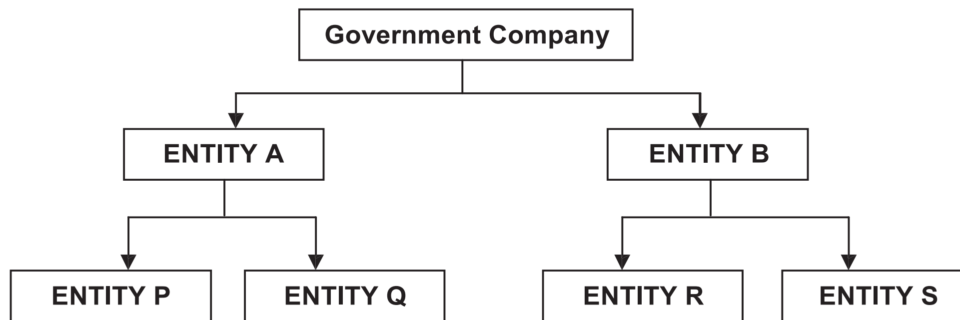
(i) A government company that has control, joint control or significant influence over the reporting entity
(ii) Any other entity that is a related party because the same government company that has control, joint control or significant influence over both the reporting entity and the other entity.

5. Para 26 of IAS 24 requires that if the above exemptions are applied the following disclosures should be made

(a) Name of the government company and its relationship with the reporting company
(b) The following information in sufficient detail

(i) The nature and amount of each significant individual transaction; and
(ii) For the other transactions which are collectively but not individually significant, a quantitative and qualitative description of their extent.

Example



The Government Company directly or indirectly controls entities A and B and entities P, Q, R and S.

In the financial statements of entity P, the following transactions will be exempted under para 26 of IAS 24
Transactions with the Government company; and
Transactions with entities A and B and entities Q, R and S.

The disclosure requirements for SMEs are similar to the requirements of IAS 24, except for certain relief which is provided in the case of the disclosure of certain related party transactions. The compensation of key management personnel need to be disclosed in total and the category-wise breakup as required in IAS 24 need not be given.

SMEs have to disclose a parent-subsidiary relationship. However they are exempt from disclosing the amount of transactions, outstanding balances and provision for uncollectable bad debts during the year for the following entities

State government (a national, regional or local government) that has control, joint control or significant influence over the reporting entity, and

Another entity that is a related party because the same state government has control, joint control or significant influence over both the reporting entity and the other entity.

Test Yourself 4

IAS 24 Related Party disclosures require disclosure of compensation of key management personnel.

Which of the following would not be considered “compensation” for this purpose?

A Short-term benefits
B Share-based payments
C Termination benefits
D Reimbursement of out-of-pocket expenses

Test Yourself 5

In accordance with IAS 24 Related party disclosures, financial statements shall include disclosures of material transactions between related parties except

A Non-monetary exchanges by affiliates
B Sales of inventory by a subsidiary to its parent
C Expense allowance for executives which exceed normal business practice
D A company's agreement to act as surety for a loan to its chief executive officer

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Answers to Test Yourself

Answer to TY 1

Mr David is a close family member (husband) of Mrs David. Mrs David has significant influence over Metalworks. Therefore in the financial statements of Glassworks, Mr David and Metalworks are related parties.

Answer to TY 2

	Fanta	Wine	Rose
Total share capital (Tshs'000)	10,000	50,000	15,000
Limca share of share capital (Tshs'000)	1,000	27,500	15,000
Limca share of share capital (%)	10%	55%	100%

Fanta is not a subsidiary of Limca
Wine is a partially-owned subsidiary of Limca
Rose Co is a fully-owned subsidiary of Limca

Therefore if Limca Co is a reporting entity, **Wine Co and Rose Co are the related parties, being members of** the same group. **However, Fanta Co is not a related party.**

Answer to TY 3

Reporting Entity	Sam Ltd	Ran Ltd	Set Ltd
Related Parties	Ran Ltd (significant influence) Set Ltd (significant influence)	Sam Ltd (significant influence)	Sam Ltd (significant influence)

Answer to TY 4

The correct option is **D.**

According to IAS 24 Related party disclosures, out of pocket reimbursements for key management personnel's are not covered under the definition of compensation.

Answer to TY 5

The correct option is **B.**

Since sales of inventory between subsidiary and parent are eliminated in preparing consolidated financial statements, such sales need not be disclosed as a related-party transaction. The other options are incorrect due to following reasons

Nonmonetary exchanges by affiliates are not specifically exempted from disclosure, and therefore must be disclosed as related-party transactions.

Compensation arrangements, expense allowances, and similar items in the ordinary course of business need not be disclosed as related party transactions. However, in this case the allowances are in excess of normal business practice and therefore must be disclosed.

Surety and guaranty agreements between related parties are not specifically exempted from disclosure and therefore must be disclosed as related-party transactions.

Quick Quiz

1. Explain the circumstances under which a person becomes a member of the key management personnel under Related Party Disclosures?

2. Are disclosures to be made separately for each category of entities viz. parent, subsidiary, associate companies, key management personnel?

3. Cole Co acquired 100% of Ashley Corp prior to 20X5. The individual companies, in their financial statements, disclose the following

	Cole (Tshs'000)	Ashley (Tshs'000)
Salary of the Officers'	150,000	100,000
Officers' expenses	40,000	20,000
Loans to officers'	250,000	100,000
Inter-company sales	250,000	-

Decide the amount that should be reported as related party disclosures in the notes to Cole 20X5 consolidated financial statements.

A Tshs195 million
B Tshs350 million
C Tshs400 million
D Tshs250 million

4. During 20X3-20X4 Harewood Co was engaged in the following transactions

(i) Salary expenses to key employees who are also principal owners Tshs200 million
(ii) Sales to associate enterprises Tshs500 million

Which of the transactions would be disclosed as related party transactions in Harewood Co 20X3-20X4 financial statements?

A Neither transaction
B Tshs500 million transaction only
C Both transactions
D Tshs200 million transaction only

Answers to Quick Quiz

1. To become a member of the key management personnel: the person should be a director of the entity; or person should have authority and responsibility for planning, directing and controlling the activities of the entity.

2. Yes. The disclosures are required to be made separately for each category of entities viz. parent, subsidiary, associate companies, key management personnel.

3. The correct option is **D.**

   Officers are not related parties, so salary to officers, officer's expenses and loans to officers are not part of related party information

4. The correct option is **C.**

   Associate enterprises and key employees are related parties, so transactions of the entity with them need to be reported.

Self Examination Questions

Question 1

Zenta Ltd is a company that complies with the minimum requirements of IAS 24. Explain whether the following relationships are related party relationships with respect to Zenta Ltd

1. Jason, a director of Zenta Ltd, owns 70% of the share capital of another entity called Santiago Ltd.

2. David owns 30% of the share capital of Zenta Ltd.

3. A person who is the son of a director of Zenta Ltd.

4. Sanio is a separate entity in which one of Zenta Ltd.'s junior managers owns 5% of the share capital.

5. Roxanne Ltd is an entity owned by the niece of Zenta Ltd.'s finance director.

Question 2

Wine Enterprises is a subsidiary of Whisky Plc. Whisky Plc has a large inventory of vodka which is a part of its slow moving inventory. According to the group policy, Wine Enterprises has to buy vodka from Whisky Plc and not from the open market. The terms of procurement from Whisky Plc are not favourable.

State the effects of this transaction on the financial statements of Wine Enterprises.

Question 3

On 1 January 20X6, Ally Corp was formed as a result of reorganisation of a group. According to the terms of the reorganisation, the following changes were to take place.

Control

Ally Corp was to own 75% of Richard Co, 55% of Billy Plc and 25% of Elaine Ltd. Ally Corp would exercise significant control over Elaine Ltd.

Sale of subsidiary

The group originally included another company, Lucy Ltd, which was a 65% subsidiary of Ally Corp. However, this company was sold on 30 June 20X6. During the year ended 31 December 20X6, there were no transactions between Lucy Ltd and Ally Corp.

Composition of the board

There are five directors on the board of Elaine Ltd, one of whom is also on the board of Ally Corp. The directors of Ally Corp also sit on the board of Richard Co and Billy Plc. One of Richard Co's directors, the director in charge of production, owns the whole of the share capital of Vivian Corp, a company that sells goods to Richard Co at market value. This particular director also acts as a management consultant to the entire group.

Other group companies

Another company called John Co, owns 25% of Ally Corp's share capital and exercises significant control over Ally Corp. The remaining 45% of the share capital of Billy Co is owned by Georgia Ltd.

The directors feel that they do not need to disclose any related party transactions as they are of the opinion that such transactions are a normal feature of business and do not require separate disclosure. As an accounting consultant, you are required to advise them on accounting for related party transactions.

Required

Draft a memo to the directors of the group outlining the following points

(i) The criteria which determine related party relationships
(ii) The importance of disclosing related party relationships
(iii) Whether any related party relationships exist and the nature of these relationships in each of the following

Within the Ally Corp group
Between Georgia Ltd and Ally Corp
Between John Co and Ally Corp

Answers to Self-Examination Questions

Answer to SEQ 1

1. Santiago Ltd is under the control of a member of the key management personnel of Zenta Ltd. Therefore Santiago Ltd is a related party.

2. If David has significant influence over Zenta Ltd due to his shareholding then David is a related party.

3. The son is a related party as the son / daughter of a member of the key management personnel falls within the definition of close family members. Therefore the son is a related party.

4. A junior manager is not a member of the key management personnel of Sanio and with only a 5% holding in Sanio, is unlikely to have significant influence over it. Therefore Sanio is not a related party.

5. The niece is not a sufficiently close relative of Zenta Ltd.'s finance director for Roxanne Ltd to constitute a related party.

Answer to SEQ 2

The above transaction will affect the statement of profit or loss and financial position of Wine Enterprises since the **mere existence of a relationship** has forced Wine Enterprises to procure vodka, which is a part of the "slow moving inventory" of Whisky Plc. Furthermore, the terms of procurement are not favourable to Wine Enterprises.

Hence, the statement of profit or loss and financial position of the entity will be affected by the transaction. However, disclosure of the transaction in the financial statements would enable the users of the financial statements to understand the implications of the transaction for the financial statements of the entity.

Answer to SEQ 3

The revised IAS 24 paragraph 9 lists all possible cases in which a party can be related to a reporting entity. Control means the power to govern the operating and financial policies of an enterprise in order to obtain benefits from its activities. Common control means that entities are controlled by management in the form of anucleus of controlling directors. Significant influence, which could be the result of share ownership, statute or agreement, relates to the power to participate in the operating and financial policies of an enterprise without controlling these policies.

In the current business scenario, usually comprising complex group structures formed for investment or commercial purposes or both or even convenience, related party transactions are a part of the normal business process. Unusual transactions arising from these relationships can affect the financial position and the results of the companies involved. These transactions may be priced at a level that would not be acceptable to unrelated parties.

Even if transactions arise between the related parties involved, there could be an effect on the operating results and financial position in the following cases

Transactions can be substantially agreed at terms different from those with unrelated parties.
Holding companies can heavily influence the subsidiary's decisions.

The framework states that information contained in the financial statements must be neutral and faithfully represent the embedded transaction. As a result, disclosing related party transactions is essential if the qualitative characteristics of the financial statements are to be assessed.

Existence of related parties within the Ally Corp group

In relation to Ally Corp, Richard Co, Billy Plc and Elaine Ltd are related parties of Ally Corp as Richard Co and Billy Plc are under the common control of Ally Corp and Ally Corp exercises significant influence over Elaine Ltd.

Lucy Ltd, the subsidiary which was sold during the year, is also a related party and this fact should be disclosed even if there were no transactions between Lucy Ltd and Ally Corp.

In the case of Vivian Corp, disclosure should be made as the director that controls Vivian Corp is a director of Richard Co and also acts as a consultant to the Ally Group.

Existence of related party relationships between Ally Group and Georgia Ltd

Georgia Ltd and Billy Plc are considered to be related parties as Georgia has invested in 45% of Billy Plc.'s share capital. However, just because of this arrangement, Georgia and Ally Corp cannot be considered related parties unless there is some significant control exercised by either of the parties that would persuade the other party to subordinate its own interests to comply with that transaction.

Existence of related party relationships between Ally Group and John Co

John Co is a related party of Ally Corp because of its significant influence over Ally Corp. As a result, John Co would be a related party in relation to Richard Co and Billy Plc, companies controlled by Ally Corp. However, it is not necessary that John Co and Elaine Ltd are related parties unless it can be proved that John Co exerts significant influence over Elaine Ltd through its holding in Ally Corp.

SECTION C

PRESENTATION OF ACCOUNTS AND DISCLOSURES

C3

STUDY GUIDE C3: ENHANCING FINANCIAL REPORTING

Get Through Intro

Today's business leaders have to look beyond economic progress. And caring for the environment is everybody's business. The mission statements of large MNCs also show their commitment towards their social, ethical and environmental responsibilities.

Consider the following case study:

The mission statement of Zebra Plc. is as follows

"Zebra Plc. aims to continually to improve its performance with respect to health and safety and the environment. To achieve this objective, we implement measures that improve the health and safety of our stakeholders. Our corporate value system integrates environmental issues, specifically relating to the prevention of climate change. Our Corporate Citizenship Policy communicates our management's commitment to achieving sustainable operations. "

The mission statement of an organisation is the answer to the question "Why do we exist?" This means that all organisations work in order to fulfil their stated mission. As fulfilling social, ethical and environmental responsibilities forms part of the mission of most organisations, the organisation has to consider these factors while measuring performance. Further the organisation also has to highlight the highs and the lows during the year. This will help the stakeholders to take informed decisions.

In the absence of this information it will not be possible for the organisation to decide whether it has achieved the purpose for which it has established! Knowing the current reporting requirements in this area will ensure that you help your organisation fulfil its obligations.

Learning Outcomes

a) Describe the impact of environmental, social, and ethical factors on performance measurement.
b) Identify and explain with examples the additional information that may be included in annual reports beyond financial statements in accordance with international best practice and other requirements including management reports, risk information, governance reports, value added reports, Corporate Social Responsibility reports, financial summaries, key performance indicators and highlights.

1. Describe the impact of environmental, social, and ethical factors on performance measurement.

[Learning Outcome a]

Gone are the days when the performance of an entity was measured only on the basis of the financial profit shown by its statement of profit or loss. Increasing awareness of environmental and social responsibilities has increased people's expectations of companies. They expect companies to earn profits and at the same time to abstain from damaging the environment by contributing positively to the improvement of the environment and society. Companies must aim at sustainable development. According to the Global Reporting Initiative (GRI), the goal of sustainable development is to "meet the needs of the present without compromising the ability of future generations to meet their own needs."

Twenty-first century companies are including performance on economic, environmental as well as social fronts in their performance measurement. This is called a **triple bottom line approach**. (3BL) Companies are voluntarily shouldering corporate responsibility. Corporate responsibility is a mechanism by which companies voluntarily integrate social and environmental concerns into their operations and their interaction with stakeholders. These commitments are over and above their legal responsibilities.

Case Study

A typical 3BL performance report may include issues such as those mentioned in the following case study relating to Megablock Ltd

ECONOMIC PERFORMANCE	US $6 billion in turnover US $20 billion in market capitalisation
ENVIRONMENTAL PERFORMANCE	Water positive corporation for 3rd successive year Moving towards being a carbon positive corporation Targeting zero solid waste
SOCIAL PERFORMANCE	Empowering 7.5 million farmers Providing health care for over 80,000 women and children

This Case Study illustrates how environmental and social factors may affect the assessment of investments. Investors prefer companies which are performing well on all fronts.

However, this assumes that the reporting on these issues is done honestly. An environmental audit is conducted to ensure honest reporting of factors related to the environment. As mentioned earlier, some reporting frameworks are being used to standardise the process. However, reporting on these issues is still evolving.

1.1 Environmental report

Many companies have started to provide environmental reports in addition to their financial reports. The following is a specimen of the contents of one such report

Case Study

Glowell's environmental report contents

Our Commitment to Environmental Management

Company Profile

Raw Materials

Significant Environmental Effects

Environmental Policy

Responsibility & Accountability for Environmental Management

Environmental Audits
Risk Assessment
Objectives and Targets
Training
Research and Development

Continued on the next page

Our Stakeholders

Customers
Regulators
Suppliers
Employees
Shareholders
Community
Finance

Objectives and Targets

Data

Conclusions

What are the three most important environmental priorities?
What are the three best accomplishments?
What are the three biggest challenges?
In what ways are we addressing sustainability?

Validation Statement

Why might entities include disclosures relating to the environment and society?

1. Performance

Investors prefer to invest their money in companies or managed funds that share their values and beliefs about 'what is right' not only economically, but also environmentally and socially. Nowadays, there is an increasing belief that environmental, social and governance issues have a material impact on portfolio value.

There are many new frameworks available to help companies measure their performance on environmental, social and ethical issues. Some such frameworks are discussed in Study Guide A3 of this text.

Financial performance can be measured in tangible terms such as the amount of profit. Issues such as the impact of a company's operations on the environment and its relationships with staff, suppliers and the communities in which it operates its business are less tangible. However, for investors deciding whether or not to invest in the company, this performance is as important as the financial performance.

Ethical performance takes into consideration not only traditional investment practices, but also the values and beliefs of the person or organisation. Investors will compare the performance of an entity against the values and beliefs it claims to be guided by. Ethical issues tend to be subjective and will have varying degrees of importance depending on the values of the individual or organisation

Example

A person may decide not to invest in the alcohol manufacturing industry because they believe that it encourages alcoholism.

Much research has been carried out into whether companies following socially responsible policies give better financial returns to investors.

The European Centre for Corporate Engagement (ECCE) concluded from these studies that "Even though they do not present irrefutable evidence that socially responsible investments generate higher returns than "normal" investments, most studies have found that they do not result in worse performance, either, while, at the same time, they might actually decrease risk exposure."

SUMMARY

Test Yourself 1

Crazy Shapes Plc. owns a plant producing plastic products. Crazy Shapes has been fined by the authorities for damaging the environment through its improper disposal of harmful waste. In response, Crazy Shapes has hired a consultant to seek advice on how to avoid this situation.

The consultant presents a report stating that Crazy Shapes is not only disposing of harmful waste but is also consuming a large amount of energy and its carbon emissions are also high.

The report also states that Crazy Shapes could safely dispose of its waste by treating it before disposal.

Crazy Shapes Plc. took the following steps during the current year:

1. Steadily reduced its emissions
2. Used electricity from renewable sources
3. Did not breach any local environment laws
4. Obtained further advice on its carbon emissions and steps to reduce these emissions

Required:

State the content of Crazy Shapes Plc.'s environmental report.

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2. Risks

While investors may find it difficult to quantify environmental and social factors, they find it easier to identify that there is a risk involved in a certain investment if it performs badly on environmental, social or ethical fronts. It is natural for investors to avoid risky investments.

Institutional investors are more proactive in that they demand disclosures related to the environment and society. Unless companies keep their investors happy, they will find it difficult to attract capital.

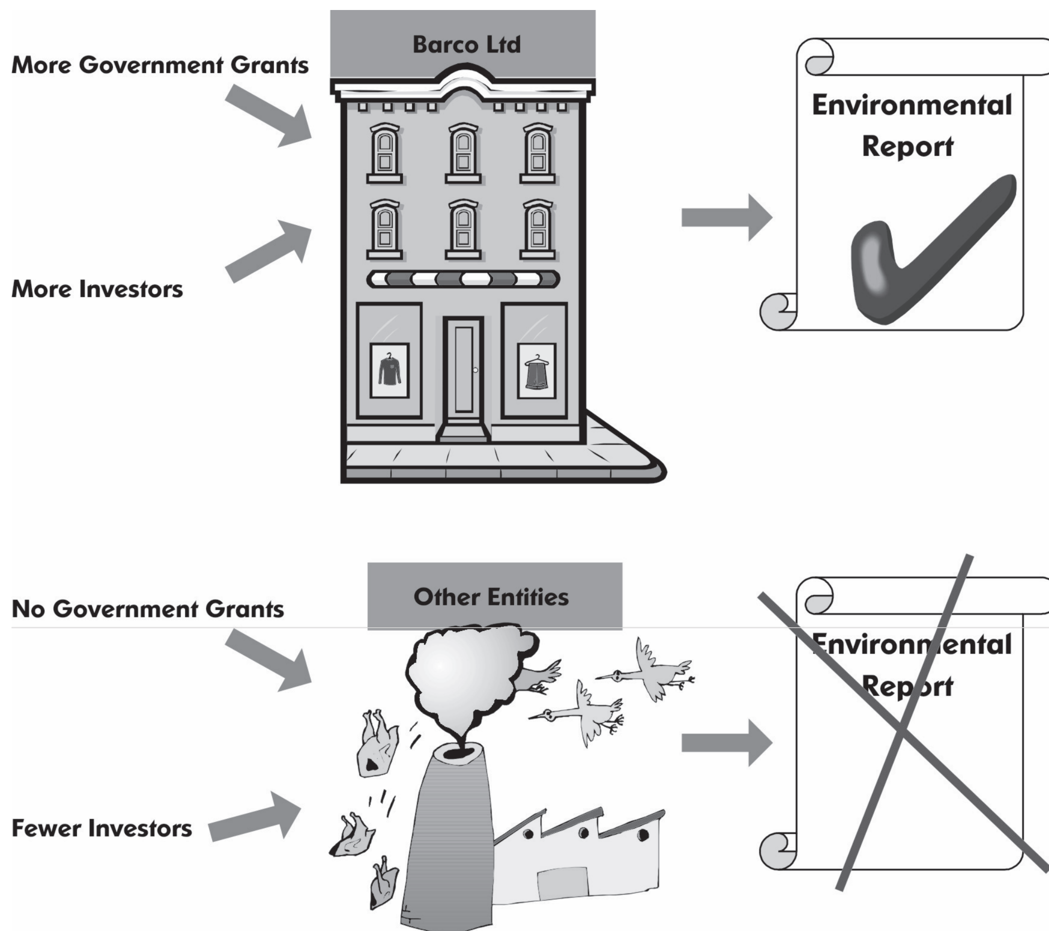
The government also encourages entities to follow ethical practices and report their performance by giving external awards and endorsements e.g. environmental league tables and employer awards. Similarly, awards are given by professional bodies such as the ICAEW, ACCA.

These are some of the reasons why companies might include disclosures relating to the environment and society.

However, previously, information on these matters was either not provided or the information provided was descriptive and unquantified. Recently, some initiatives have taken place which attempt to set out a framework for reporting.

Market forces themselves will not achieve the degree of consistency required in environmental reports. It is desirable that the report is regulated by a major national or international standard-setting body.

Diagram 1: Benefits of environmental reporting to entities



1.2 Voluntary disclosure

Apart from mandatory disclosures which we have discussed inn various IFRSs / IAS's, there are certain voluntary disclosures that companies make. These are also components of the annual report and are disclosed although they are not mandated by law or regulation.

Voluntary disclosures made by companies may include

(a) The chairman's and the CEO's statements regarding the company position. These are required since they will instil a sense of confidence in the company amongst the readers. Even if this information is provided voluntarily it needs to be given to enhance value of the report.

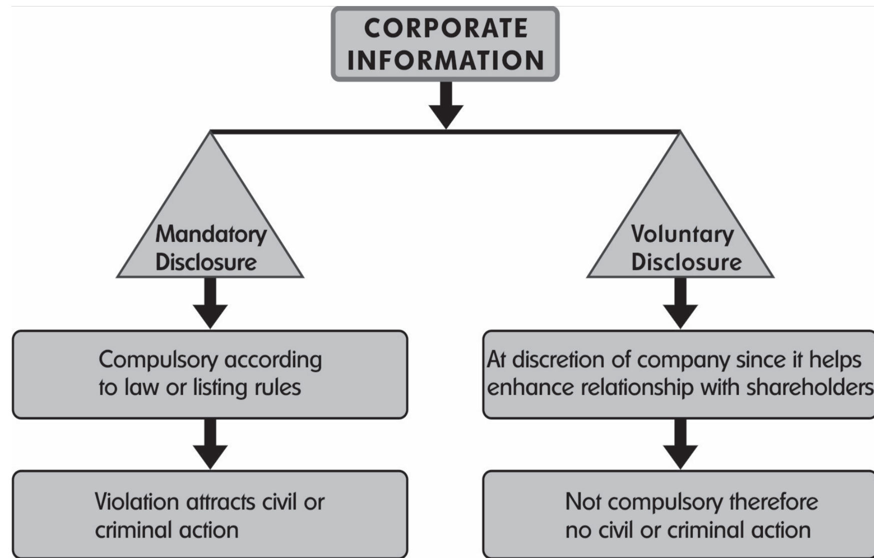
(b) A corporate social responsibility (CSR) report that contains details of the CSR activities carried out by the company. These are generally referred to as sustainability reports now.

(c) A narrative operating and financial review report that is understandable by all readers of the statements i.e. not just the technical experts. This document should be future-oriented and should narrate the financial performance and prospects of the company. Investors generally demand a report of this kind in order to obtain an idea of the various risks and the social and environmental projects carried out by the company.

(d) An annual report that is circulated in the AGM and provides a picture of the company. Beyond this annual report, the company may also make disclosures through the various media forms e.g. press releases, analyst's reports on the company's performance and forecasts made by management.

The major difference between mandatory and voluntary disclosures is that **mandatory disclosures are always compulsory** under a provision in company law, the Listing Rules or any other regulations applicable**. Voluntary disclosures are,** however, **at the discretion of the company**. These disclosures are given by the companies since they add value to the reports and help to improve relations with shareholders.

Diagram 2: Corporate information



The main motivations behind voluntary disclosures in a principles-based reporting environment are:

1. The new reporting regime requires companies to address their social responsibilities and accept corporate accountability for any actions and decisions they take. Many companies use these disclosures as a tool to build social relationships with shareholders. Social and environmental reporting has been used by companies to portray an ethical image of the company so that the share value of the company increases.

2. Ethical companies might provide information in the annual report regarding the various risks that the business faces and the environmental programmes that the company has undertaken since they believe that the shareholders need to know this.

3. Providing voluntary disclosures in the annual reports helps to improve a company's communication with its shareholders since it encourages dialogue and a sense of ownership of the company amongst the shareholders. Such disclosures in the annual report may help to initiate a discussion at the AGM itself. Stakeholders' confidence in the company may also increase.

4. The voluntary disclosures regarding the risks and the opportunities that the business faces also help to bridge the information asymmetry between the directors and the shareholders.

Example

Ninja Plc. manufactures pesticides. Its annual report for the year 20X7 contained a disclosure that the company faces an operational risk if its market competitors reduce the price of their product from the existing Tshs5,000 per litre of pesticide to Tshs4,000 per litre of pesticide. This is because the company will run into losses if it sells the pesticides at a price of Tshs4,000 per litre.

5. Increased transparency in reporting through the various voluntary disclosures can help to attract and retain institutional and other major investors in the company. This, in turn, helps to reduce the cost of capital since shareholders continue to invest in the company on the same terms, i.e. without the incentive of higher returns, because they believe in the company.

Example

Excellor Plc has been regularly reporting in its annual report about the various foundations it supports and the social benefits that women and children from various backward areas have received through its initiatives. It also keeps the shareholders informed of any upcoming projects along with the various risks that the business faces in the form of competitors, finance requirements, labour unions etc. Pension Funds (institutional investors) has been investing in the company for the last 10 years and wishes to continue investing even though the company has increased its rate of dividend only once in the last 5 years. This is because the transparency in its operations that Excellor has maintained confirms that it is an ethical company and hence investors can always earn money by trading its shares on the market. This has helped to reduce the cost of capital for Excellor.

6. Many countries have now made several voluntary disclosures compulsory under law as a part of corporate governance best practices. Therefore any non-compliance can result in civil actions in courts. E.g. companies in the UK are required to publish CSR reports regarding the various social activities they have undertaken.

7. Mandatory external reporting of internal controls and risks will ensure accountability. This in turn will mean that internal control failures and business probity risks will be intimated to the shareholders at an early stage and will be nipped in the bud as the existing board can be replaced before the position becomes more serious.

8. Information on internal controls would enhance shareholder confidence and satisfaction.

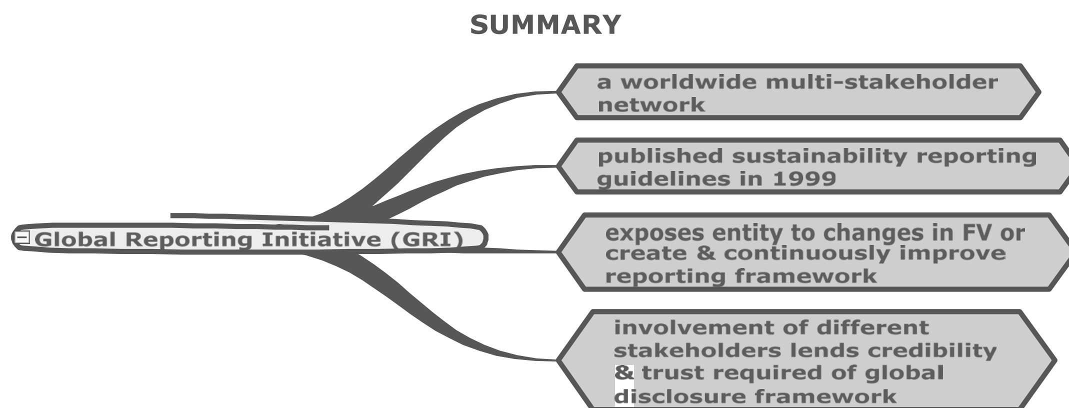
9. Compulsory external reporting on internal controls will encourage good practice in the company.

1.3 Global reporting initiative (GRI)

There is a need to ensure that management's policies and decisions are environmentally-friendly. Similarly, it is desirable that the performance indicators on this front are reported to investors and other stakeholders.

A document entitled 'Sustainability Reporting Guidelines' was published in 1999 by the Global Reporting Initiative (GRI). The GRI is a worldwide, multi-stakeholder network. Diverse groups, e.g. businessmen, civil servants, labourers, investors and accountants, work together in order to create and continuously improve the reporting framework. The involvement of different stakeholders lends the credibility and trust required of a global disclosure framework. The framework is intended for voluntary use by organisations.

SUMMARY



The important performance indicators expected to be reported regarding environment and social factors are as follows:

1. Environmental performance indicators include

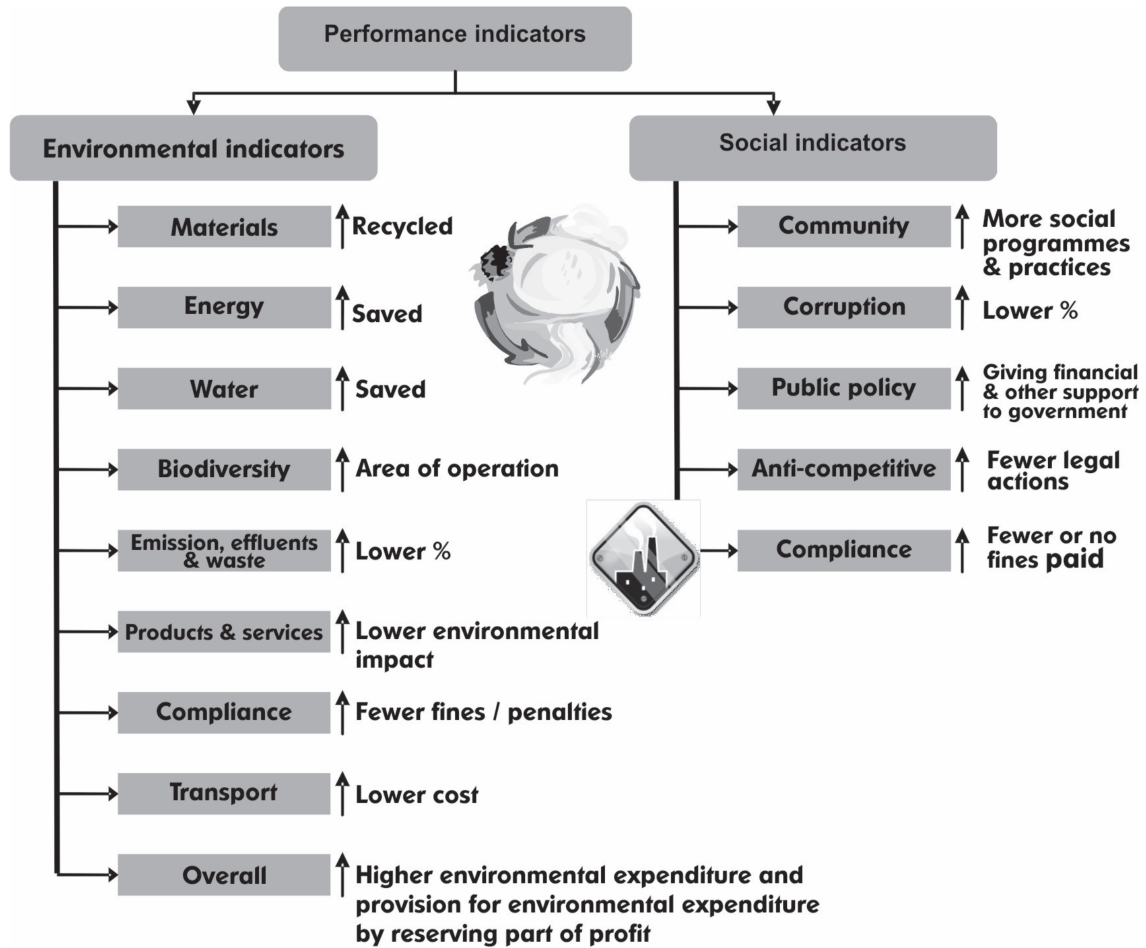
Indicators	Reporting requirements
Environmental performance indicators	
Materials	materials used by weight or volume percentage of materials used that are recycled input materials
Energy	direct and indirect energy consumption by primary energy source energy saved due to conservation and efficiency improvements initiatives to provide energy-efficient or renewable energy-based products and services, and reductions in energy requirements as a result of these initiatives initiatives to reduce indirect energy consumption and reductions achieved
Water	total water withdrawal by source water sources significantly affected by withdrawal of water percentage and total volume of water recycled and reused
Biodiversity	location and size of land owned, leased, managed in, or adjacent to, protected areas and areas of high biodiversity value outside protected areas description of significant impacts of activities, products and services on biodiversity in protected areas and areas of high biodiversity value outside protected areas habitats protected or restored strategies, current actions and future plans for managing impacts on biodiversity

Continued on the next page

Indicators	Reporting requirements
Environmental performance indicators	
Emissions, effluents and waste	total direct and indirect greenhouse gas emissions by weight initiatives to reduce greenhouse gas emissions and reductions achieved emissions of ozone-depleting substances by weight and other significant air emissions by type and weight total water discharge by quality and destination total weight of waste by type and disposal method total number and volume of significant spills weight of transported, imported, exported or treated waste deemed hazardous under the Terms of the Basel Convention identity, size, protected status and biodiversity value of water bodies and related habitats significantly affected by the reporting organisation's discharges of water and runoff
Products and services	initiatives to mitigate environmental impacts of products and services, and extent of impact mitigation percentage of products sold and their packaging materials that are reclaimed by category
Compliance	monetary value of significant fines and total number of non-monetary sanctions for non-compliance with environmental laws and regulations
Transport	significant environmental impacts of transporting products and other goods and materials used for the organisation's operations and transporting members of the workforce
Overall	total environmental protection expenditure and investments by type
Social performance indicators	
Community	nature, scope and effectiveness of any programmes and practices that assess and manage the impacts of operations on communities (this would include the impact of entering, operating and discontinuing any operations)
Corruption	percentage and total number of business units analysed for risks related to corruption percentage of employees trained in organisation's anti-corruption policies and procedures actions taken in response to incidents of corruption
Public policy	public policy positions and participation in public policy development and lobbying total value of financial and in-kind contributions to political parties, politicians and related institutions by country
Anti-competitive behaviour	total number of legal actions for anti-competitive behaviour, anti-trust and monopoly practices and their outcomes
Compliance	monetary value of significant fines and total number of non-monetary sanctions for non-compliance with laws and regulations

Social performance also includes a review of labour practices, human rights and product responsibility.

Diagram 3: Performance indicators reported regarding environmental and social factors



Test Yourself 2

It is predicted that, in the future, the inclusion of a statement of environmental cost disclosing all the expenditures of the entity will be made mandatory. Businesses which do not disclose these items or fail to comply with the accounting rules for environmental items will be penalised.

Required:

Describe the information that should be disclosed in an environmental report.

Other guidelines on practices and reporting

GRI is widely used by business units. However, there are some other frameworks, for example

The Friends of Earth Environment Charter for Local Government

United Nations Global Compact

ISO 14001: an international specification for an environmental management system, which defines the organisational structure, responsibilities, practices, procedures, processes and resources for implementing environmental management throughout the organisation.

1.4 Reporting on sustainability of development

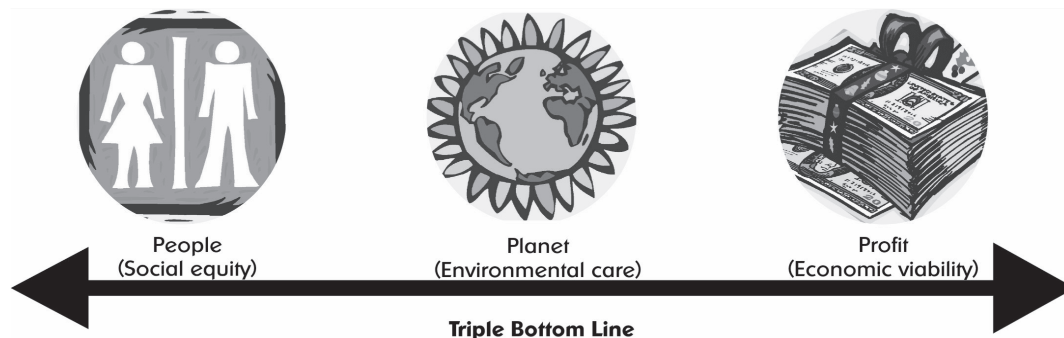
Traditional accounting methods include measuring the company's economic activity with respect to assets purchased / used, liabilities and expenses incurred and income earned. However, such accounting practices do not look at the results of economic activities on those assets which do not belong to the organisation, such as water, minerals, etc. and the liabilities that it does not have to pay, such as waste generated and emissions made. In short, such accounting methods do not examine the environmental and social impact of economic activities.

There is an increasing realisation throughout the world that methods of accounting and reporting on environmental and social impacts need to be developed much further. Existing methods used by some companies include

Triple bottom line
Sustainability balanced score card
Sustainability Assessment Models (SAM) and Full Cost Accounting (FCA)

1. Triple Bottom Line (TBL)

Diagram 4: Triple Bottom Line



Sustainable development refers to the impact of economic activity on **value creation in terms of economic, social and environmental factors**. It is also referred to as the 'triple bottom line'. These three factors can be likened to people (i.e. the social factor), planet (i.e. the environmental factor) and profit (i.e. the economic factor). The economic factor is not just conventional accounting (see below) so TBL cannot be taken as conventional accounting plus the social and environmental factors.

(a) People

This refers to business practices involving employees, community and the location in which an organisation operates. A triple bottom line enterprise strives to benefit groups of people without causing harm to any group.

For example:

(i) Not using child labour, paying fair salaries to workers, maintaining a safe work environment. In short it would not exploit a community or its work force.
(ii) Contributing to the strength and growth of the community by supporting health care and education.
(iii) Ensuring a safe work place.

The measuring of this bottom line is relatively new, problematic and often subjective. The Global Reporting Initiative (GRI) has developed certain guidelines which enable corporations and NGOs to report on the social impact of a business.

(b) Planet

This refers to measures taken to reduce the environmental footprint. A TBL company strives to do least harm to the environment. For example

Careful management of energy consumption
Reducing manufacturing waste
Rendering waste less toxic before disposal in a safe and legal manner
Not producing harmful or destructive products e.g. chemical weapons, lead based batteries
Avoiding over fishing or other practices which lead to depletion of resources

(c) Profit

This refers to the economic benefit enjoyed by the company and also the wider society as a result of the company's activities. To be sustainable, profits made must be determined after identifying the organisation's wider impact, including resource utilisation and wealth creation.

Example

The following is an extract from the TBL policy of HT Hydro.

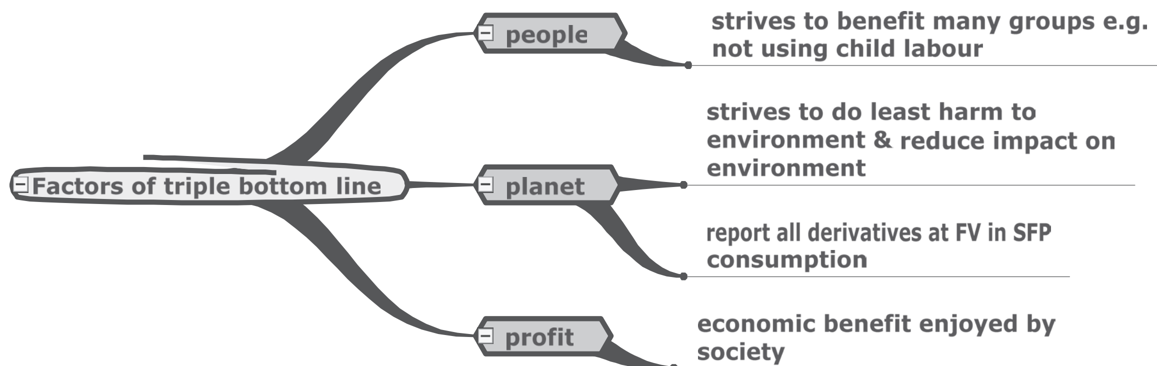
HT Hydro is committed to protecting the environment, to meeting the needs of the community and to delivering excellent financial results. As such, we are striving on the path of sustainability by balancing and measuring our performance along environmental, social and economic bottom lines.

Our environmental bottom line consists of the ways in which we deal with the impacts from our operations, measure environmental values with economic ones and plan for a future with more green energy in our system.

Our social bottom line involves ensuring the safety and well-being of our employees, customers and general public and the health of the communities we live and work with.

By being efficient, productive and profitable and by providing value to our customers and community, we take care of our economic bottom line.

SUMMARY



2. Balanced scorecard

The balanced scorecard, measures whether the activities of a company are meeting its objectives in terms of vision and strategy. It focuses on financial results and human factors. This enables organisations to understand their business well and to act in their best long-term interests. It enables managers to focus on performance and at the same time balance financial objectives with employees, customers and process. Accounting based on the scorecard includes the following

(a) Financial perspective

This involves a study of whether the execution of business strategies would lead to an increase in the company's profitability. This contains three stages: growth, sustenance and harvest.

(i) The growth stage involves increase in turnover, getting new customers, growth in revenue, etc.

(ii) The sustenance stage involves determination of the effectiveness of the organisation in managing its operations and costs, by calculating the return on capital employed the return on investment etc.

(iii) The harvest stage is based on cash flow analysis. Some of the most common financial measures that are incorporated in the financial perspective are revenue growth, costs, profit margins, cash flow, net operating income etc.

(b) Customer perspective

This determines the measures taken by organisations to satisfy customers and thereby enhance sales at the best rate of profit. Therefore it adds value to an organisation.
The measures that are selected are

(i) The value that is delivered to the customer which may involve time, quality, performance, service and cost
(ii) The results of the above measures such as customer satisfaction and market share

(c) Internal process perspective

This deals with the processes that create and deliver the values mentioned under customer perspective. It focuses on all the activities and important processes required for the company to excel at providing the value expected by customers.

These activities and processes can include both short-term and long-term objectives as well as incorporating innovative process development in order to bring about growth.

Examples of practices by organisations are

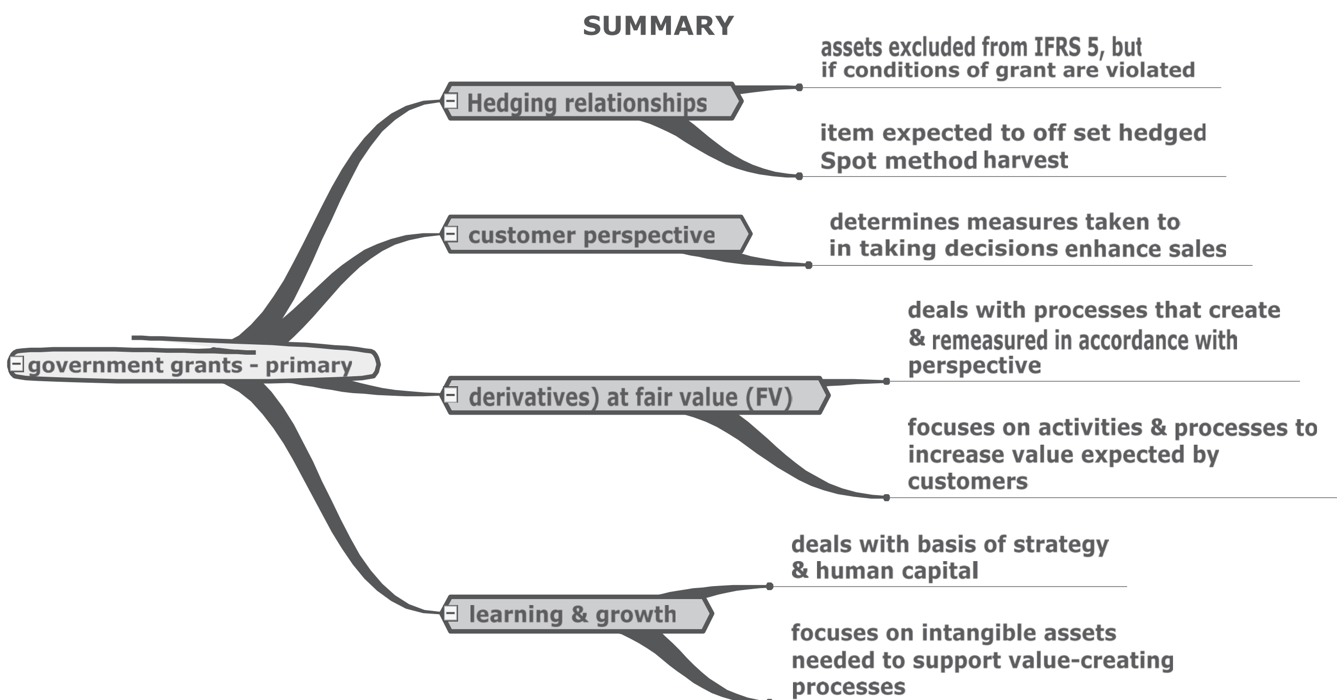
Operations management i.e. by improving asset utilisation, supply chain management etc.
Customer management i.e. by expanding and improving relationships
Innovation i.e. by introducing new products and services
Regulatory and social i.e. by maintaining good relationships with external stakeholders

(d) Learning and growth

This deals with the basis of forming strategy. It focuses on the intangible assets of an organisation, such as capabilities and the internal skills which are needed to support the value-creating internal processes. It also deals with human capital. An improvement in the learning and growth perspective, will lead to the long-term success of the company.

Therefore, an organisation adopting the balanced scorecard will set goals and targets for each perspective mentioned above and set up pointers to compare the actual results with the targets. Such an outlook will ensure that organisations give importance to non-financial factors which lead to the long-term growth of the organisation.

SUMMARY

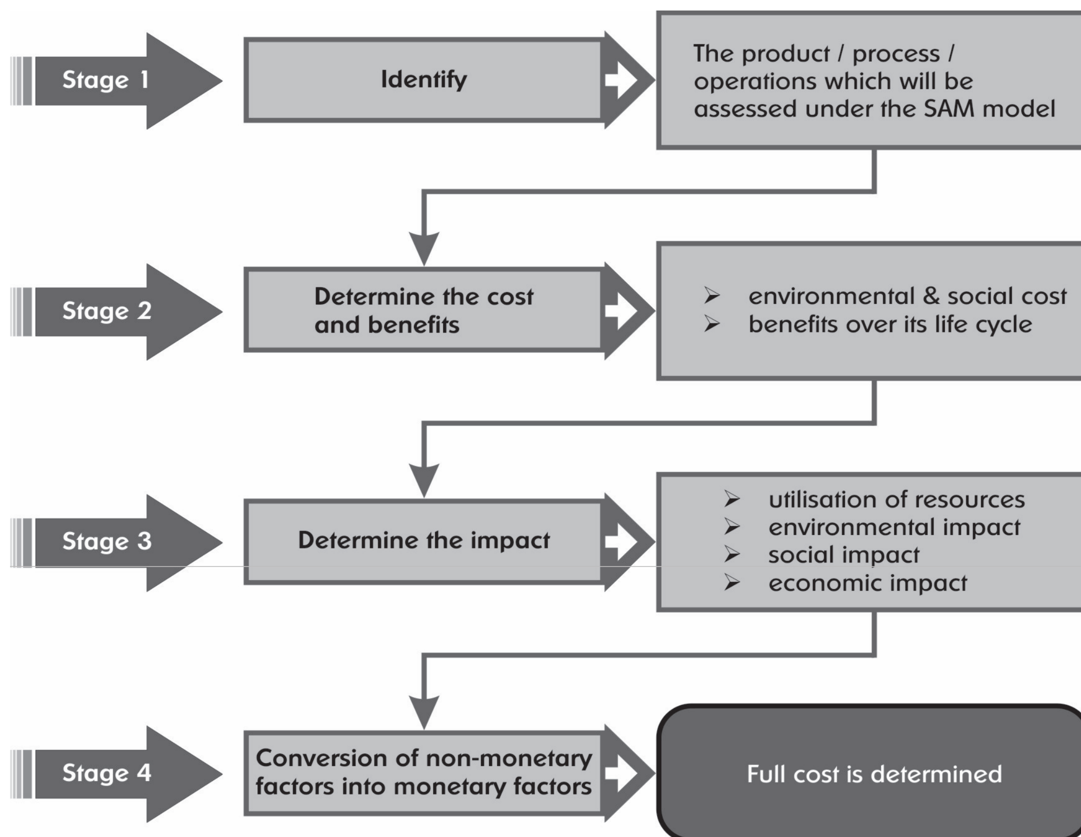


3. Sustainability Assessment Model (SAM) and Full Cost Accounting (FCA)

As with the TBL, which reports the economic, environmental and social factors for the previous year, SAM measures the sustainability of the products which are produced over the entire life cycle of the company i.e. from the time of using the resource in the process of economic activity up to its final consumption. Therefore this method incorporates the non-financial costs incurred by an enterprise as well as the direct cost of the product and the cost of environmental and social footprint.

FCA is the cost of the total impacts mentioned above under SAM. SAM assesses the performance of a company as an index of sustainability. This method enables one to determine the performance of the company vis-à-vis the sustainability worked out. The SAM method takes into account the cost of the product through its entire life cycle mentioned above. This involves the following stages

Diagram 5: Determination of full cost using SAM



Therefore the objective of FCA is to internalise all costs which are incurred both within and outside the organisation.

Example

Ranka Petrochemicals Company was set up two years ago. The company's factory adjoins a lake, which is owned by Samson. The lake contains many varieties of rare fish. Mr. Samson makes a living by breeding the fish. The company's activities give rise to an oil spill in the lake that kills most of the fish in the lake.

Mr. Samson has filed a suit against the company for Tshs1 million as damages along with Tshs2 million for loss of earnings. The court has directed the company to pay Mr. Samson Tshs3 million in this connection.

The court has assigned Mr. Jackson, an environmental expert, to undertake an independent study of the lake and value the cost of getting the lake into its original state. Mr, Jackson has estimated the cost of such activity as Tshs5 million.

The company follows full cost accounting. The method of determining the FCA for the oil spill is as follows:

Step 1: identify the process: the process is the oil spill

Step 2: determine the cost incurred: the cost awarded by the court: Tshs3 million.

Continued on the next page

Step 3: determine the impact of the oil spill: the impact of the oil spill was:

This could be whether remedial actions can be taken to return the lake to its original state.
If any of the fish have become extinct.

Step 4: conversion of all non-monetary costs into monetary terms: this involves determining the cost of step 3 i.e. the cost of remedial action Tshs5 million.

The cost of losing the fish which have become extinct cannot be determined. Therefore the cost of the oil spill is Tshs8 million (Tshs3 million plus Tshs5 million).

Advantages of FCA

Measures to reduce footprint: FCA requires detailed study of the cost of economic activity and the resulting footprint. Due to an awareness of the cost of a footprint, organisations would be encouraged to take steps to reduce it.

Such reporting informs investors about environmental footprint liabilities. This enables them to understand the risks faced as well as the hazards caused by the business.

FCA can enable organisations to understand product / process footprints. Such measures add value when making decisions and enable organisations to act as responsible citizens, and increase long term profits.

Drawbacks of FCA

FCA involves attaching costs to all the impacts. However the method of assigning costs in the area of environmental impacts and social impact is a difficult and often subjective.

FCA requires an organisation to undertake substantial research thus increasing costs.

FCA requires expert scientific knowledge to determine the impact of the economic activity.

If FCA is made mandatory, organisations may try to relocate to countries where there is no such regulation.

Test Yourself 3

The Volven Catchment is a part of the Murray River valley. The catchment covers 10.5% of the State of Victoria. The region stretches from close to the outskirts of Melbourne in the south, to the Murray River in the north. It includes the municipalities of Moira, Campaspe, Mitchell, Murrindindi, Mansfield and Strathbogie Shires, Benalla Rural City and the City of Greater Shepparton.

The region supports major agricultural (dryland and irrigated) and forestry industries. Some 189,590 people live in the catchment. Rapid population growth is occurring in some parts of the catchment, notably centres within commuting distance of Melbourne and the City of Greater Shepparton.

The activity of irrigation leads to considerable environmental change. A few decades back, it was the normal perception that such activities led to greater economic and social benefits as compared to the environmental costs.

However, public attitudes have changed over time from acceptance of development and exploitation to greater concern regarding environmental issues and sustainability such as:

- canal smells
- dust
- unknown effect of surface area of water from channels
- changes in the conditions of water use, including water logging and flooding
- changes in sediment transport
- impacts on groundwater conditions
- changes in flora and fauna
- effects on soil and vegetation

Required:

Suggest the ways in which the company in the catchment can communicate to the public the steps taken by it towards sustainability.

---

2. Identify and explain with examples the additional information that may be included in annual reports beyond financial statements in accordance with international best practice and other requirements including management reports, risk information, governance reports, value added reports, Corporate Social Responsibility reports, financial summaries, key performance indicators and highlights.

[Learning Outcome b]

Currently the financial statements provided by most of the companies help the stakeholders to evaluate the historical performance, rather than providing insights into the business strategies and performance prospects.

As a result of these shortcomings, the accounting profession with the help of various industry groups, leading multi-national companies, investors, legislators and regulators have been making efforts for enhancing the business reporting. An important step in this direction is the publication of Management Commentary and Sustainability Reports to allow stakeholders to make informed judgements about the organisations prospects.

A part of enhancing the financial reports is increased and better disclosures. In Section C of this Study Guide, we have seen various disclosure requirements under the International Financial Reporting Standards, which aim at improving the financial reports. In this Learning Outcome, we will be discussing reports which form part of annual information published by entities along with the financial statements. These include reports such as:

(i) Management Commentary
(ii) Value added reports
(iii) Corporate Social Reports (including sustainability reporting)
(iv) Risk Information
(v) Governance Reports
(vi) Financial Summaries and highlights
(vii) Key performance indicators

Earlier in Study Guide, we have already discussed Director's Report which included information to be disclosed on Corporate Governance, Key performance indicators, Risk Information, etc.

2.1 Management Commentary (MC)

A key aspect of management reports is the Management Commentary.

Definition

Management commentary is a narrative report that provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain its objectives and its strategies for achieving those objectives.

Management Commentary, IFRS Practice statement

Identification of management commentary

MC is expected to supplement and complement financial statement information. Management commentary should be clearly distinguished from other information in financial report.

Principles for the preparation of management commentary

The management commentary included should be useful in making decision about the entity. It should:

- Provide management's view of the entity's performance, position and development;
- Supplements and complements information presented in the financial statements; and
- Should have an orientation to the future.

It should aim at communicating information about an entity's resources, the claims thereon and transactions, events and other circumstances that may affect those resources and claims. Therefore it should help the users of financial statements to understand

- The entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies;
- How resources that are not presented in the financial statements could affect the entity's operations; and
- How non-financial factors have influenced the information presented in the financial statements.

Supplementing and complementing the financial statement information

(a) Supplementing financial statements

MC includes additional explanations of the figures included in the financial statements and explains conditions and events that shaped the information.

Example

Where an entity has disclosed the results of discontinued operations in its financial statements, an explanation of the reasons that led to the discontinuation of the operations and the company's alternative strategies may be found in MC.

(b) Complementing financial statements

MC includes financial and non-financial information that is not reported in the financial statements. MC may contain narrative as well as quantified information.

Through the eyes of the management

MC is expected to enable investors to see the company through the eyes of management. Management has all the information at its disposal and can draw informed conclusions. Information from management's perspective is very useful to decision-makers.

Orientation to the future

MC is expected to communicate, through management's eyes, the direction the entity is taking. It is expected to analyse the main trends and factors that are likely to affect the entity's future.

Example

MC may include information about the goals to be achieved in terms of market penetration, profitability, geographical expansion etc.

Past performance is relevant only to the extent that it helps in taking decisions about the future.

Qualitative characteristics

The qualitative characteristics expected of MC are understandability, relevance, supportability, balance and comparability over time. MC should be transparent. It should discuss the positive as well as the negative factors affecting the entity.

Presentation and content of management commentary

The IASB has not suggested any specific format or content of management commentary to be included in financial reports. It should reflect the nature of the business, strategies employed, and the legal and regulatory environment in which the entity operates.

Also if segment information is provided in financial reports the management commentary should also reflect that segmentation.

Duplication of information given in notes to accounts should be avoided in management commentary.

General disclosures should be avoided because they do not contribute to an understanding of an specific entity.

IASB has suggested the following contents of a management commentary

(i) **Nature of business:** industry overview, main markets, competitor analysis, significant legal, regulatory and macro-economic environment that influence entity, etc.

(ii) **Objectives and strategies:** management strategies to meet the objectives, priorities, any major threats or opportunities.

(iii) Resources, risks and relationships: most significant financial and non-financial resources owned. For example personnel, geographical advantages, etc. Also MC may include its principal strategic, commercial, operational and financial risks and uncertainties, relationship with customers and investors and how these relationships are managed.

(iv) Results and prospects: clear description of the entity's financial and non-financial performance, the extent to which that performance may be indicative of future performance and management's assessment of the entity's prospects.

(v) Prospects: an analysis of the prospects of the entity, including targets for financial and non-financial measures.

(vi) Performance measures and indicators: the critical performance measures and indicators used by management to steer the entity and assess its performance against stated objectives.

Advantages of management commentary

Mandatory MC would have many advantages

(a) It would provide users with information to take decisions.

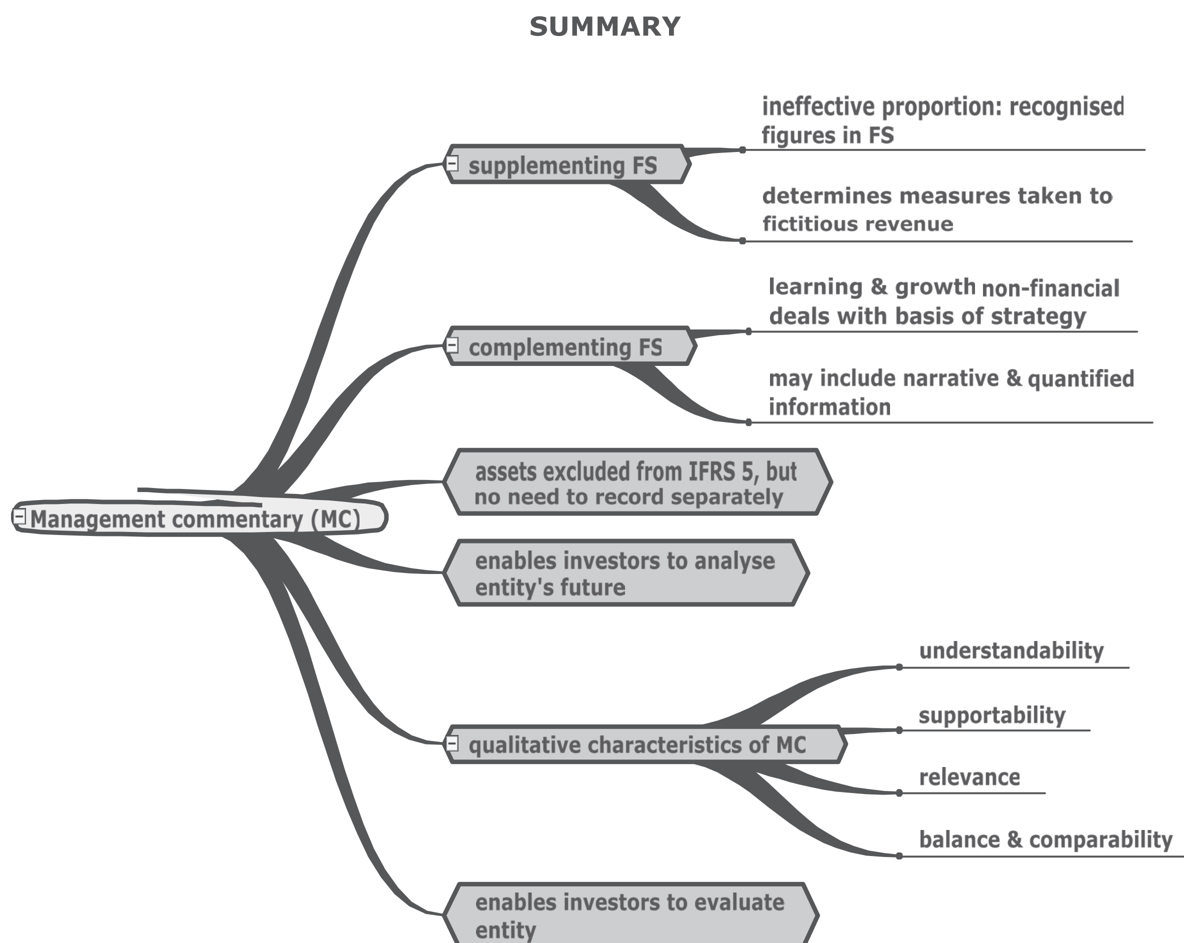
(b) It would enable the company to judge the necessary contents of the report and the pattern of reporting.

(c) Reports would be more robust and comparable.

(d) It would avoid the risk of non-compliance and misinformation.

(e) It would give a broader picture of the entity and the direction it is heading in, rather than focusing on specific short term issues such as short-term financial impact and risk management.

SUMMARY



Test Yourself 4

Carbony Petrochemicals will have to spend Tshs10 million on repairing its waste treatment plant as the laws of the jurisdiction in which it operates have changed. In the past, Carbony was fined Tshs7 million for causing pollution through releasing untreated waste into the environment.

Required:

You are the chief financial officer of Carbony. State the note that you will prepare for the board which will explain your proposed treatment of the above matter.

2.2 Value added reports

Value added reports include the following measures of performance:

Economic value added (EVA)
Shareholders value added
Market value added

1. Economic value added (EVA)

EVA™ is a measure of 'economic profit' of the firm as different from the normally used 'accounting profit' for assessing performance of an organisation. It is based upon the concept that all the funds (i.e. capital) used by a business come at a cost and only the earnings above the cost of capital employed create value for the shareholders. EVA™ measures the value created by the managers above the shareholders and lenders' required return.

Tip

EVA™ was popularised by Stern, Stewart & Co and it is their trademark.

(i) Calculation of EVA™

EVA™ is the surplus left after the cost of capital employed has been deducted from Net Operating Profit after Tax (NOPAT). NOPAT is the profit derived from a company's operations after taxes but before non-cash expenses and financing costs. It is the profit available to a company that can be returned in cash to those who have provided capital to the company.

[EVA = NOPAT - (c x K)]

Where,

NOPAT is net operating profit after tax
c is the weighted average cost of capital (WACC)
K is capital employed

Alternatively, the formula can be stated as

[EVA = (r – c) K]

Where,

r is return on capital invested and calculated as

NOPAT is also called cash earnings before interest but after tax.

$$\frac{NOPAT}{K}$$

(ii) Adjustments required for calculating EVA™

NOPAT is arrived at after making certain adjustments to the accounting profit. Also, certain changes are required to calculate the correct WACC.

The most common adjustments made to accounting profit and capital employed for calculating EVA™ are

Particulars	Accounting profit	Capital employed	Reason
Non-cash expenses charged to SOPL	Add back	No effect	NOPAT is the earnings that a company can distribute among providers of funds.
Intangibles such as advertising, research and development	Add back	Add	Funds spent on intangibles can be considered discretionary spending by management. These funds could have been used to pay dividends or to reduce the amount of debt in the firm's SOFP.
Depreciation / Amortisation / Goodwill	Add back. Accounting depreciation must be added back and economic depreciation must be deducted.	Add the cumulative amount of depreciation / amortisation / goodwill charged on the assets in use.	Management, instead of acquiring assets, could have repaid the funds to the shareholders. Economic depreciation must be deducted because it represents the funds actually consumed by the business.
Provisions such as for bad and doubtful debts, deferred tax.	Add back	Add	They are charged to the net profit due to the conventional accounting practices. Provisions undermine the reported net profit and reduce the amount of capital employed.
Interest	Add	Add debt and leases to net assets	Non-addition of debt will affect the managers' decision on the capital structure of the firm. The managers will substitute equity capital with debt capital to increase the EVA™.

Test Yourself 5

From the following information on Select Ltd, calculate the NOPAT as adjusted for EVA.

	Tshs million
Sales revenue	80.0
Less: Operating costs	(48.0)
Less: Interest costs	(2.0)
Earnings before tax	30.0
Less: Tax @35%	(10.5)
Earnings after tax	**19.5**

(iii) Assessing corporate performance using EVA™

Although usually used to measure corporate performance from the viewpoint of shareholders, the EVA™ can also be used as a yardstick to measure the performance of individual managers / departments on frequent basis. EVA™ allows the lenders of funds to determine how efficiently the managers are using the funds provided by them. The higher the EVA™ during any period, the better the job managers are doing in using the capital to create additional value.

It can be said that a manager / division / company failing to generate EVA™ (i.e. when the NOPAT is less than the cost of capital employed) has failed to create any value for its shareholders.

Example

Radiant Inc has two divisions, division S and division M, which are managed by two different managers. The following information is related to their performance for the year ending on 31/12/20Y0.

	Division S Tshs million	Division M Tshs million
Total operating assets (as on 31/12/20Y0)	100,000	80,000
Revenue	107,000	90,000
Expenses	**87,000**	**70,000**

The minimum rate of return on investments for Radiant Inc is 12.5%.

The applicable corporate taxation rate is 35%.

Expenses include interest payable on 10% debentures worth Tshs50,000 million in division S and interest payable on an 11% loan worth Tshs10,000 million in division M. EVA^{TM} can be used to measure the performance of the managers.

NOPAT and adjusted capital employed are required to calculate EVA^{TM}.

Details	Division S	Division M
	Tshs million	Tshs million
Revenue	107,000	90,000
Less: Operating expenses	82,000	68,900
Earnings before tax (EBT)	25,000	21,100
Less: Taxation @ 35%	(8,750)	(7,385)
NOPAT	**16,250**	**13,715**

EVA^{TM}

For division S

EVA = NOPAT – cost of capital

= Tshs16,250 million - (Tshs100,000million x 12.5%)

= Tshs16,250 million - Tshs12,500 million

= Tshs3,750 million

For division M

EVA = NOPAT – cost of capital

= Tshs13,715 million - (Tshs80,000 million x 12.5%)

= Tshs13,715 million - Tshs10,000 million

= Tshs3,715 million

Conclusion - According to EVA^{TM}, division S is performing better than division M.

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2. Shareholder value analysis (SVA)

SVA = Discounted present value of the projected future cash flows – Market value of debt

3. Market value added (MVA)

MVA = Market value of equity – Capital employed

This is an indication of the value added by management over and above the value of funds invested by shareholders.

2.3 Corporate social reports (including sustainability reporting)

Corporate social reports have been covered in detail in Learning Outcome 1

2.4 Governance Reports

In a narrow, technical sense, corporate governance is about two key areas: first of all corporations (in this case, companies) and secondly governance (how the companies are run; in this case how the directors run them).

Companies are legal entities registered at Company Houses (or their equivalent) and have to operate in accordance with their constitution, statute and, where appropriate, case law (e.g. companies formed in England will have to function in accordance with The Companies Act 2006).

The study of corporate governance focuses on the processes, mechanisms and structures that are put in place to enable directors to manage businesses operated as companies, and to provide checks and balances on the directors and executives. **Corporate governance** represents the **set of policies and procedures** that **determine how an organisation is directed, administered and controlled**. It sets the broad framework or parameters within which the people in the organisation must operate.

The study of corporate governance also requires you to think about the purpose or role of enterprises in the economic and social framework of a state including their economic and potential social and environmental roles and responsibilities and the extent to which government intervention may be required.

Definition

The OECD (Organisation for Economic Co-operation and Development) defines corporate governance as "the system by which business corporations are directed and controlled".

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1. Corporate governance is broadly about two aspects of an organisation

The mechanisms by which corporations are **directed and controlled**
The mechanisms by which those who direct and control the corporation (board of directors) are **monitored and supervised**

In short, it deals with the mechanisms that ensure that those who are in control are **accountable.** The above points are explained in turn below.

(a) Mechanisms by which corporations are directed and controlled

Companies are controlled by those who have the majority of shares and they can appoint themselves or others as directors because of their voting power. Other shareholders may have influence but lack control. Directors run companies through the board of directors as a body and as executives through their management of activities and processes. Authority comes from their legal position and power often comes from their personality and capability to build power bases.

Listed companies generally have substantial investor interest in their success from shareholders who are not directors actively involved in the business.

Many executive directors of large listed companies are professional managers who have been promoted to the board or brought in from outside for their contribution. Boards of listed companies need to engage with and talk to major shareholders.

Directors have the responsibility to craft corporate missions, visions, objectives and targets and to set out and implement the required strategies. To give reasonable assurance that the strategies will succeed, directors need to build appropriate risk management processes, mechanisms and controls, including appropriate information and communication systems for planning, monitoring and controlling the business.

Example

Well-lit Plc. manufactures light-bulbs. Its objectives are to become the market leaders in bulbs, make good quality bulbs and make profits. The company has laid down policies and procedures for all its major activities such as the purchase of raw materials, the purchase of non-current assets and sales. All the activities of the company relating to purchases and sales are to be carried out according to these policies and procedures.

The company has a personnel manual where all the personnel rules for recruitment, training, leave, salary, etc. applicable to the employees are laid down. All activities relating to personnel such as recruitment, training, salary, etc. are to be carried out according to the personnel manual of the company.

Continued on the next page

The company prepares a corporate business plan, annual budgets and monthly MIS reports. The MIS reports include the monthly statement of financial position and statement of profit or loss and a report of the expenses and revenue which have adverse variances along with reasons for the variances. The MIS is periodically tested by the internal audit function. The MIS reports are considered by the board at monthly meetings. Executive directors must explain the results and set out any actions to be taken.

To summarise, some of the mechanisms by which the company is effectively directed and controlled are:

The company's strategic plans, its policies and procedures
The personnel manual
The internal audit assurance work
Monthly MIS reports
The monthly board meetings

(b) Mechanisms by which those who direct and control the corporation are monitored and supervised

The board of directors is responsible for the conduct of business so as to achieve the objectives of the organisation**.** The mechanisms by which those who direct and control the corporation are monitored and supervised refer to the methods by which the actions of the board of directors can be examined and controlled.

The mechanisms for such examination and control include internal audits, the inclusion of non-executive directors in the board of directors, setting an audit committee for the company, etc.

Example

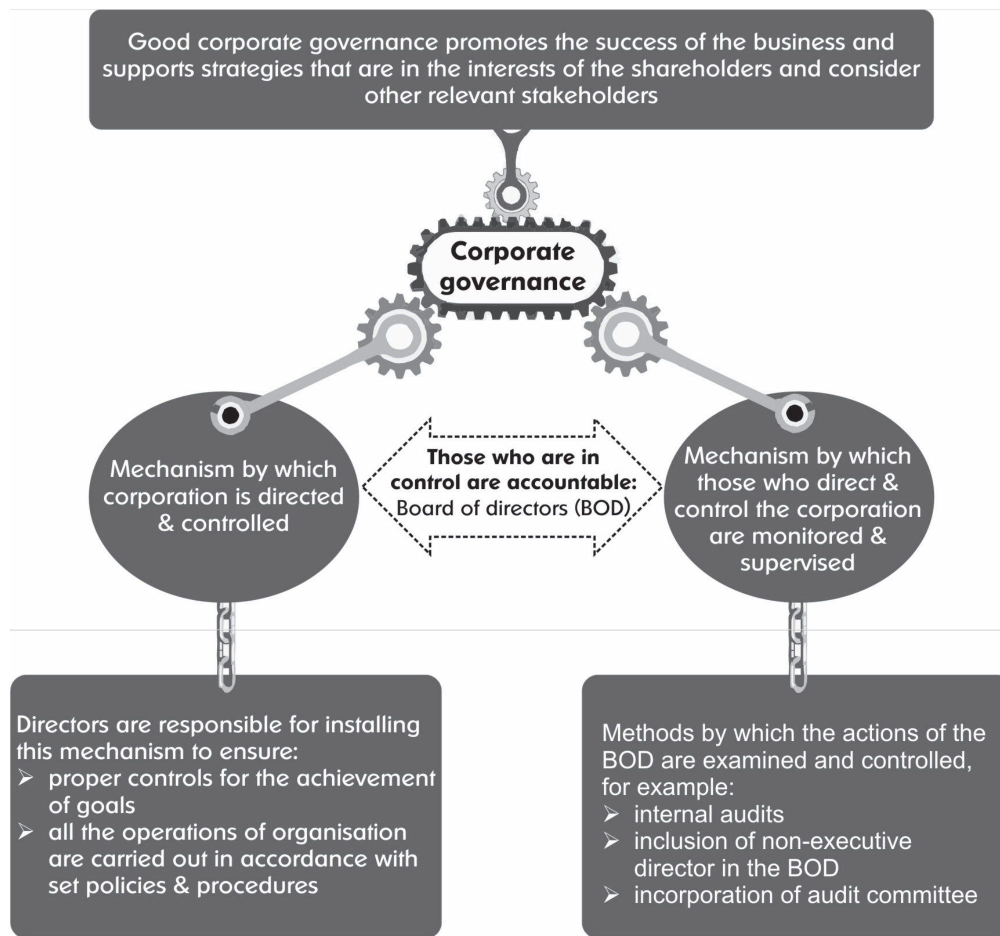
Continuing with the example of Well-lit Ltd,

The following are the mechanisms employed by the company to monitor and supervise the board

Activity	How it helps in monitoring and supervising the board
The company has three non-executive members on its board. The company has separate persons functioning as CEO and chairman of the company.	This will enable the company to ensure that there is no concentration of power and the decisions taken by the board are unbiased. The non-executive directors can question and challenge the executives.
The company has appointed a firm of chartered accountants to carry out internal audits of the company's activities on a monthly basis. The scope of the internal audit is defined by the audit committee. The audit committee meets each month and discusses the internal audit reports.	The review of the activities and internal controls by the audit committee gives assurance to the board and through disclosure to shareholders that the company has a system of effective controls and risk management processes.
As a policy, the company does not assign any non-audit work to its external auditors and internal auditors.	This will give assurance to the shareholders, that the work of the auditor is objective and reliable.
The administration manager of the company provides guidance on applicable laws of the countries in which the organisation is located.	This promotes ethical behaviour and compliance.
The audit committee reviews the draft annual financial statements, receives explanations and approves the financial statements prior to approval of the main board.	This promotes confidence and improves transparency.

These mechanisms promote **accountability.**

Diagram 6: Corporate governance



There are several guidelines in place to address best practice in the area of corporate governance. These include the

The ASX Corporate Governance Council's Corporate Governance Principles and Recommendations
The Combined Code (2006) published by the UK Financial Reporting Council,
The New York Stock Exchange's Corporate Governance Standards,
The Sarbanes-Oxley Act 2002

The extent to which a company must comply with the above guidelines is dependent upon the content of corporate governance reports from a statutory and regulatory perspective.

In Tanzania, Corporate Governance reports form part of Directors' Report. A proforma of a corporate governance report is given below for reference.

Proforma of a corporate governance report from TFRS 1 Directors' Report

The Board of…………………consists of …………..Directors, apart from the Managing Director, no other directors hold executive positions in the Company. The Board takes overall responsibility for the Company, including responsibility for identifying key risk areas, considering and monitoring investment decisions, considering significant financial matters, and reviewing the performance of management business plans and budgets. The Board is also responsible for ensuring that a comprehensive system of internal control policies and procedures is operative, and for compliance with sound corporate governance principles.

The Board is required to meet at least four times a year. The Board delegates the day to day management of the business to Managing Director assisted by senior management. Senior Management is invited to attend board meetings and facilitates the effective control of all the Company's operational activities, acting as a medium of communication and coordination between all the various business units.

Continued on the next page

The company is committed to the principles of effective corporate governance .The directors also recognize the importance of integrity, transparency and accountability. During the year the Board of …………………………….company has the following board sub-committees to ensure a high standard of corporate governance throughout the company.

……….. Committee (1st committee)

	Name	Position	Qualifications / Discipline	Nationality	Remarks
1.					
2.					
3.					
4.					

The … ………… Committee reports to……………………….
The ……………….. Committee met ………….. times during the year.

Audit Committee (2nd committee)

	Name	Position	Qualifications / Discipline	Nationality	Remarks
1.					
2.					
3.					
4.					

The … ………… Committee reports to……………………….
The ……………….. Committee met ………….. times during the year.

Mention any other specific committees.

The Board met ……. times during the year.

2.5 Risk Information

Recent failure of multinationals like Enron, Satyam and WorldCom has created a need for risk assessment by financial institutions, regulators and investors. Major risks were underestimated or ignored, and so the proportions of these scandals led to huge losses

This has led to growing demands for better risk reporting. Such demands have not been aimed only at the financial sector, but have extended to public companies in all sectors.

In accordance with **TFRS1 Directors' Report**, the operating and financial review should include a description of the principal risks and uncertainties facing the entity, together with a commentary on the directors' approach to them.

The following principles need to be adhered to in disclosing principal risks and uncertainties

(i) While different industries and entities use different risk models or approaches for identifying and managing risk, all entities face and should disclose strategic, commercial, operational and financial risks where these may significantly affect the entity's strategies and development of the entity's value.

(ii) The principal risks and uncertainties facing entities will vary according to the nature of the business, although it is expected that some risks, such as reputation risk, will be common to all.

(iii) The description of the principal risks and uncertainties should cover potential opportunities. The directors' policy for managing principal risks should be disclosed.

(iv) The operating and financial review should cover the principal risks and uncertainties necessary for an understanding of the objectives and strategies of the business, both where they constitute a significant external risk to the entity, and where the entity's impact on other parties through its activities, products or services, affects its performance. Directors should consider the full range of business risks

Generally, the disclosure of risk information is mainly divided into two main categories:

Financial risk, and
Non-financial risk

The main difference between the above two categories is that financial risks can be quantified easily, while the other cannot. Financial risk information helps the users in assessing the financial statement and other quantitative information within the annual report. Non-financial risk information can be described by making use of narrative sections of the annual report.

Non-financial risk information has no direct bearing on the quantified information found in the annual report's financial statements, but still discloses risks that may affect the company far beyond its statement of financial position.

(i) Financial risk information

Financial risk information is generally disclosed in line with the requirements of IFRS and generally this information includes credit and market risk. Disclosure on liquidity risk is required by IFRS, so all companies based in IFRS-adopting countries do disclose this information. Especially IFRS 7 Financial Instruments Disclosure requires entities to quantify credit risk and liquidity risks.

(ii) Non-financial risk information

Non-financial risk information may include disclosure which is not stringent and the information disclosed is generally not specific unlike financial risk information. This type of information disclosure actually follows much more localised requirements and guidance.

2.6 Key Performance Indicators (KPI)

KPIs are factors by reference to which the new developments, performance and position of the business of the entity can be measured effectively. They are quantified measurements that reflect the critical success factors of an entity and disclose progress towards achieving a particular objective.

An entity should provide information that enables members to understand each KPI disclosed in the Operating and Financial Review. KPIs can vary from business to business and therefore there is no standard set of KPI that each company is required to follow.

KPI for various sectors are given below

Banking Sector	Mining and Petroleum	Retails
Customer retention	Capital expenditure	Customer satisfaction
Capital adequacy	Exploration success rate	Sales per square metre
Asset quality	Capital expenditure	Capital expenditure
Customer service	Refinery capacity	Profitability of new stores

---

For each KPI disclosed in the Operating and Financial Review (OFR):

- the definition and its calculation method and current level should be explained;
- its purpose should be explained;
- the source of underlying data should be disclosed and, where relevant, assumptions explained;
- quantification or commentary on future targets should be provided;
- where information from the financial statements has been adjusted for inclusion in the OFR, that fact should be highlighted and a reconciliation provided;
- where available, corresponding amount for the financial year immediately preceding the current year should be disclosed; and
- any changes to KPIs should be disclosed and the calculation method used compared to previous
- Financial years, including significant changes in the underlying accounting policies adopted in the financial statements, should be identified and explained.

2.7 Financial summaries and highlights

Financial summaries and highlights are a summary of the major points in a financial report. The financial summaries are a part of the annual report and include any financial information which is important and to be displayed prominently in the annual report.

In the context of annual reports, financial highlights can include performance statistics of the company as a whole and of individual departments and products. For example if a mobile company launched a new range of cell phones, it may highlight the performance of this product range during the year through the financial summary and highlights.

Answers to Test Yourself

Answer to TY1

The content of Crazy Shapes Plc.'s environmental report would be as follows:

(a) Disclosure of the environmental policy stating the business activity in total. The use of renewable electricity and the reduction of emissions could be included in this.

(b) The management strategy implemented in the minimisation of environmental risks.

(c) The environmental training given to the staff.

(d) It could even include the statistics of its verified emissions to air / water and land and report on its environmental performance in these areas. Its line of action to further reduce its emissions. It also may include the operating site reports for local communities for businesses with high environmental impacts.

(e) The data on emissions could be presented in graphs and the current emissions of carbon dioxide and the levels of electricity used compared with those of previous periods. This would give a clear idea to stakeholders of the entity's environmental performance and improvement during the current period.

(f) Details of any fines and penalties would also be included.

(g) It could also include the historical trends for key indicators in comparison with the corporate targets.

Answer to TY2

Environmental costs are created by the constant use, misuse or misapplication of resources by both large and small businesses. However, there are not many legal or other rules which bind the entity to disclose these facts of the business in the corporate report.

The accounting profession should take this absence of requirements to disclose these facts as an opportunity to present itself as socially responsible by making it mandatory for businesses to report on environmental costs.

The information that should be disclosed in an environmental report is as follows

(a) Provision of expenditure in the future: laws change continuously so liabilities should be provided for towards restoration of a site before vacating at a future date.

(b) The business policy regarding environmental costs in the notes to accounts. This should include the actual intentions of the entity rather than false or very idealistic statements.

(c) The detailed expenditure incurred during the accounting period on the environment i.e. cost relating to prevention of damage to the environment or remedial action for the damage caused to the environment. These costs should be classified as mandatory and voluntary costs. This will show the entity's legal performance and the voluntary targets it has achieved. For example, if there are emissions of poisonous gases, then the methods used to reduce the volume of poisonous gases emitted and statistics on the reduction of emissions.

(d) Additional disclosures may include the following

An analysis of the environmental risks from the entity's operations and its strategy to mitigate these risks i.e. by way of insurance or from its own resources. The deficit in the insurance cover would give potential shareholders an indication of the risk they would undertake by investing in the company.

Disclosure of any standby facility available which can withstand a disaster, its cost, the estimate of the cost of the consequences of a disaster and how the society can benefit from it.

Practically, it may not be possible to estimate some of the above figures but an attempt should nevertheless be made to quantify such matters. An alternative method should be adopted. However, the utility of this information to shareholders is debatable.

Answer to TY3

The company has adopted the triple bottle line reporting. Under this form of reporting, sustainability development refers to the impact of economic activity towards value creation in terms of economic, social and environmental factors. The company has adopted this structure of reporting because it includes not just financial factors but also environmental, social and cultural elements. This approach provides a more balanced view of water use with socio-economic benefits and environmental consequences.

The adoption of this technique will enable the company to derive the following benefits

This approach will lead to a more transparent and informed debate on the sustainable use of resources between all parties. Therefore it would lead to sound corporate governance and ethics systems throughout all levels of an organisation.
Currently the company's corporate governance initiatives are focused at the board level. However, TBL will help ensure a values-driven culture is integrated at all levels.

Such an approach would also lead to an improved management of risk through enhanced management systems and performance monitoring.

The company would also ensure a formal communication with key stakeholders such as the finance sector, suppliers, community and customers. This would allow the entity to have a more proactive approach to addressing future needs and concerns.

The company would also be able to attract and retain competent staff by demonstrating that they are focused on values and its long-term existence.

This would lead to a competitive advantage with customers and suppliers, as well as enhanced access to capital as the finance sector continues to consider non-financial performance within credit and investment decisions.

Answer to TY4

As the chief financial officer of Carbony, I will explain my proposed treatment of the matter as follows

An asset is the right or the access to future economic benefits by the business due to a past transaction. The waste treatment plant will enable the company to run the business lawfully and to make profits. This cost can be capitalised and amortised over the useful life of the plant. It should be tested for impairment so as to check that the carrying value is not more than its recoverable value.
The penalty for the previous pollution should be charged to the statement of profit or loss as it does not qualify as a prior year adjustment as it has not resulted from a change in an accounting policy or a fundamental error.

Answer to TY5

NOPAT as adjusted for EVA

	Tshs million
Sales revenue	80.0
Less: Operating costs	(48.0)
Earnings before interest and tax	32.0
Less: Tax @35%	(11.2)
Operating profit after tax (as adjusted)	**20.8** (i.e. NOPAT for the EVA calculation)

Quick Quiz

1. Categorise the following under the headings “environmental factors” and “social & ethical factors”

   - efficient use of resources
   - employees’ satisfaction
   - product biography
   - waste management
   - health & safety standards
   - corruption
   - compliance with local laws
   - pollution

2. State whether the following statement is true or false

   “Environmental and social & ethical factors are not related to each other. They are separate factors.”

3. State the environmental performance indicators.

4. State the social performance indicators.

5. State the role of an accountant with respect to environmental factors at different stages of accounting and on different occasions.

6. What is the goal of sustainable development according to the GRI?

7. Economic value added is the surplus calculated after deducting the ____________ from the net operating profit after taxes.

Answers to Quick Quiz

1.

Environmental factors	Social and ethical factors
Efficient use of resources	Employees contentment
Product biography	Health and safety standards
Waste management	Corruption
Pollution	Compliance with local laws

2. **False.** Environmental and social and ethical factors are closely related as one issue may have more than one aspect i.e. environmental, ethical and social

3. **The environmental performance indicators** are

   - materials
   - energy
   - water
   - biodiversity
   - emissions, effluents, and waste
   - products and services
   - compliance
   - transport
   - overall

4. **Social performance indicators are**

   - community
   - corruption
   - public policy
   - anti-competitive behaviour
   - compliance

5. The role of an accountant with respect to environmental factors at different stages of accounting and on different occasions is as follows

   (a) Accounting

   Measurement and recording of costs such as site clean-up and waste treatment costs assessment of the impact of environmental factors on measurement and recognition of assets and liabilities e.g. liability for penalties and estimation of estimated future cash flows for the purpose of impairment testing

   Assessment of the effect of environmental factors on the company's statement of financial position future prospects and its relation with third parties like bankers performance evaluation in annual reports

   (b) Other areas (Management accounting/MIS/auditing)

   - Environmental costs / benefits analysis
   - Investment appraisal
   - Environmental audit of proposed takeovers as well as existing operations
   - Review of systems to ensure compliance with environmental requirements

6. According to the Global Reporting Initiative (GRI), the goal of sustainable development is to "meet the needs of the present without compromising the ability of future generations to meet their own needs."

7. Cost of capital

Self-Examination Questions

Question 1

Healthline is a charitable hospital located in UK. It was founded in 2002 by five trustees. It provides free high quality palliative care for terminally ill cancer patients. It strives to provide beneficial services to all classes of society.

The hospital has 100 beds. It is headed by a full-time director who is assisted by two medical doctors, an administration manager, three clerical staff members and 12 employees who look after the patients. The hospital also employs the services of seven consultants who work on a voluntary basis.

The hospital has 17 social service volunteers. These volunteers provide counselling for the patients and their families, arrange for various entertainment programmes for the patients, visit cancer hospitals and interact with families of those patients and encourage the patients to make use of the hospital's services. The company has a system of auditing its accounts from a practising chartered accountant. However, the trustees are keen to ensure that the activities of the hospital are transparent and also follow good governance practices.

Required:

(a) Suggest the benefits of good corporate governance for the hospital.
(b) Identify its responsibility to its stakeholders so as to ensure good governance of the hospital.

Question 2

Statement of profit or loss of DumDum Inc. for the year ended on 31/12/20Y0

Particulars	Tshs million
Turnover	150.00
Cost of sales	(84.90)
Depreciation	(1.06)
Research and development	(4.80)
Interest	6.30
Profit before tax	**65.54**
Tax @ 30%	(19.66)
Profit after tax	**45.88**

Statement of financial position of DumDum Inc. as on 31/12/20Y0

Particulars	Tshs million
Assets	
Non-current assets	280
Current assets	215
Total	495
Equity and liabilities	
Current liabilities	294
Long term borrowings	81
Equity capital and free reserves	120
Total	495

Additional information

1. The weighted average cost of capital (WACC) for DumDum Inc. is 10%.
2. The amount of economic depreciation is equivalent to the accounting depreciation charged for that period.
3. The cumulative research and development expenditure for the company is Tshs40.2 million.

Required:

Comment using EVA whether DumDum Inc. has created wealth for its shareholders

Answer to Self-Examination Question

Answer to SEQ 1

(a) NGOs do not have the specific rules or regulations of corporate governance as are found in the corporate sector. However, their effectiveness is based on the achievement of the core objectives of corporate governance. In the case of Healthline the core objective is to serve all people suffering from cancer with **free** high quality medical care**.**

If Healthline has to achieve its objectives, it has to devise and adhere to good corporate governance practices. The following are the measures that the organisation must adopt

Transparency in various operations and financial reporting: this is the only way the organisation can enhance its credibility. The trustees are keen to ensure that the activities of the hospital are transparent and also follow good governance practices e.g. the hospital can prepare monthly MIS statements and made them available to its trustees and major donors.

Vision and the mission of the organisation: ensure that all activities are aimed at achieving the core objectives of the organisation. Dedicated efforts need to be made to ensure that the beneficiary services are made available to all classes of society e.g. the volunteers must regularly meet poor patients in hospitals and encourage them to make use of the services of the hospital.

Proper allocation of resources: ensure proper allocation of resources for essential activities. E.g. encourage additional doctors in the field to be involved in the activities of the trust.

Good managerial process: set up a good managerial process that decentralises authority and ensures decision-making at the appropriate levels and at the right time.

Designing a system of rules and regulations for operations: e.g. all the practices of the company need to be documented.

Review mechanism: designing and implementing a review mechanism for ensuring that the operations of the organisation are focused on the objectives of the NGO e.g. having internal audits on all activities of the organisation.

(b) For good corporate governance practices, an NGO must identify its responsibility towards each of its stakeholders. As Healthline is a charitable hospital, identification of responsibility should be on the following basis:

To the beneficiaries: (those who receive the services)

Ensure quality medical care **free** of cost are made available

Ensure an advisory service of educating the beneficiary**,** about the medical issue and for post-treatment care and continuous association between the beneficiary and the NGO

Ensure ethical conduct (equality) and courtesy to the beneficiary

To the society

Ensure beneficiary services are made available to all classes of society and in most deserving areas

Promote health education-related programmes for the general wellbeing of society

To the employees

Provide opportunities for employees to carry out meaningful work and receive proper training in order to develop their abilities

Provide hospitable work environment and best possible conditions of employment through fair wages and working environment

To the governing body

Ensure that adequate information regarding the operations of the organisation is provided

Ensure persistence and development of the organisation through investing funds in essential tools, facilities and infrastructure for the operations

Answer to SEQ 2

Calculation of NOPAT

Particulars	Tshs million
Accounting profit according to SOPL	45.88
Add:	
Research and development cost	4.80
Interest	6.30
Total	**56.98**
Less: Tax @ 30% (W1)	(21.55)
NOPAT	**35.43**

Workings

W1 Tax calculation

Tax charged while calculating EVA^{TM} must include the tax relief on interest paid by the company.
Tax charge = Tax on accounting profit + 30% of interest charged
= Tshs19.66 million + (Tshs6.3 million x 30%)
= Tshs19.66 million + Tshs1.89 million
= Tshs21.55 million

Calculation of capital employed

Particulars	Tshs million
Equity capital and free reserves	120
Add:	
Long term borrowings	81
Research and development cost	40.2
Total	**241.2**

Cost of capital = Tshs241.2 million x 10%
= Tshs24.12 million

EVA™ = NOPAT – Cost of capital
= Tshs35.43 million - Tshs24.12 million
= Tshs11.31 million

Conclusion: DumDum Inc has created wealth for its shareholders by Tshs11.31 million

SECTION D

FINANCIAL STATEMENTS OF GROUP OF ENTITIES

D1

STUDY GUIDE D1: BUSINESS COMBINATIONS

Get Through Intro

Business combinations have become the flavour of the season with multinational companies acquiring new subsidiaries every other day. A lot of field work, planning and business acumen is needed when making such acquisitions but do the CEOs ever spare a thought for the poor accountant who has to record it all!

In Paper B2 Financial Accounting, we have dealt with the accounting of simple groups. We now deal with complex groups i.e. where a parent has subsidiaries and sub-subsidiaries and mixed groups (you will learn all about it in the Study Guide). To add some spice to the calculations we will also deal with cases where you have step acquisitions during the accounting period.

For example: Hermione Co acquired shares in Hamlet Co in the following stages

15% on 1 April 20X7
25% on 1 June 20X7
20% on 1 July 20X7

What are the consequences of these acquisitions?

Shares in Hamlet Co is an investment of Hermione Co between 1 April 20X7 to 31 May 20X7 (15%).
Hamlet Co is an associate of Hermione Co between 1 June 20X7 to 30 June 20X7 (15% + 25% = 40%).
Hamlet Co is a subsidiary of Hermione Co after 1 July 20X7 (40% + 20% = 60%).

This Study Guide also discusses the accounting of associates and joint arrangements and preparation of consolidated statement of cash flows.

A chance of having to consolidate accounts of simple groups in real life is rare. More often than not you will be dealing with groups having multiple subsidiaries and sub subsidiaries acquired in steps. This Study Guide will prepare you for consolidating accounts of such complex groups according to the relevant standards.

Learning Outcomes

a) Evaluate and apply the principles to determine control in accordance with IFRS 10 Consolidated Financial Statements.
b) Apply the recognition and measurement criteria for identifiable acquired assets and liabilities.
c) Account for goodwill, gain on bargain purchase and non-controlling interest in accordance with International Financial Reporting Standards.
d) Prepare and present financial statements and extracts from the financial statements of a group that presents consolidated financial statements taking into account a variety of transactions on the basis of chosen accounting policies and in accordance with IFRSs and local regulations.
e) Draft and advice upon suitable accounting policies based on a business scenario under local and international requirements for public and private sector entities including single and consolidated financial statements.
f) Identify from a given scenario a subsidiary, associate or joint venture according to IFRSs.
g) Evaluate and apply the knowledge of group accounting in situations of complex group structures.
h) Apply the principles of group accounting in preparation of group statements of cash flows.

1. Evaluate and apply the principles to determine control in accordance with IFRS 10 Consolidated Financial Statements.

[Learning Outcome a]

1.1 Criteria used to identify a subsidiary

IFRS 10 - Consolidated Financial Statements

IFRS 10 Consolidated Financial Statements was issued during May 2011 so as to replace the consolidation related provisions in the IAS 27 Consolidated and Separate Financial Statements and SIC-12 Consolidation—Special Purpose Entities.

It is effective for annual periods beginning on or after 1 January 2013, although earlier application is permitted.

The need for IFRS 10

1. There was a divergence in practice in applying IAS 27 and SIC-12, which led to varied application of the control concept in the following circumstances

(a) Where reporting entity controls another entity but holds less than a majority of the voting rights of the entity
(b) In agency relationships

2. There was a perceived conflict of emphasis between IAS 27 and SIC-12

(a) IAS 27 required the consolidation of entities based on control and it defined control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
(b) SIC-12, which interpreted the requirements of IAS 27 in the context of special purpose entities, placed greater emphasis on risks and rewards.

The global financial crisis that started in 2007 highlighted the lack of transparency about the risks to which investors were exposed from their involvement with 'off balance sheet vehicles' (such as securitization vehicles), including those that they had set up or sponsored.

As a result, the G20 leaders, the Financial Stability Board and others asked the Board to review the accounting and disclosure requirements for such 'off balance sheet vehicles'.

IFRS 10 states that consolidated financial statements have to be prepared where a group of entities are controlled by a parent.

Definition

IAS 27 revised defines consolidated financial statements as "The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity."

IAS 27, Para 4

In order to understand the definition and meaning of a subsidiary, it is essential to understand the concept of a group.

Concept of a group

Definition

Group is a parent and all its subsidiaries.

Parent is an entity that controls one or more entities.

Subsidiary is an entity that is controlled by another entity

IFRS 10, Appendix A

Separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 Financial Instruments

IAS 27, Para 4

1.2 Concept of control

Under IFRS 10, an investor controls an investee if and only if the investor has ALL the following

1. Power over the investee;
2. Exposure, or rights, to variable returns from its involvement with the investee; and
3. Ability to use its power over the investee to affect the amount of the investor's returns.

Diagram 1: Guidance on how to apply the control principle in various circumstances

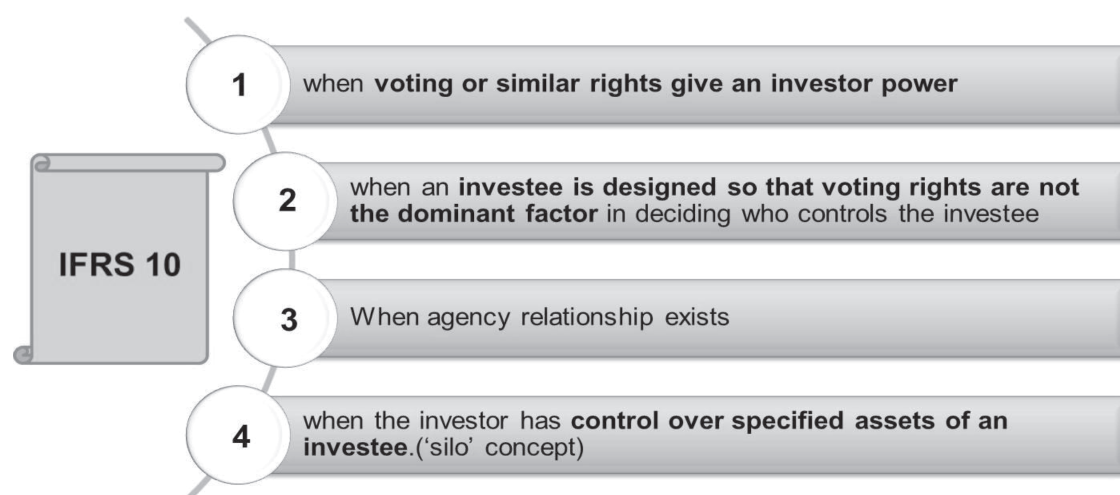


Diagram 2: Control

These are discussed in turn below

1. Power

One of the important elements of control is **power**. IFRS 10 provides by far the most detailed guidance in evaluating whether an entity has power over the investee. The guidance in IFRS 10 requires an investor to evaluate all of the following to determine if it has power over the investee

Right to direct the relevant activities of the investee
The way decisions about the relevant activities are made
The rights that the investor and other parties have in relation to the investee
Factors to be considered in consolidating a deemed separate entity (SILO)

Power arises from rights.

To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities.

Examples of rights that, either individually or in combination, can give an investor power include but are not limited to

(a) Rights in the form of voting rights (or potential voting rights) of an investee;
(b) Rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;
(c) Rights to appoint or remove another entity that directs the relevant activities;
(d) Rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and
(e) Other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

(a) Existing rights to direct relevant activities of investee

To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities.

In order to assess power, only substantive rights should be considered.

For a right to be a substantive right, the holder must have the practical ability to exercise that right. Usually, for rights to be substantive, the rights need to be currently exercisable.

(b) Are rights substantive?

Determining whether rights are substantive requires judgement, taking into account all facts and circumstances. Factors to consider in making that determination include but are not limited to

(i) Whether there are any barriers (economic or otherwise) that prevent the holder (or holders) from exercising the rights

Example

Examples of such barriers include but are not limited to:

- financial penalties and incentives that would prevent (or deter) the holder from exercising its rights
- an exercise or conversion price that creates a financial barrier that would prevent (or deter) the holder from exercising its rights
- terms and conditions that make it unlikely that the rights would be exercised, for example, conditions that narrowly limit the timing of their exercise
- the absence of an explicit, reasonable mechanism in the founding documents of an investee or in applicable laws or regulations that would allow the holder to exercise its rights
- the inability of the holder of the rights to obtain the information necessary to exercise its rights
- operational barriers or incentives that would prevent (or deter) the holder from exercising its rights (e.g. the absence of other managers willing or able to provide specialised
- services or provide the services and take on other interests held by the incumbent manager)
- legal or regulatory requirements that prevent the holder from exercising its rights

(ii) When the exercise of rights requires the agreement of more than one party, or when the rights are held by more than one party, whether a mechanism is in place that provides those parties with the practical ability to exercise their rights collectively if they choose to do so

Example

Removal rights exercisable by an independent board of directors are more likely to be substantive than if the same rights were exercisable individually by a large number of investors

(iii) Whether the party or parties that hold the rights would benefit from the exercise of those rights

Example

The terms and conditions of potential voting rights are more likely to be substantive when the instrument is in the money or the investor would benefit for other reasons (e.g. by realising synergies between the investor and the investee) from the exercise or conversion of the instrument.

The investee has annual shareholder meetings at which decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months.

However, shareholders that individually or collectively hold at least 5 per cent of the voting rights can call a special meeting to change the existing policies over the relevant activities, but a requirement to give notice to the other shareholders means that such a meeting cannot be held for at least 30 days.

Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings.

Amazing (an investor) is party to a forward contract to acquire the majority of shares in the investee. The forward contract's settlement date is in 25 days.

Does Amazing have a substantive right?

Answer

The existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract will have been settled. Amazing's forward contract is a substantive right that gives it the current ability to direct the relevant activities even before the forward contract is settled.

(c) Protective Rights

Rights that are purely protective do not contribute to power under IFRS 10. Protective rights are designed to protect the interests of their holder, but do not give that party power over the investee. Protective rights give the holder protection in exceptional circumstances or prevent fundamental changes from being made to the activities of the investee.

Examples of protective rights include

(i) A lender's right to restrict a borrower from undertaking activities that could significantly change the credit risk of the borrower to the detriment of the lender.

(ii) The right of a party holding a non-controlling interest in an investee to approve capital expenditure greater than that required in the ordinary course of business, or to approve the issue of equity or debt instruments.

(iii) The right of a lender to seize the assets of a borrower if the borrower fails to meet specified loan repayment conditions.

(d) Relevant activities

After determination of existing rights, the next step is to determine the relevant activities. For the purpose of this IFRS, relevant activities are activities of the investee that significantly affect the investee's returns.

While assessing control over an investee, an investor shall consider the purpose and design of the investee in order to identify the relevant activities.

Examples of relevant activities include:

(i) Selling and purchasing of goods or services;
(ii) Managing financial assets during their life (including upon default);
(iii) selecting, acquiring or disposing of assets;
(iv) Researching and developing new products or processes; and
(v) Determining a funding structure or obtaining funding.

Directing the relevant activities may include

(i) Establishing operating and capital decisions of the investee, including budgets; and
(ii) Appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.

Important

If two or more investors have rights to direct different relevant activities, the investors must decide which of the relevant activities most significantly affects the returns of the investee.

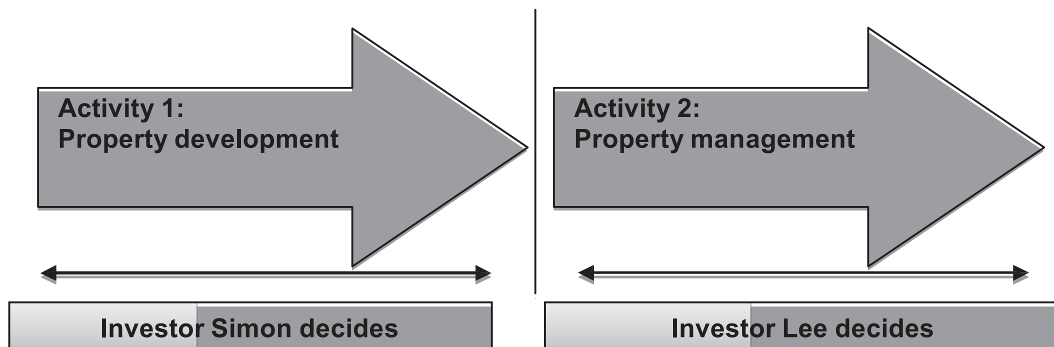
Example

Two investors, namely Simon and Lee, form an investee to develop and market an investment property. One of the investor (Simon) is responsible for developing and obtaining regulatory approval of the property—that responsibility includes having the unilateral ability to make all decisions relating to the development of the property and to obtaining regulatory approval.

Once the regulator has approved the property, the other investor (Lee) will manage the property by leasing or otherwise —this investor has the unilateral ability to make all decisions about the selling or leasing of the property.

Who should, if at all, consolidate the investee?

Answer



If all the activities are relevant activities, each investor needs to determine whether it is able to direct the activities that most significantly affect the investee's returns.

The investors shall reconsider this assessment over time if relevant facts or circumstances change.
In determining which investor has power, the investors would consider

(i) The purpose and design of the investee;
(ii) The factors that determine the profit margin, revenue and value of the investee as well as the value of the investment property;
(iii) The effect on the investee's returns resulting from each investor's decision-making authority with respect to the factors in (b); and
(iv) The investors' exposure to variability of returns.

In the given case, if the regulatory approvals have a negligible effect and the subsequent management has a major effect on the returns, then Lee controls the entity, and hence, should consolidate.

Test Yourself 1

Delta Ltd has invested in shares of Eagle Ltd. In the annual general meetings of Eagle, decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months.

The shareholders that individually or collectively hold at least 5 per cent of the voting rights can call a special meeting to change the existing policies over the relevant activities. However, there is a requirement that a notice to the other shareholders should be given at least 30 days in advance. Decisions regarding approval of material sales of assets as well as making or disposing of significant investments can be made at such meetings.

Determine whether Delta ltd controls Eagle Ltd for the following scenarios

(i) Delta Ltd holds majority of shares in Eagle Ltd.
(ii) Delta Ltd is party to a forward contract to acquire the majority of shares in Eagle Ltd and the forward contract's settlement date is in 25 days.
(iii) Delta Ltd is party to a forward contract to acquire the majority of shares in Eagle Ltd and the forward contract's settlement date is within the next 6 months.

(e) The way decisions are made about the relevant activities

In some circumstances, it may be difficult to determine whether an investor's rights are sufficient to give it power over an investee. In such cases, to enable the assessment of power to be made, the investor shall consider evidence of whether it has the practical ability to direct the relevant activities unilaterally.

Consideration is given, but is not limited, to the following, which when considered together with its rights and other indicators may provide evidence that the investor's rights are sufficient to give it power over the investee.

(i) The investor can, without having the contractual right to do so, appoint or approve the investee's key management personnel who have the ability to direct the relevant activities.
(ii) The investor can, without having the contractual right to do so, direct the investee to enter into, or can veto any changes to, significant transactions for the benefit of the investor.
(iii) The investor can dominate either the nominations process for electing members of the investee's governing
(iv) Body or the obtaining of proxies from other holders of voting rights.
(v) The investee's key management personnel are related parties of the investor (for example, the chief
(vi) Executive officer of the investee and the chief executive officer of the investor are the same person). (v) The majority of the members of the investee's governing body are related parties of the investor.

(f) Voting rights – various possibilities

(i) Power with a majority of the voting rights: control arises when an investor owns over 50% of the voting rights of an investee. This is the most common form for obtaining control over an investee. However, the voting rights should be substantive and not protective. For example, if an investor holds the majority of the voting rights, but legal or regulatory requirements prevent the holder from exercising its rights, then such rights would not give control over the investee.

A company controls another entity directly when it acquires majority of the voting rights of the other entity.

Wholly-owned subsidiary	An entity acquires 100% voting rights of another entity
Partially-owned subsidiary	An entity acquires more than 50% to 100% voting rights of another entity

If the subsidiary is not fully owned (i.e. if the parent company holds less than 100% shares in the subsidiary), the remaining shareholders together are called the non-controlling interest.

Definition

Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

IFRS 3, Appendix A

(ii) Majority of the voting rights but no power: in some cases, voting rights may be designed in a manner such that they are not the dominant factor in deciding control over an investee. This may happen if the investor cannot direct the relevant activities of the investee or the rights may not be substantive. In such cases, the investor does not control the investee.

Example

Hope Co holds 100% of the shares of Wish Co, 70% of the shares of Dream Co and 40% of the shares of Fear Co.

Then by virtue of the majority of the voting rights:

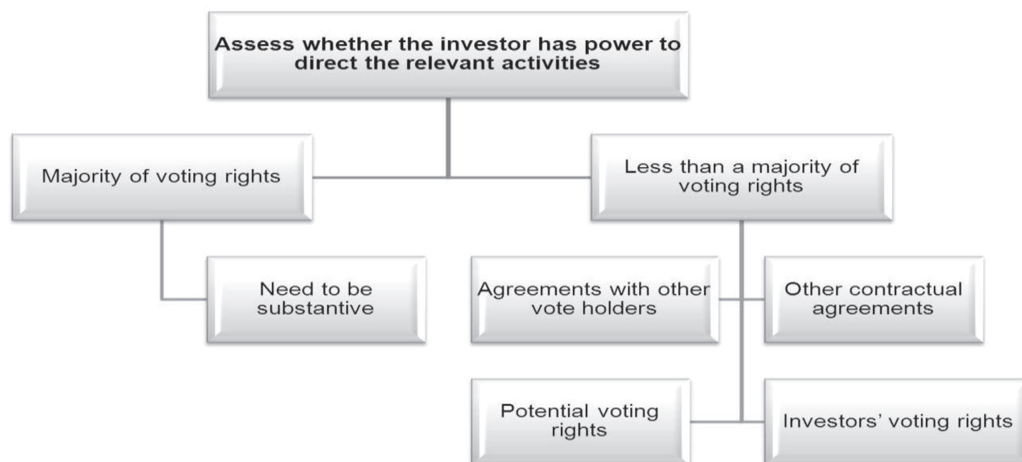
Wish Co is a fully owned subsidiary of Hope Co.
Dream Co is a partially owned subsidiary of Hope Co.
Fear Co is not a subsidiary of Hope Co.

Moreover, Hope Co needs to check whether the voting rights are substantive and whether they give it power to direct the relevant activities of the investee in order to consolidate Wish Co, Dream Co and Fear Co.

(iii) Power without a majority of the voting rights: this could be due to:

- a contractual arrangement between the investor and other vote holders;
- rights arising from other contractual arrangements;
- the investor's voting rights, referred to as de facto control (for example, when the investor holds significantly
- greater voting rights than any other vote holder or organised group of vote holders)
- potential voting rights (considered only if they are substantive); or
- a combination of all above four

Diagram 3: Rights over an investee



Test Yourself 2

Wonder Ltd holds 40 per cent of the voting rights of an investee and twelve other investors each hold 5 per cent of the voting rights of the investee. A shareholder agreement grants Wonder the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities.

To change the agreement, a two-thirds majority vote of the shareholders is required.

Does Wonder have power over the investee?

Example

Appointments of CEO and the majority of the board members in Demanto Ltd are controlled by Genfast Ltd as a result of a contract. The voting rights of shareholders relate to administrative tasks only. In this case, the conduct of relevant activities is directed by means of contractual arrangements.

(g) Control over specified assets

An investor shall consider whether it treats a portion of an investee as a deemed separate entity and, if so, whether it controls the deemed separate entity.

This deemed separate entity or 'silo' is a new concept compared to IAS 27, which dealt with only the legal entities. This opens up a possibility that only a part of the entity represented by this 'silo' may be consolidated.

An investor shall treat a portion of an investee as a deemed separate entity **if and only if** the following conditions are satisfied:

(i) Specified assets of the investee (and related credit enhancements, if any) are the only source of payment for specified liabilities of, or specified other interests in, the investee.
(ii) Parties other than those with the specified liability do not have rights or obligations related to the specified assets or to residual cash flows from those assets.
(iii) In substance, none of the returns from the specified assets can be used by the remaining investee and none of the liabilities of the deemed separate entity are payable from the assets of the remaining investee.

Thus, in substance, all the assets, liabilities and equity of that deemed separate entity is ring-fenced from the overall investee. Such a deemed separate entity is often called a 'silo'.

If the investor controls the deemed separate entity, the investor shall consolidate that portion of the investee.

(h) Purpose and design of an investee

When assessing control of an investee, an investor shall consider the purpose and design of the investee in order to identify:

- The relevant activities;
- How decisions about the relevant activities are made;
- Who has the current ability to direct those activities; and
- Who receives returns from those activities?

An investee may be designed such that voting rights are not the dominant factor in deciding, who controls the investee,

Example

Appointments of CEO and the majority of the board members in Demanto Ltd are controlled by Genfast Ltd as a result of a contract. The voting rights of shareholders relate to administrative tasks only. In this case, the conduct of relevant activities is directed by means of contractual arrangements.

(i) More than passive interest

The following suggests that the investor has more than a passive interest in the investee and, in combination with other rights, may indicate power:

The investee's key management personnel who have the ability to direct the relevant activities are current or previous employees of the investor.
The investee's operations are dependent on the investor, such as in the following situations:

The investee depends on the investor to fund a significant portion of its operations.
The investor guarantees a significant portion of the investee's obligations.
The investee depends on the investor for critical services, technology, supplies or raw materials.
The investor controls assets such as licences or trademarks that are critical to the investee's operations.
The investee depends on the investor for key management personnel, such as when the investor's personnel have specialised knowledge of the investee's operations.

A significant portion of the investee's activities either involve or are conducted on behalf of the investor.

The investor's exposure, or rights, to returns from its involvement with the investee is disproportionately greater than its voting or other similar rights. For example, there may be a situation in which an investor is entitled, or exposed, to more than half of the returns of the investee but holds less than half of the voting rights of the investee.

2. Variable returns

The second element of control pertains to returns. To control an investee, an investor must be exposed, or have rights to variable returns from its involvement with the investee.

This happens when the investor's returns from its involvement have the potential to vary as a result of the investee's performance.

Although only one investor can control an investee, more than one party can share the returns of an investee. For example, holders of non-controlling interests can share the profits or distributions of an investee, but cannot control the investee.

Example

Baywatch Ltd holds a bond with fixed interest payments. Is this investment subject to variable returns?

Answer

The fixed interest payments are variable returns for the purpose of IFRS 10 because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond.
The amount of variability (i.e. how variable those returns are) depends on the credit risk of the bond.

---

3. Link between power and returns

This is the third and final element of 'control'. The link between power over an investee and the returns is essential to having control. The investor does not control the investee in the following circumstances: (a) an investor has power over an investee, but cannot benefit from that power

(b) An investor receives a return from an investee, but cannot use its power to direct the activities that significantly affect the returns of that investee

Therefore, it becomes necessary that the investor should have the ability to use its power over the investee to affect its returns.

When an investor with decision-making rights (a decision maker) assesses whether it controls an investee, it shall determine whether it is a principal or an agent.

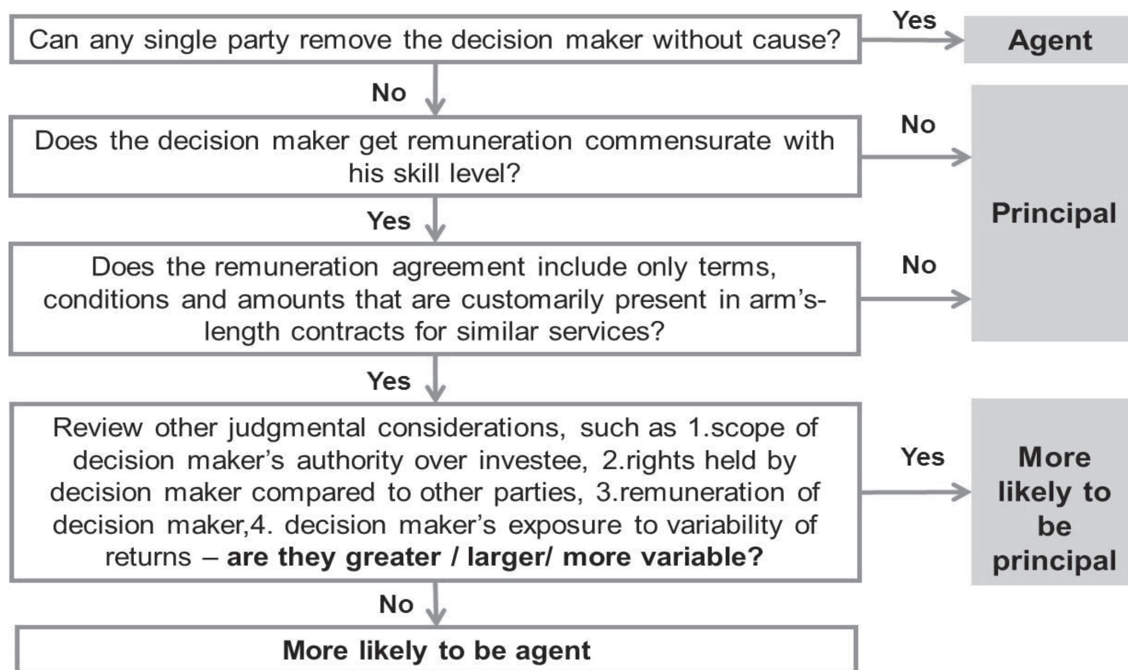
An investor shall also determine whether another entity with decision-making rights is acting as an agent for the investor.

An agent is a party primarily engaged to act on behalf of and for the benefit of another party or parties (the principal(s)) and therefore does not control the investee when it exercises its decision-making authority.

A decision maker shall consider the overall relationship between itself, the investee being managed and other parties involved with the investee (in particular all the factors below) in determining whether it is an agent:

The scope of its decision-making authority over the investee
The rights held by other parties
The remuneration to which it is entitled in accordance with the remuneration agreement(s)
The decision maker's exposure to variability of returns from other interests that it holds in the investee

Diagram 4: Principal and agent



Continuous assessment of control

IFRS 10 requires a continuous assessment of control of an investee. This continuous reassessment would consider both changes in an investor's power over the investee and changes in the investor's exposure or rights to variable returns. This assessment will be made based on changes in facts and circumstances, but would be revisited at least at each reporting period.

1.3 Accounting requirements

The accounting requirements of IFRS 10 are similar to those stipulated by IAS 27. The accounting for subsidiaries is explained in detail in the subsequent Learning Outcomes.

1.4 Disclosure requirements

1. Disclosure requirements for consolidated financial statements are specified not in IFRS 10, but in IFRS 12 'Disclosure of Interests in Other Entities'.

2. IFRS 12 presents a single disclosure standard for reporting entities with special relationships with other entities, including subsidiaries, joint arrangements, associates and unconsolidated structured entities.

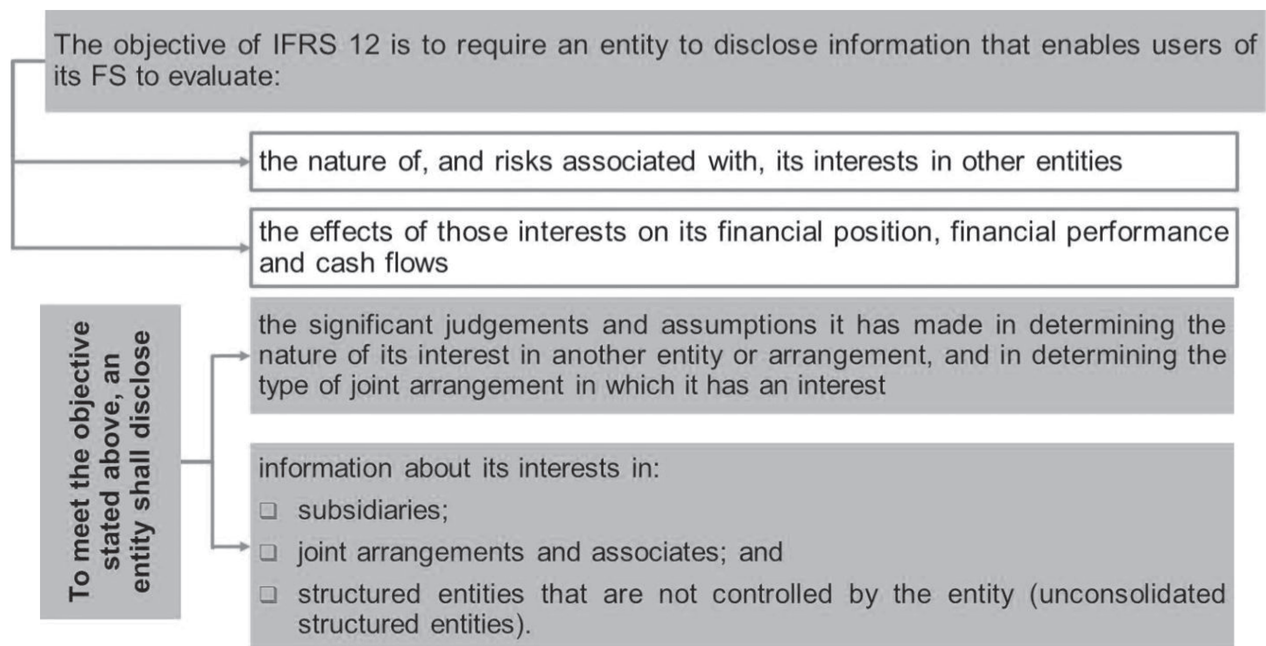
3. IFRS 12 expands the disclosure requirements for both consolidated entities and unconsolidated structured entities.

4. These disclosures will help them identify the profit and cash flows available to the reporting entity.

5. The disclosure objectives in IFRS 12 will give preparers flexibility to tailor their individual disclosures to meet these objectives.

6. An entity may have to fine tune the ERP system so as to obtain the additional disclosure requirements.

Diagram 5: Disclosure objective



Transition

How to manage the transition to IFRS 10?
There are three possibilities.

No change in the consolidation status
Consolidating an investee that was not consolidated earlier
No longer consolidating an investee that was consolidated earlier

The first point does not need any accounting adjustments. Second and third points are discussed in the following diagrams:

Diagram 6: Consolidating an investee that was not consolidated earlier

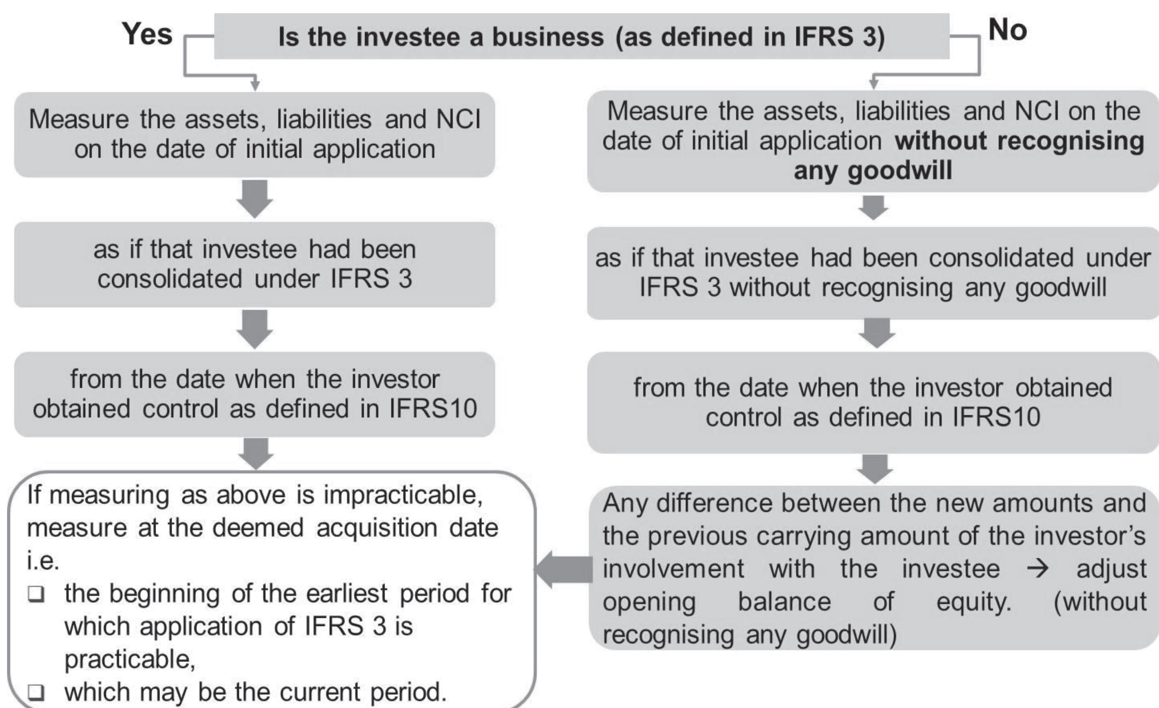
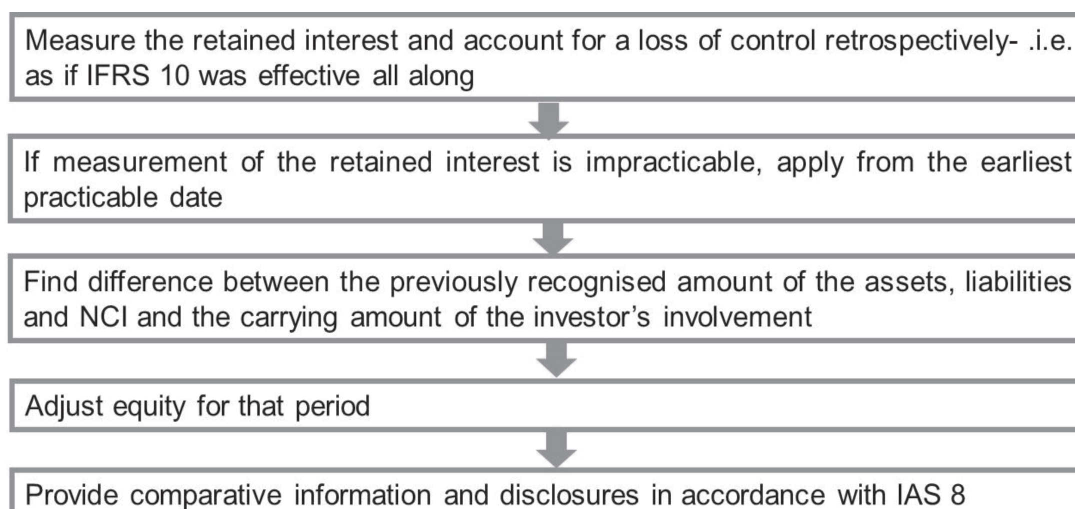


Diagram 7: No longer consolidating an investee that was consolidated earlier



1.5 Criteria to Identify an Associate

At Paper B2 Financial Accounting we have already discussed associates and the criteria for determining a parent associate relationship. Let us discuss the provisions in brief here:

Definition

An associate is an entity, including an unincorporated entity such as partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

IAS 28 Para 2

Significant influence is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.

IAS 28 Para 2

A company exercises significant influence over another when it cannot dictate terms yet the other entity has to consider what it says.

The parent associate relationship may be determined with reference to:

1. **Direct holdings:** when an entity directly holds more than 20% and less than 50% of the voting rights in another entity.

2. **Indirect holdings:** when an entity holds more than 20% and less than 50% of the voting rights in another entity.

3. **Holdings due to the existence and effect of potential voting rights:** where an entity may own presently exercisable share warrants, share call options or debt or equity instruments that can be converted into ordinary shares of another company. It could also have similar instruments which have the potential, if the right is exercised or converted, to increase the share of its voting power or reduce the share of some other's voting power over the financial and operating policies of the other entity.

Example

If Sun Co holds 12% shares of Moon Co and Sun Co also holds debt instruments which have the potential to be converted into ordinary shares of Moon Co: The conversion rights are currently exercisable.

If and when these are converted, Sun Co will acquire power over 10% of the voting rights of Moon Co, Sun Co has the potential to acquire power over 22% (12% + 10%) of the voting rights of Moon Co.

Then, by passing the 'test of control due to potential voting rights' Moon Co and Sun Co become associate companies, even though Sun Co holds less than 20% shares of Moon Co.

Important

When potential voting rights exist, the proportions of profit or loss and changes in equity allocated to the parent and non-controlling interests are determined on the basis of present ownership interests and do not reflect the possible exercise or conversion of potential voting rights. This is to say that potential voting rights are relevant to the classification of an acquiree but do not affect the percentages to be used in accounting for the acquiree in consolidated financial statements.

Test Yourself 3

At 30 November 2008, the Wan Chai Group has equity interests of 51% in a subsidiary, Po Lam. Another company, Lai King, owns the remaining 49% of equity interest in Po Lam. In June 2008, Wan Chai, the parent company of the Wan Chai Group, entered into an option agreement with Lai King under which Wan Chai granted an option to Lai King to acquire from Wan Chai 5% of the equity interest of Po Lam at zero consideration.

Such option is exercisable during the period from 30 November 2005 to 30 November 2009. Po Lam has been making a profit for several years. The net assets of Po Lam amount to approximately Tshs50 million.

Required:

What is the impact of the potential voting rights of the option on Wan Chai Group and Po Lam?

1.6 Identifying a business combination

In accordance with IFRS 3, an entity shall determine whether a transaction or other event is a business combination by applying the definition in this IFRS, which requires that the assets acquired and liabilities assumed constitute a business. **If assets acquired do not constitute a business it shall be accounted as an asset acquisition.**

The acquisition method

Each business combination must be accounted for by applying the acquisition method. The acquisition method requires the following steps to be adhered:

1. Identifying the acquirer;
2. Determining the acquisition date;
3. Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and
4. Recognising and measuring goodwill or a gain from a bargain purchase.

One of the parties to a business combination can always be identified as the acquirer, being the entity that obtains control of the business or acquiree. In a business combination effected through a share exchange, the entity that issues the equity interests is usually the acquirer.

An acquirer might obtain control of an acquiree in a variety of ways, for example:

By transferring cash, cash equivalents or other assets;
By incurring liabilities;
By issuing equity interests;
By providing more than one type of consideration; or
Without transferring consideration, including by contract alone.

The **acquisition date** is the date on which the acquirer obtains control of the acquiree and is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree; what IFRS 3 refers to as the closing date.

However, control may be obtained on a date that is earlier or later than the closing date. This is important in determining pre and post-acquisition reserves of the acquiree. For example, the acquisition date will be earlier than the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date.

The recognition and measurement criteria for identifiable acquired assets and liabilities and goodwill are discussed in Learning Outcome 2 in detail.

1. Acquisition related costs

Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. Under IFRS 3 the acquirer is required to recognise acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. **The costs to issue debt or equity securities are recognised in accordance with IAS 32 (for equity) and IFRS 9 (for debt)**.

Example

Trico incurred costs for the services of lawyers, investment bankers, accountants and valuation experts in the process of acquiring Becatol. It also incurred costs for issuing shares (consideration is paid in the form of shares). These costs, except for cost of issue of shares, would be recognised as expenses as they are not part of the fair value exchange between the buyer and the seller of the acquired business. They are recognised as an expense in statement of profit or loss in which payments are made in exchange for services rendered. The costs related to share issue should be charged to equity.

2. Contingent consideration

The consideration transferred may include cash, other assets, a business or subsidiary of the acquirer, contingent consideration, ordinary or preference equity instruments, options or warrants. Where the consideration includes a contingent consideration arrangement, that contingent element shall be measured at acquisition date fair value and included as part of the consideration transferred. The contingent consideration should be classified as either equity or liability in accordance with IAS 32.

If the value of the contingent consideration subsequently changes within the measurement period (maximum one year from acquisition date) as a result of additional information obtained about circumstances at acquisition date, then such changes are measurement period adjustments. Such changes will adjust the goodwill initially recognised. However, changes resulting from events after acquisition date, i.e. meeting profit targets, are not measurement adjustments. These will be accounted for as follows:

(a) Contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity.

(b) Contingent consideration classified as an asset or a liability that:

(i) Is a financial instrument and is within the scope of IFRS 9 or IAS 39 shall be measured at fair value, with any resulting gain or loss recognised either in profit or loss or in other comprehensive income in accordance with IFRS 9.

(ii) Is not within the scope of IFRS 9 shall be accounted for in accordance with IAS 37 or other IFRSs as appropriate.

Example

On 1 April 2007 Alpha purchased 56 million shares in Beta for an immediate cash payment of Tshs90 million. The terms of the business combination provide for the payment of an additional Tshs12 million on 31 March 2009 if the performance of Beta reaches a specified level in the two year period ended 31 March 2009. The directors of Alpha estimated that the fair value of the contingent consideration at 1 April 2007 was Tshs10 million. This estimate was unchanged at 30 September 2008.

The total consideration for this would be:

	Tshs million
Cash payment	90
Contingent consideration (acquisition date fair value)	10
Total	**100**

3. Deferred consideration

Any consideration which is not payable immediately but is payable in the future and which is not contingent is called a deferred consideration.

Such consideration should be valued at present value of the amount payable. For this, amount payable in future should be multiplied by the present value factor (present value factor is calculated using the cost of capital to the parent).

Example

On 1 January 20X7, Welldone Co acquired 80% Tshs1,000 shares in Don Co, out of the 100,000 shares.

It agreed to pay Tshs5,000 per share in cash immediately and Tshs120 million after 31 December 20X9. Cost of capital of Welldone is 10%.

Therefore total consideration will be:

Present value factor is used for calculation

	Tshs million
Immediate 100,000 x 80% x Tshs5,000	400
Deferred Tshs120m x [1/(1.10)^2]	99
Total consideration	**499**

Unwinding of the discount on the deferred consideration is required on the reporting date. The amount should be charged to finance cost. Unwinding does not affect the consideration amount.

Example

Continuing the previous example of Welldone Co

In the above case, on 31 December 20X8, the following entry should be made in order to record approx. Tshs10 million (Tshs99 million x 10%)

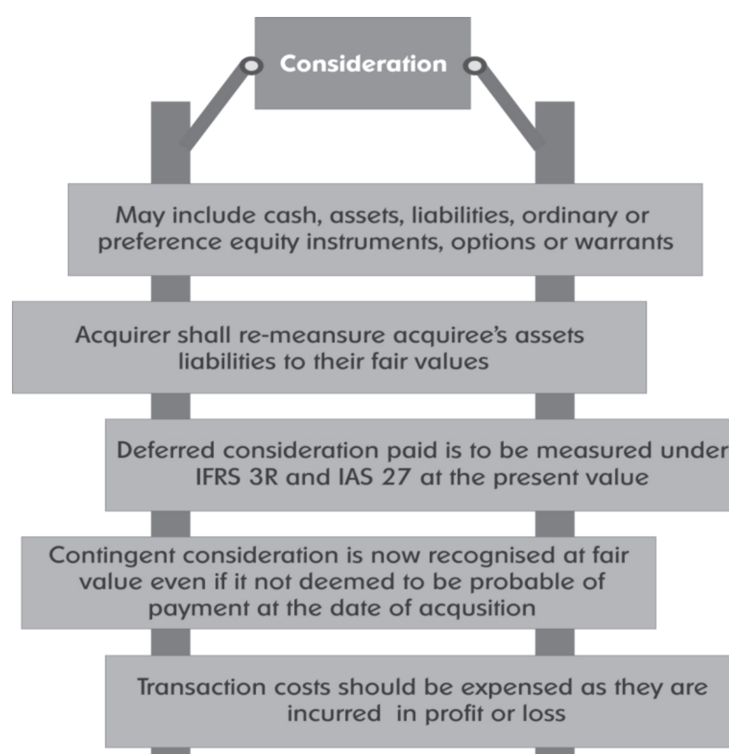
Dr Finance cost	Tshs10 million	
Cr Provision for deferred consideration		Tshs10 million

Being unwinding of the discount on deferred consideration

As a result of this, the amount payable will be Tshs109 million (Tshs99 million + Tshs10 million) at the end of 31 December 20X8.

On 31 December 20X9 by further unwinding of approx. Tshs11 million (Tshs109 million x 10%), after which the carrying amount of the provision will be Tshs120 million (Tshs109 million + Tshs11 million).

Diagram 8: Consideration



4. Different reporting dates

If the parent and all its subsidiaries in the group do not have the same year end, the consolidated financial statements will not reflect a correct picture of the financial status of the group. To avoid this problem, IFRS 10 requires that the financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as of the same date.

However, there could be certain situations where the parent and its subsidiaries do not have coterminous year ends. Where it is possible to prepare additional financial statements, the subsidiary should prepare additional financial statements to the reporting date.

Where it is impractical (as mentioned above) then the subsidiary entity's accounts can be used for consolidation. However,

Adjustments should be made for the effects of significant transactions or events that occur between the reporting dates of the subsidiary and parent.

A gap of not more than three months between the reporting date of the parent and the subsidiary is allowed

5. Uniform accounting policies

Remember that consolidated financial statements are prepared by combining the financial statements of all the group entities, in order to determine the financial status of the group as if it were one single entity.

IFRS 10 requires that consolidated financial statements shall be prepared using uniform accounting policies for like transaction and other events in similar circumstances.

If not all the entities in the group follow uniform accounting policies, then the consolidated financial statements will not reflect a correct picture of the financial status of the group. In such a case appropriate adjustments should be made so that their financial statements are suitable for consolidations.

Important

The circumstances in which a group is required to prepare consolidated financial statements and the circumstances in which a group may claim an exemption from the preparation of consolidated financial statements have been discussed in detail Study Guide D2.

2 Apply the recognition and measurement criteria for identifiable acquired assets and liabilities.
3 Account for goodwill, gain on bargain purchase and non-controlling interest in accordance with International Financial Reporting Standards.
[Learning Outcomes b and c]

2.1 Valuing non-controlling interest at acquisition

Before we understand goodwill under the revised IFRS 3 we must understand non-controlling interest. This is because non-controlling interest now forms part of the goodwill calculation. According to IFRS 3 any non-controlling interest in an acquiree is measured at fair value or as the non-controlling interest's proportionate share of the acquiree's net identifiable assets. This means that for each business combination, the acquirer has the option to measure any non-controlling interest **either**

At fair value **or**
At the non-controlling interest's proportionate share of the acquiree's identifiable net assets measured at fair value

Note two further points:
Management must **elect,** for each acquisition, the option to measure the non-controlling interest.
If non-controlling interest is measured at fair value – it can be determined by referring to the market price of shares held by non-controlling shareholders just before the acquisition by the parent.

Tip

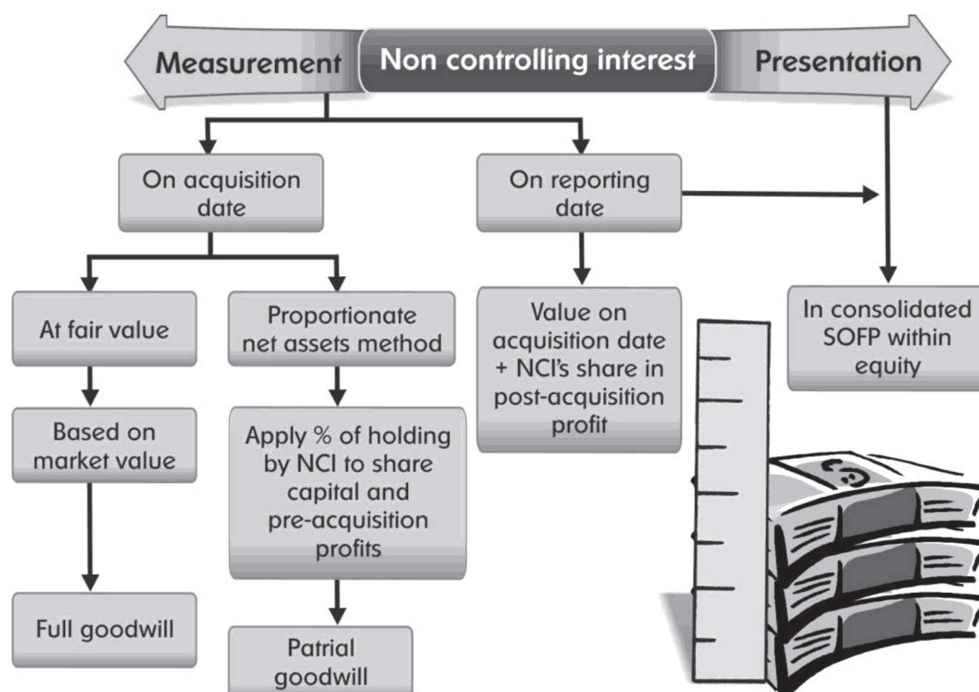
Since there is an option to value non-controlling interest at fair value, it is expected that the examiner will specify the method to use in the question by stating

'It is the group policy to value non-controlling interest at ……..'

If you are asked to use fair value, there are three options to calculate it:
Value is given in the question on the basis of the subsidiary's share price just before acquisition the amount of goodwill attributable to non-controlling interest is given.

In case (c), calculate non-controlling interest's value as share of net assets and add non-controlling interest's share in goodwill to it.

Diagram 9: **Measurement and presentation of non-controlling interest**



2.2 Goodwill arising in a business combination: the two alternative approaches of IFRS 3

Under the revised IFRS 3 goodwill can be measured in two different ways.

Under IFRS 3, goodwill is the excess of a) over b) below:

1. The aggregate of:

(a) The consideration transferred measured in accordance with IFRS 3;
(b) The amount of any non-controlling interest in the acquiree (note the choice as to measurement of the non-controlling interest given above); and
(c) In a business combination achieved in stages the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

2. Values of net identifiable assets acquired and the liabilities assumed in accordance with IFRS 3 (Refer paragraph 2.4 of this Learning Outcome).

If (a) is less than (b) a bargain purchase arises: what the old standard described as negative goodwill. We deal first with goodwill and then with a bargain purchase.

Important

Consolidated goodwill = Consideration paid by the parent + Non-controlling interest – Fair value of the subsidiary's net identifiable assets

Partial goodwill

If the non-controlling interest is valued at the non-controlling interest's proportionate share of the acquiree's identifiable net assets measured at fair value (as stated above) then the resultant goodwill is partial goodwill. This approach is similar to the method under the old IFRS 3 - goodwill is the difference between the consideration paid to the acquirer and its share of identifiable net assets acquired. This is referred to as a 'Partial goodwill' method because goodwill related only to the parent is brought into the books of accounts. The method used for valuation of non-controlling interest indirectly ensures that there is no goodwill recognised for the non-controlling interest's share.

Full goodwill

If the non-controlling interest is valued at fair value, the resultant goodwill is full goodwill. It is called the full goodwill method because the goodwill pertaining to the parent as well as the non-controlling interest is recognised in the financial statements.

Example

Argo Ltd purchases 60% of the equity shares of Barco Plc for Tshs1,260 million. Based on the trading price of the shares in Barco Plc at the date Argo Ltd obtains control, a value of Tshs800 million is assigned to the 40% non-controlling interest. The trading price of Argo Ltd.'s purchase of its 60% holding in Barco Plc is, therefore Tshs1,200 million (Tshs800 million x 60/40). Therefore, Argo Ltd has paid a control premium of Tshs60 million (Tshs1,260 million – Tshs1,200 million). The fair value of Barco Plc.'s identifiable net assets is Tshs1,400 million.

First, we need to measure the non-controlling interest. This is done separately for each business combination. IFRS 3 allows us a choice. We can **either** measure non-controlling interest at fair value **or** the non-controlling interest's share of the fair value of the identifiable net assets of Barco Plc. **In the first case**, on the basis of traded values at acquisition-date, the fair value of the non-controlling interest is Tshs800 million. On this basis, goodwill is determined as follows:

Particulars	Tshs million
Consideration transferred	1,260
Add: Fair value of non-controlling interests	800
	2,060
Less: Fair value of identifiable net assets acquired	(1,400)
Goodwill	**660**

Goodwill is measured as Tshs660 million.

Continued on the next page

In the second case, the non-controlling interest is measured as the proportionate share of the fair value of the identifiable net assets of Barco Plc i.e. (40% x Tshs1,400 million) Tshs560 million. On this basis, goodwill is determined as follows:

	Tshs million
Consideration transferred	1,260
Add: Non-controlling interest's share	560
	1,820
Less: Fair value of identifiable net assets acquired,	(1,400)
Goodwill	**420**

Goodwill is measured as Tshs420 million.

You may have observed that goodwill calculated under the second case is the same as under the old IFRS 3. It is the first case calculation that is new under IFRS 3. Under this first case scenario note that non-controlling interest at acquisition date is greater than under the second case scenario, and by the same amount.

In the first case, goodwill consists of two amounts. First the goodwill attributed to the controlling interest Tshs420 million (Tshs1,260 million – [60% x Tshs1,400 million]) plus, second, goodwill attributed to the non-controlling interest which is the remaining goodwill of Tshs240 million (Tshs660 million – Tshs420 million).

In the second case, goodwill recognised at acquisition-date is that attributed the controlling interest only, Tshs420 million.

What should an entity do: should it calculate "full goodwill" or "partial goodwill"?

The choice only makes a difference in an acquisition where less than 100% of the acquired business is purchased.

Recognising "full goodwill" will increase reported net assets in the consolidated statement of financial position. The amount recognised for goodwill will be higher and, therefore, any future impairment of goodwill will be higher. Measuring non-controlling interest at fair value may prove difficult in practice where, for example, there are no market prices to rely on.

On the plus side, a company planning a cash buy-out of the non-controlling interest may wish to record non-controlling interest at fair value and recognise full goodwill in a business combination as there will be a lower difference between the consideration paid for the non-controlling interest and its recorded value resulting in a lower decrease in equity following the purchase of the non-controlling interest (step acquisition is discussed later in this Study Guide).

The US standard on business combinations requires that goodwill be calculated on a "full" basis.

The underlying principle in IFRS 3 is for all components of the business acquired to be recognised at their fair value. This effectively means that the consideration paid and the assets and liabilities of the acquiree and equity attributable to the non-controlling interest are measured at fair value. This was the proposed requirement of the exposure draft that preceded the revised standard.

However, in acknowledging the strong disagreement of many commentators on the revision of the business combinations standard with recognising non-controlling interest at fair value, the IASB introduced a choice as to how non-controlling interest is measured. This results in allowing entities to determine goodwill in the same way as under the old standard.

Choice has a negative impact on comparability that is not entirely compensated by disclosure. Allowing a choice as to the valuation of the non-controlling interest results in the choice exercised being driven by future intentions to acquire the non-controlling interest. If there is an intention to purchase the non-controlling interest, determining goodwill on a "full" basis is likely to be the adopted choice as the reduction in equity after the purchase, as noted above, is reduced. Standards are intended to ensure consistency. With respect to goodwill, this is not achieved under IFRS 3.

Test Yourself 4

Co 1 acquires 60% of Co 2 for Tshs2,000 million. The carrying amount of Co 2's identifiable net assets on the combination date is Tshs2,400 million. The fair value of Co 2's identifiable net assets on the combination date is Tshs3,000 million. The fair value of the non-controlling interest on the combination date has been assessed as amounting to Tshs1,300 million.

Required:

Determine the goodwill to be recognised in the consolidated financial statements at the combination date under

(a) The "full" basis and
(b) The "partial" basis.

2.3 Gain on bargain purchase

When there is negative goodwill, it is called a gain on bargain purchase. When a bargain purchase arises, a gain on acquisition is recognised in profit or loss. Before the gain can be recognised, the acquirer must reassess the procedures used to identify and measure acquisition-date fair values of:

The identifiable assets acquired and liabilities assumed;
Any non-controlling interest in the acquiree;
In step acquisitions, the acquirer's previously held interest in the acquiree; and
The consideration transferred.

Any excess that remains is recognised as a gain which is attributed only to the acquirer.

Example

On 1 July 20X8, Gertrude Plc was finally successful in acquiring the entire share capital of Prudence Ltd. The terms of the bid by Gertrude Plc had been improved several times to counter other offers made for the acquisition of Prudence Ltd. The terms of the initial bid by Gertrude Plc were as follows:

20,000 ordinary shares in Gertrude Plc of Tshs1,000 at a price Tshs3,500 each immediately prior to the bid;
a cash element of Tshs15 million.

The final bid that was eventually accepted on 1 July 2008 by Prudence Ltd.'s shareholders improved the cash offer to Tshs25 million and included a redeemable loan note of a further Tshs25 million that will be redeemed on 30 June 20Y2. The loan note carried no interest but market rates for this type of loan note were 13% per annum. There was no increase in the number of shares offered but at the date of acceptance the price of Gertrude Plc's shares on the market had risen to TShs4,000 each.

The present value of Tshs1 receivable in a future period where interest rates are 13% can be taken as:

At end of year 3 = Tshs0.70
At end of year 4 = Tshs0.60

In addition, it is agreed that consideration paid should include deferred and contingent consideration. Details are as follows:

It was agreed, at acquisition date, 1 July 20X8 that deferred consideration of Tshs7 million to be paid to selling shareholders on 30 June 20Y0. Use 10% as discount rate to arrive at present value of deferred consideration.

It was also agreed that contingent consideration of an uncertain amount would be paid in cash to selling shareholders at 30 June 20Y1 provided Prudence achieved specified earn-out targets in each of the three years after acquisition. The directors of Gertrude determine, at acquisition-date, that the fair value of this contingent consideration amounts to Tshs3.8 million. On 30 June 20X9, the directors of Gertrude reassessed the fair value of this contingent consideration at Tshs3.5 million. Fees payable to banks, lawyers and accountants arising from various issues arising as a result of the business combination amounted to Tshs2.5 million.

Continued on the next page

Required:

What is the fair value of the consideration paid at the date of acquisition, including the earn-out and how should Gertrude account for the change in the fair value of the contingent consideration at 30 June 20X9?

Answer

The fair value of the consideration paid is determined as follows:

The purchase consideration is:

	Tshs million
Shares (20 million x Tshs4,000 – acquisition date fair value)	80
Cash	25.00
Deferred consideration: present value of amount certain to be paid in two years' time (Tshs7 million x 0.826)	5.78
Contingent consideration: provided for at acquisition date at fair value	3.80
Loan note (Tshs25 million x 0.60)	15.00
	129.58

Acquisition costs of Tshs2.5 million are no longer included in consideration paid and must now, under IFRS 3, be recognised in profit or loss. Previously, under the old standard, changes in the contingent consideration provision would have resulted in a corresponding change in goodwill. Under IFRS 3, the fall in fair value of Tshs300,000 is recognised in profit or loss.

Tutorial note

Note that contingent consideration classified as equity is not always remeasured through income. It depends on the features of the earn-out and how the number of shares to be issued is to be determined.

An earn-out payable in shares where the number of shares varies to give the recipients a fixed value meets the definition of a financial liability and will need to be fair valued through income.

Where a fixed number of shares either will or will not be issued depending on performance, regardless of the fair value of the shares, the earn-out is likely to meet the definition of equity and, therefore, is not remeasured through income.

2.4 Fair value of the identifiable assets and liabilities

You dealt with fair value changes at acquisition as a result of the fair value exercise at acquisition at Paper B2 level. There are limited changes to the assets and liabilities recognised in the acquisition statement of financial position. The old requirement to recognise all of the identifiable assets and liabilities of the acquiree at fair value is retained in IFRS 3. Most assets are recognised at fair value, with exceptions for certain items such as deferred tax and pension obligations. All changes in the values of acquired assets after acquisition are included in profit or loss

Note the following points that might arise in exam questions on business combinations. Some of these points are complex.

1. Intangible assets

Acquirers are required to recognise brands, licences and customer relationships, development expenditures separately from goodwill only if they are identifiable. IFRS 3 includes an explicit requirement to recognise a separate intangible asset for an operating lease that is at market but has a value for which market participants would be willing to pay.

2. Contingent liabilities

Many acquired businesses contain contingent liabilities example, pending lawsuits, warranty liabilities and future environmental liabilities. There is uncertainty in relation to such liabilities; payment will arise only by the occurrence or non-recurrence of a specific event or outcome. The amount of any outflow and the timing of an outflow may also be uncertain.

Under IFRS 3, contingent assets are not recognised and contingent liabilities are measured at fair value. After combination date, contingent liabilities are remeasured at the higher of the original amount and the amount under IAS 37. This requirement may change in the near future as a result of the Fair Value Measurement Project and the on-going project relating to improvements in IAS 37.

To be recognised as an actual liability the contingency must arise from a past event that can be reliably measured.

3. Restructuring and future losses

An acquirer will often have plans to streamline an acquired business; Synergies can be achieved through restructurings. An estimate of the cost savings will have been included in the buyer's assessment of how much it is willing to pay for the acquiree. Provisions will be recognised in relation to restructuring costs. The question arises as to whether these provisions be treated as pre or post acquisition.

A restructuring provision can be recognised in a business combination (reduction in pre-acquisition profit and increase in goodwill) only when the acquiree has, at the date of acquisition, an existing liability, for which there are detailed conditions in IAS 37 Provisions, contingent liabilities and contingent assets.

4. Exchange of share based payments awards

A problem may arise at acquisition from the exchange of share based payment awards. Employees of the acquiree entity exchange the share-based awards of the acquiree for the share-based awards of the acquirer. These exchanges arise as the acquirer will want to avoid having non-controlling interests' in the acquiree (which is what will happen when acquiree's employees take up the new shares of the acquiree). Another reason may be to motivate former employees of the acquiree to contribute to the overall results of the combined, post-acquisition business.

These exchanges are accounted for as a modification of a plan under IFRS 2

There may be two possibilities the acquirer is either obliged or not obliged to issue replacement awards in exchange for acquiree share-based payment awards held by employees of the acquiree

(a) If the acquirer is obliged, then all or a portion of the market-based measure of the acquirer's replacement awards should be treated as part of the consideration transferred by the acquirer. The effect of this is to increase goodwill and record a corresponding amount in equity.

    Note that the acquirer is considered to have an obligation if the employees or the acquiree can enforce replacement

(b) If, however, the acquirer is not obliged to issue replacement awards but elects to do so, none of the replacement awards are treated as part of the consideration transferred and there will be no impact on either goodwill or equity in this case the cost is a post-acquisition modification giving rise to employee compensation expenses

5. Other exceptions to recognition and measurement principle

Generally, net assets are measured at fair value at the date of acquisition with limited exceptions. These exceptions include:

(a) Assets held for sale – in accordance with IFRS 5
(b) Leased assets - in accordance with IAS 17
(c) Insurance contracts – in accordance with IFRS 4
(d) Financial instruments - must be reviewed to determine how should they be classified and designated and subsequently accounted for.
(e) Deferred tax assets and liabilities - in accordance with IAS 12. Fair value adjustments affect SOFP carrying value but not the tax base giving rise to temporary differences in consolidated accounts.

6. Measurement period: IFRS 3 allows a maximum of one year to change the purchase consideration

An acquirer has a maximum period of one year to finalise accounting for an acquisition. The adjustment period ends when the acquirer has gathered all the necessary information, subject to the one year maximum, from the acquisition date. This means that changes in estimates of fair value can be made by adjusting goodwill for a one year period after acquisition. After that, adjustments must be made through the statement of profit or loss and other comprehensive income.

7. Effect of fair value adjustments (to assets and liabilities) on consolidated goodwill

IFRS 3 requires that the fair values of net assets be considered when calculating goodwill. As goodwill is the difference between the consideration paid for assets / liabilities and the fair value of those assets / liabilities, it follows that, the higher the (fair) value of assets, the smaller the 'difference' and hence the lower the goodwill. Goodwill calculations based on fair values are more **realistic** as they take into account the **changing prices.**

The four possible outcomes of fair value adjustments are:

Increase in value of **asset**	Value of goodwill **decreases**
Decrease in value of **asset**	Value of goodwill **increases**
Increase in value of **liabilities**	Value of goodwill **increases**
Decrease in value of **liabilities**	Value of goodwill **decreases**

8. Effect of fair value accounting on non-controlling interests

Where the parent co-owns the subsidiary with non-controlling interests, the impact of the fair value accounting will increase (or decrease) the value of the non-controlling interest. For example if the non-controlling interest owns 30% of the subsidiary, then 30% of the net asset revaluation will be attributable to the non-controlling interests.

9. Accounting for temporary differences due to fair value adjustments

Recognition of assets and liabilities at fair values creates taxable / deductible temporary differences. IAS 12 'Income Taxes' states that a deferred tax liability is not recognised for taxable temporary differences arising at the time of initial recognition of goodwill. This is because goodwill is a residual amount (the difference between the purchase consideration paid by the parent co and the net assets of the subsidiary measured at fair value).

Deferred tax liability: an increase in the fair value of assets and decrease in the fair value of liabilities mean that the carrying value of the net assets in the consolidated financial statements is more than the tax base. As a result, in future, taxable profits will be greater than the accounting profits. This creates a taxable temporary difference which means that a deferred tax liability has to be recognised.

A deferred tax liability is recognised by making the following journal entry:

Dr	Goodwill	X	
Cr	Deferred tax liability		X

Being the entry to recognise deferred tax liability due to fair value adjustments

Deferred tax asset: a decrease in the fair value of assets and an increase in the fair value of liabilities mean that carrying value of the net assets in the consolidated financial statements is less than the tax base. As a result, in future, the taxable profits will be greater than the accounting profits. This creates a deductible temporary difference which means that a deferred tax asset has to be recognised.

A deferred tax asset is recognised by making the following journal entry:

Dr	Deferred tax asset	X	
Cr	Goodwill		X

Being the entry to recognise deferred tax asset due to fair value adjustments

The amount of deferred tax asset / liabilities will be calculated by using the tax rate on the difference between the opening and closing fair values.

2.5 Step acquisitions - new rules

An acquirer may obtain control of an acquiree in stages, by successive purchases of shares commonly referred to as a step acquisition. If the acquirer holds a non-controlling equity investment in the acquiree before acquiring control, that investment is remeasured to fair value as at the date of gaining control**. Any gain or loss on remeasurement is recognised in profit or loss.**

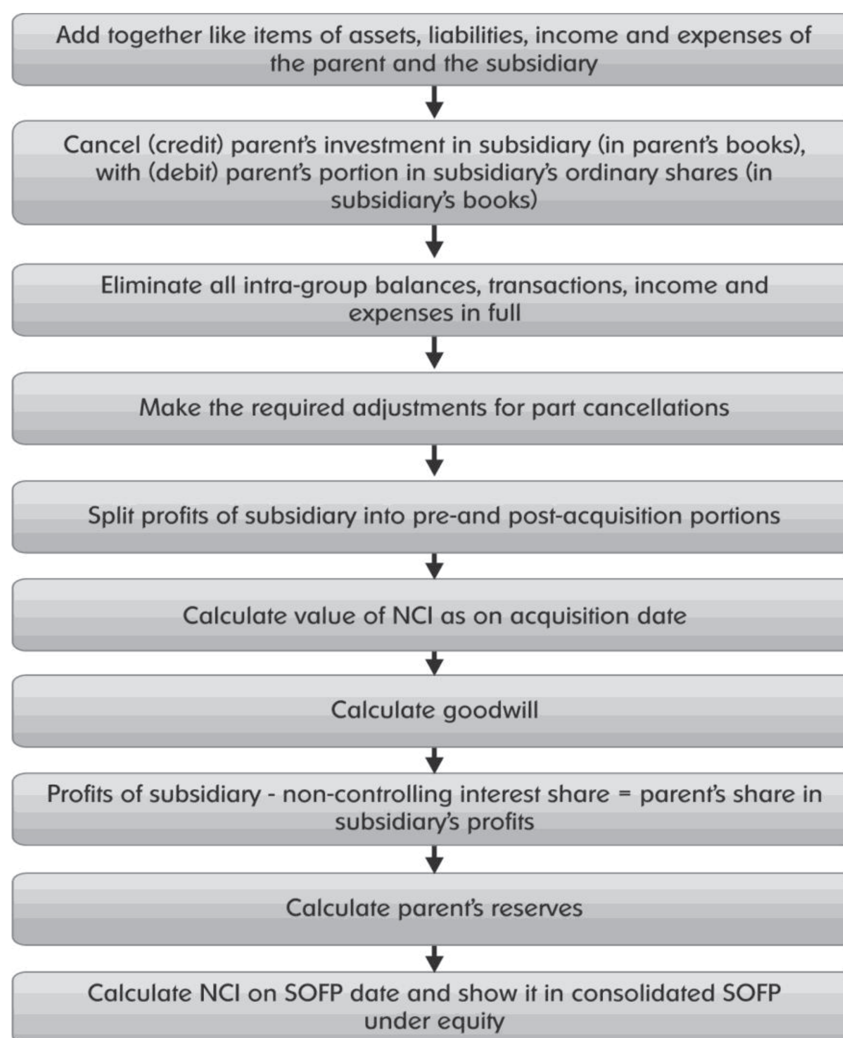
This is because a change from holding a non-controlling equity investment in an entity to obtaining control of that entity is regarded as a significant change in the nature of the investment. This results in a change in the classification (for example, associate to subsidiary) of the investment. This is a significant change from the cost accumulation model under the old IFRS 3 whereby goodwill was calculated separately for each purchase. If you have previously covered step acquisitions under the old rules, disregard the old rules and focus on the IFRS 3 approach as outlined here.

4	**Prepare and present financial statements and extracts from the financial statements of a group that presents consolidated financial statements taking into account a variety of transactions on the basis of chosen accounting policies and in accordance with IFRSs and local regulations.**
5	**Draft and advice upon suitable accounting policies based on a business scenario under local and international requirements for public and private sector entities including single and consolidated financial statements.**
6	**Identify from a given scenario a subsidiary, associate or joint venture according to IFRSs.**
	[Learning Outcomes d, e and f]

3.1 Consolidation procedures including inter-company transactions between group companies

IFRS 10 lays down the guidelines which have to be followed when preparing consolidated financial statements of a parent and its subsidiaries.

Diagram 10: Consolidation process



You may find the following points useful in understanding consolidation:

1. Non-controlling interest in the statement of financial position is made up of:

(a) The amount of non-controlling interest at acquisition: this is measured at either fair value or the non-controlling interest share of the fair value of the identifiable net assets of the acquiree at acquisition date, **plus**

(b) The non-controlling interest's share of changes in equity since the acquisition date i.e. post-acquisition profits.

2. Total comprehensive income is attributed to the owners of the parent and to the non-controlling interest even if this results in non-controlling interest having a debit balance in the consolidated statement of financial position.

3. Many exam questions include problems arising from inter-company transactions. This Learning Outcome of this Study Guide attempts to provide some clarity in relation to inter-company transactions and the elimination of URP where these transactions are between group companies. (Transactions between the group and associates are dealt with in paragraph 3.3 of this Learning Outcome).

3.2 Unrealised profit in inter-company transactions

IFRS 10 requires that any unrealised profit on inter-company transactions must be eliminated in full. Neither IFRS 10 nor IFRS 3 provide guidance as to the extent that the non-controlling interest should bear its share of the eliminated profit.

There are three possibilities:

1. Do not allocate URP to non-controlling interest, regardless of whether the parent or a subsidiary made the sale and the profit.
2. Allocate URP to the group and non-controlling interest in proportion, regardless of whether the parent or a subsidiary made the sale and the profit.
3. Allocate URP to the group and non-controlling interest in proportion only if a subsidiary made the sale and the profit. If the parent made the sale and the profit the whole of the URP adjustment is borne by the group.

A group has a choice of accounting policy.

If the first possibility is adopted, it would be on the basis that non-controlling interest is not a part of the group and, therefore, they should bear no part of the URP adjustment. Under the second possibility, the argument would be that the group and non-controlling interest are included in equity and, therefore, there should be no difference in treatment for controlling and non-controlling interests.

Under the third possibility, the argument is that the non-controlling interest is affected only if the profit or loss of a subsidiary is affected and, therefore, non-controlling interest should bear its share of the URP only if a subsidiary made the sale and the profit.

There are theoretical issues involved here and these are not adequately addressed in either IFRS 3 or IFRS 10. An exam question should tell you which policy to adopt in this regard. If there is no given information in the question it is, arguably, best to adopt the third possibility above (which, incidentally, was required practice in the UK until accounting went global).

How to account for URP? Here are the consolidation journals to help you understand.

Step 1: Eliminate the whole of inter-company sales / purchases:

Dr	Revenue	X	
Cr	Cost of sales		X

There is no effect on consolidated gross profit.

Step 2: Calculate the URP on goods that remain in the inventory of the buying company at the year-end.

Step 3: Eliminate the whole of the URP:

Dr	Cost of sales	X	
Cr	Inventory in the SOFP		X

Step 4: Calculate the deferred tax (DT) on the URP: this is URP x tax rate.

Tip

URP adjustments on consolidation give rise to temporary differences (TDs) in consolidated accounts. This is because the statement of financial position carrying value of inventory reduces but there is no change in the tax base of inventory. Accordingly, a deductible TD arises and this gives rise to a DT asset that should be recognised in the consolidated accounts.

Step 5: Account for the DT on the URP:

Dr Deferred Tax Asset	X	
Cr Tax charge in income		X

Step 6: Refer to the accounting policy adopted in relation to URP on consolidation. Is non-controlling interest to bear its share or not?

If not, allocate the profit after tax of the subsidiary to the non-controlling interest, without any adjustment:

Dr Consolidated SOPL	X	
Cr NCI in SOFP		X

If yes, allocate the profit after tax to the non-controlling interest after reducing it by the URP adjustment net of the deferred tax thereon. The reduced profit after tax is:

Dr Consolidated SOPL	X	
Cr NCI in SOFP		X

Example

P purchased 60% of the ordinary shares of S in 20X6. During the year ended 31 December 20X8:

1. P sold inventory to S at a transfer price of Tshs150,000. P has a gross profit margin on all sales of 20%. S retains all of these goods in its inventory at 31 December 20X8.

2. Data as in 1 except that S retains only 45% of these goods in its inventory at 31 December 2008.

3. S sold inventory to P at a transfer price of Tshs135,000. The goods were transferred at a mark-up of 25% of the cost. P retains one quarter of these goods in its inventory at 31 December 20X8.

The normal accounting policy the P group is to eliminate the whole of any unrealised profit on sales, downstream and upstream, between P and S and to charge the non-controlling interest with its share only if the subsidiary made the sale.

The tax rate is 25%. Recognise the deferred tax implications of unrealised profit adjustments in consolidated accounts.

Required:

Calculate the URP to be eliminated in respect of the three sales outlined above and prepare journal entries for the purpose of adjusting the consolidated accounts of the P group as at and for the year ended 31 December 20X8.

Answer

1. P to S (downstream transaction)

Profit on sale Tshs30,000 (20% x Tshs150,000). All of the goods remain in the inventory of the buying company at the year-end and the URP to be eliminated on consolidation is Tshs30,000. There is no charge to the non-controlling interest as the parent made the sale.

	Tshs	**Tshs**
Dr Revenue	150,000	
Cr Cost of sales		150,000
Being elimination of the intra-group transaction on consolidation		
Dr Consolidated profits (cost of sales)	30,000	
Cr Inventory in SOFP		30,000
Being elimination of URP on consolidation		
Dr Deferred tax asset (25% x Tshs30,000)	7,500	
Cr Tax charge in SOPL		7,500
Being accounting for deferred tax on URP)		

Continued on the next page

Allocate the profit after tax of S to non-controlling interest by DR consolidated profit and CR non-controlling interest in the statement of financial position. Do not adjust profit after tax of S for any URP (net of DT) adjustments.

2. P to S (downstream transaction)

Profit on sale as above Tshs30,000. Only 45% of the goods sold remain in the inventory of the buying company at the year-end and, therefore, the URP to be eliminated on consolidation is Tshs13,500 (45% x Tshs30,000).There is no charge to the non-controlling interest as the parent made the sale.

	Tshs	Tshs
Dr Revenue	150,000	
Cr Cost of sales		150,000
Being elimination of the intra-group transaction on consolidation		
Dr Consolidated profits (cost of sales)	13,500	
Cr Inventory in SOFP		13,500
Being elimination of URP on consolidation		
Dr Deferred tax asset (25% x Tshs13,500)	3,375	
Cr Tax charge in SOPL		3,375
Being accounting for deferred tax on URP		

Allocate the profit after tax of S to non-controlling interest by DR consolidated profit and CR non-controlling interest in the statement of financial position. Do not adjust profit after tax of S for any URP (net of DT) adjustments.

3. S to P (upstream transaction)

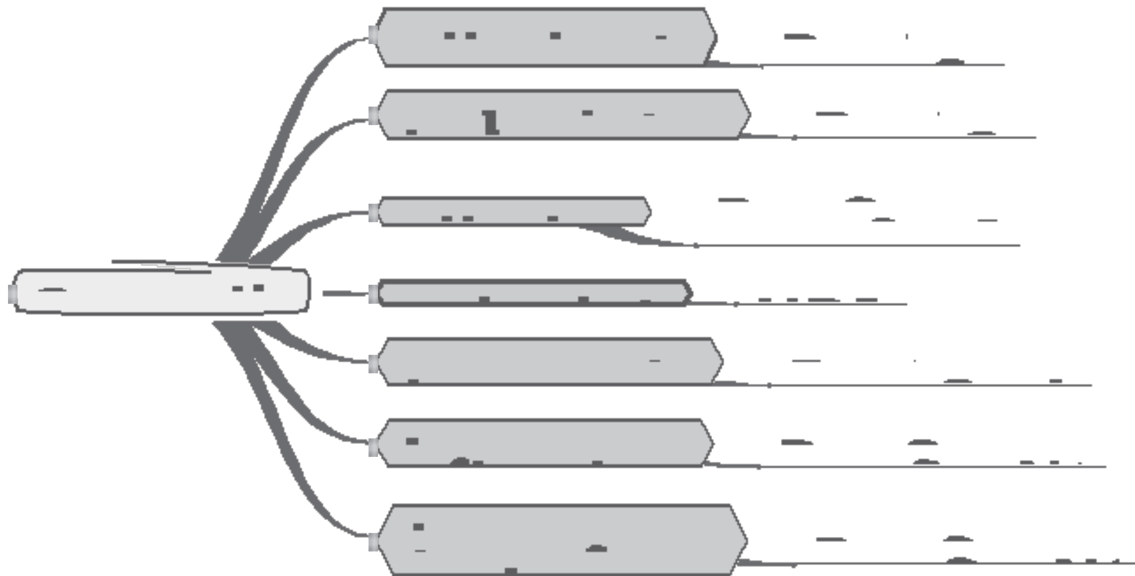
Profit on sale Tshs27,000 (25/125 x Tshs135,000). One quarter of the goods sold remain in the inventory of the buying company at the year-end and, therefore, the URP to be eliminated on consolidation is Tshs6,750 (1/4 x Tshs27,000). The non-controlling interest will be charged with its share as the subsidiary made the sale.

	Tshs	Tshs
Dr Revenue	135,000	
Cr Cost of sales		135,000
Being elimination of the intra-group transaction on consolidation		
Dr Consolidated profits (cost of sales)	6,750	
Cr Inventory in SOFP		6,750
Being elimination of URP on consolidation		
Dr Deferred tax asset 25% x Tshs6,750	1,688	
Cr Tax charge in SOPL		1,688
Being accounting for deferred tax on URP		

Allocate the profit after tax of S to non-controlling interest by DR consolidated retained earnings and CR non-controlling interest in the statement of financial position.

Adjust profit after tax of S for any URP (net of DT) adjustments. Reduce the S profit after tax to be allocated to non-controlling interest by Tshs5,062 (Tshs6,750 – Tshs1,688).

SUMMARY



Important

Part-cancellations - In real life, not all intra-group transactions as recorded in the books of the subsidiary and parent match or fully cancel each other. Refer the example below.

Example

Few reasons why intra-group transactions may not match each other are:

There could be goods in transit and cash in transit as at the reporting date.
Loan stock may be issued by one company to the other, but the other company may not have taken it up entirely.
A cheque issued by one company to the other may not have been realised in the other's bank account.

3.3 Accounting for associates and joint arrangements

You are already familiar with accounting for associates after studying the Paper B2. However accounting for joint arrangements in consolidated financial statements is new to you. In this Learning Outcome, we will discuss in detail the accounting for interest in joint arrangement, along with a quick revision of accounting for associates.

The relevant accounting standards applicable to accounting for joint arrangement are:

IAS 28 Investment in Associates and Joint ventures
IFRS 11 Joint arrangements

1. Associates

Definition

An **associate** is an entity over which the investor has significant influence.

Significant influence is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.

IAS 28 Para 3

Equity accounting

IAS 28 states that **investments in associates** shall be accounted for using the **equity method.** The equity method of accounting is used because the investor, in an associate company, is actually the non-controlling interest of the associate company.

Consolidation (explained below) is not suitable because the investor does **not have control** over the assets and liabilities of the associate company. It can only exert significant influence. Hence consolidation would depict a misleading picture of the assets and liabilities of the group.

Definition

Equity accounting is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

IAS 28 Para 3

Principles of equity accounting

Under this method:

(i) In the consolidated statement of financial position

On date of acquisition: The **investment** in the associate company is **stated at cost.**

After acquisition: Every year, the investment in associate company will be reflected in the consolidated statement of financial position after making the following adjustments:

(a) If the associate makes a profit: Group share of **profit** will be **added** to **investment.**
(b) If the associate makes a loss: Group share of **loss** will be **deducted** from **investment**

The procedures used for determining the profit / loss under the **equity method** are similar to those used for determining profit/loss under the **full consolidation method.**

(ii) In the consolidated statement of profit or loss

(a) The group's share in the pre-acquisition profits of the associate company

On the date of acquisition, the pre-acquisition profits have to be revised, to incorporate all fair value adjustments. The group's share in this revised profit will be **deducted from consideration** in arriving at **goodwill.** (The accounting treatment of goodwill for associates is explained in the below paragraphs).

(b) The group's share in the post-acquisition profits of the associate company is included in the consolidated statement of profit or loss.

Example

Silk Co owns 35% in Cotton Co. The profits of Cotton Co as on the date of acquisition, after making all fair value adjustments, are Tshs2,500 million.

Required:

What part of these profits will be included as income in the consolidated statement of profit or loss?

Answer

Silk Co's share in the adjusted **pre-acquisition profits** of Cotton Co is 35% x Tshs2,500 million = Tshs875 million. However, these profits will **not** be included in the consolidated statement of profit or loss. Tshs875 million will be **included in the net assets** when calculating **goodwill.** On the end of the reporting period, the **post-acquisition profits** will be revised to incorporate all fair value adjustments. The group's share in the revised post-acquisition profits is included in the consolidated statement of profit or loss.

Procedures to be followed for the equity method of accounting

(a) Eliminate group's share in **unrealised intra-group profits**

(i) Downstream transactions

If the sale of goods / assets at profit / (loss) is made by **the investor to the associate,** it is known as a **downstream transaction.**

The journal entry to eliminate group's share in **unrealised intra-group profits** when there are **downstream transactions** and the goods are still held by the associate, is:

Dr	Cost of sales (reflected in consolidated SOPL)	X	
Cr	Investment in associate (reflected in consolidated SOFP)		X

Being the elimination of group's share in unrealised intra-group profits

This will have the effect of eliminating the investor company's share of the profit made on the sale to the associate. Remember that a part of the profit has been realised, as the associate is owned by other third parties. Only the portion which is related solely to the investor should be eliminated.

The journal entry to eliminate group's share in **unrealised intra-group losses** when there are **downstream transactions** is:

Dr	Investment in associate (reflected in consolidated SOFP)	X	
Cr	Cost of sales (reflected in consolidated SOPL)		X

Being elimination of group's share in unrealised intra-group losses

Tip

Only the **group's share in unrealised profits has to be eliminated** from profits when accounting for associates using the equity method of accounting.

Do not make the common error of deducting unrealised profits in full.

(ii) Upstream transactions

If the sale of goods / assets at profit is made by **the associate to the investor**, it is known as an **upstream transaction.**

The adjustment made to eliminate group's share in **unrealised intra-group profits**, when there are **upstream transactions** and the inventory is still held by the associate, is

Dr	Cost of sales	X	
Cr	Inventory		X

Being reduction in URP on inventory due to upstream transactions

This will have the effect of reducing the inventory value in the statement of financial position and correspondingly in the statement of profit or loss and OCI too.

The adjustment made to eliminate group's share in **unrealised intra-group loss**, when there are **upstream transactions** is

Dr	Inventory	X	
Cr	Cost of sales		X

Being increase in URP on inventory due to upstream transactions)

This will have the effect of increasing the inventory value in the statement of financial position and correspondingly in the statement of profit or loss and OCI too.

Joyful Co invested Tshs20 million and holds 30% of Content Co. The post-acquisition profit of Content Co is Tshs2 million.

The inventory of Joyful Co includes Tshs1.5 million of purchases made from Content Co. Content Co has made a profit of Tshs0.3 million on this sale to Joyful Co.

Required:

Determine the group share of associated company profit.

Answer

Joyful Co owns 30% share in Content Co. Hence, Content Co is an associate of Joyful Co. The sale of goods is an upstream transaction. URP in the inventory of Joyful Co is Tshs0.3 million.
Group share = 30% x Tshs0.3 million = Tshs0.09 million.

The journal entry to be passed is:

		Dr	Cr
Dr	Cost of sales	Tshs0.09 million	
Cr	Inventory		Tshs0.09 million

Being elimination of URP for sale of goods from Content to Joyful

Joyful's share in profit of Content will be Tshs0.6 million (Tshs2 million x 30%) and Tshs0.9 million will be reduced from the consolidated retained earnings.

The amount of investment in Content will be shown in the CSOFP as:

	Tshs'000
Amount invested	20,000
Add: Post-acquisition profit (Tshs2,000 x 30%)	600
	20,600

Summary

Elimination of URP	Debit	Credit
Sale of goods from investor to associate	Cost of sales	Investment in associate
Sale of goods from associate to investor	Cost of sales	Inventory

Tip

In the case of downstream transactions, URP is included in the associate's inventory. However associate's inventory is not shown in the investor's financial statements as it does not consolidate the accounts of the associate. Therefore the URP should be eliminated from the investment and not from inventory.

In the upstream transaction, URP is in the investor's inventory which we show in the consolidated financial statements, and therefore it should be eliminated from the inventory. The corresponding effect will always be in the retained earnings.

(b) Goodwill

Goodwill is calculated as follows:

	Tshs
Cost of investment	X
Less: investor's share of the net fair value of the associate's identifiable net assets	(X)
Goodwill	X

Accounting treatment

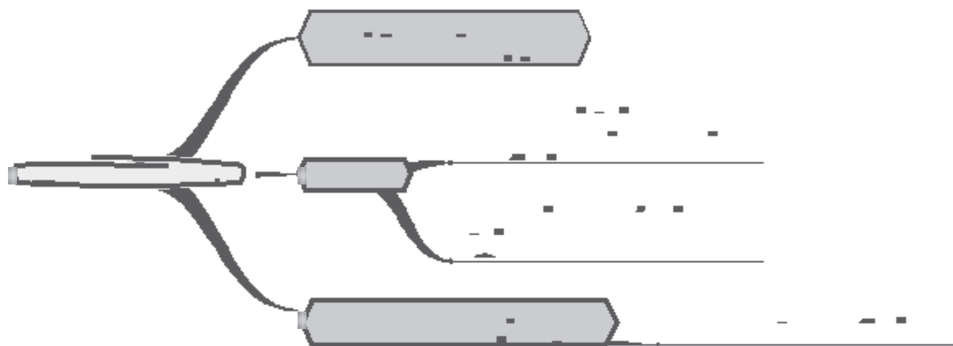
Positive goodwill is already **included (inherent) in the cost of investment,** and so needs no further accounting treatment.

Gain on bargain purchase is added to the carrying amount of the investment and included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.

All adjustments made for goodwill impairment and fair value changes in accounting for subsidiaries are also made in accounting for associates.

If the group's share in the losses of the associate exceeds its investment in the associate, then the investor has to stop accounting for further losses. The cost of investment will be recorded at nil in the consolidated financial statements. Any further loss will be reflected in the consolidated financial statements only if the investor has directly made some payment or guarantees on behalf of the associate.

SUMMARY



The following are some important points.

(i) Do not use the equity method for an associate in consolidated accounts if there is evidence that the investment is acquired and held exclusively with a view to its disposal within twelve months from acquisition and management is actively seeking a buyer.

(ii) An investor should discontinue the use of equity accounting from the date it ceases to have significant influence over an associate. On loss of associate status, the investment should be accounted for under IFRS 9 unless it has become a subsidiary.

(iii) In the separate financial statements of the investor, investments in associates should be accounted for either at cost or under IFRS 9. The equity method of accounting is not used in the separate financial statements of the investor.

(iv) There are new rules in dealing with a change in the status of associates:

Following IFRS 3, the loss of control over an entity and the loss of significant influence over an entity are economically similar events and should be accounted for similarly.

The loss of significant influence is an economic event that changes the nature of the investment.

When an investor loses significant influence (recall the factors that give rise to significant influence from your Paper B2 Financial Accounting), the investor measures any retained investment at fair value. Any difference between the carrying amount of the associate when significant influence is lost, the disposal proceeds (if any) and the fair value of any retained interest is recognised in profit or loss.

Tip

See Self Examination Question 3 for accounting for associates using the equity method.

2. Joint Arrangements

Definition

Joint arrangement is an arrangement of which two or more parties have joint control.

(IFRS 11 Appendix A)

Definition

Joint Control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the **relevant activities** require the unanimous consent of the parties sharing control

(IFRS 11 Appendix A)

Important

To identify the existence of joint arrangement according to IFRS 11:

First we need to analyse whether collective control exists; and
then we need to analyse the contractual arrangement to ascertain whether the parties to the contract possess joint control over the arrangement.

Note: control, group, holding company and subsidiary bear the same meaning as in IFRS 10.

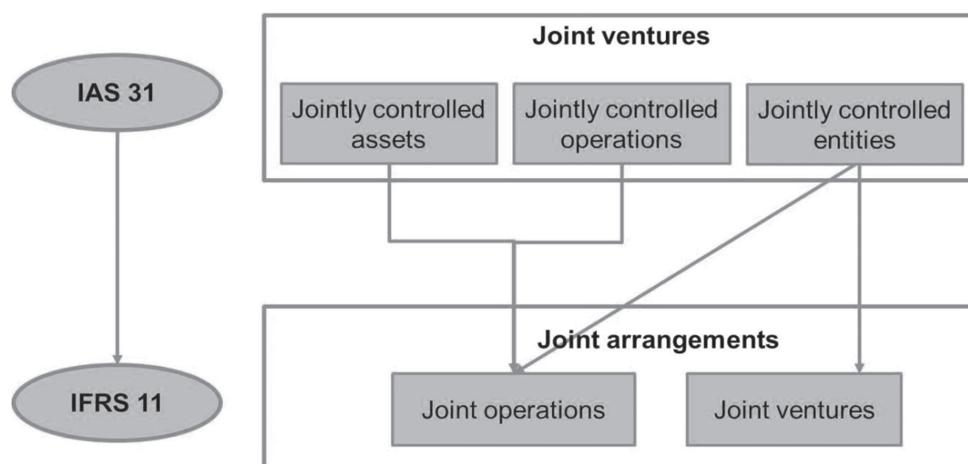
Collective control has not been defined in IFRS 11; however, it can be interpreted as the ability of all the parties to the contract to collectively exercise control.

Thus, the standard requires that at the first stage, it should be assessed whether all the parties collectively exercise control over the arrangement.

Joint control exists only when decisions related to relevant activities (activities that significantly affect the returns of the joint arrangement) require unanimous consent of the parties sharing the control.

Thus, in the case of joint control, a single party or parties holding the majority of stake cannot take decisions without the consent of other party/parties to the contract.

Diagram 11: Change in terminology from IAS 31 to IFRS 11



The **characteristics of a joint arrangement** are

(i) The **existence of a contract** between two or more parties

This is the main feature which distinguishes a joint arrangement from an investment in an associate. There is no contractual agreement when there is an investment in an associate while a contract always exists when there is a joint arrangement.

A contract is usually in writing and contains:

- The activity, duration and reporting obligations of the joint venture
- The appointment of the board of directors or equivalent governing body of the joint venture
- The voting rights of the venturers (the parties to the contract)
- The capital contributions by the venturers; and
- The sharing by the venturers of the output, income, expenses or results of the joint venture.

(ii) As a result of this contract the parties exercise joint control over the resulting arrangement.

The main characteristic of joint control is the requirement of **unanimous consent** of the parties sharing control **before any financial or operating decision can be taken**. This means that all the parties to the contract are on the same footing and no party is superior to the other.

The contract may decide that one party is the operator of the joint arrangement. This does not mean that the operator has more control than the others. The operator has to abide by the financial and operating decisions taken by all the parties.

Example

Entities A, B, C and D each hold a 25% interest in Alpha Inc. Decisions in Alpha Inc need to be approved by a 75% vote of the parties.

Alpha Inc is not jointly controlled. For there to be joint control, the voting arrangements would have to require unanimous agreement between those sharing the joint control of Alpha Inc. The voting arrangements of Alpha Inc allow agreement of any combination of three of the four investors to make decisions.

The standard refers to this as collective control. Each investor will account for its interest in Alpha Inc as an associate since each entity is presumed to have significant influence, but not joint control.

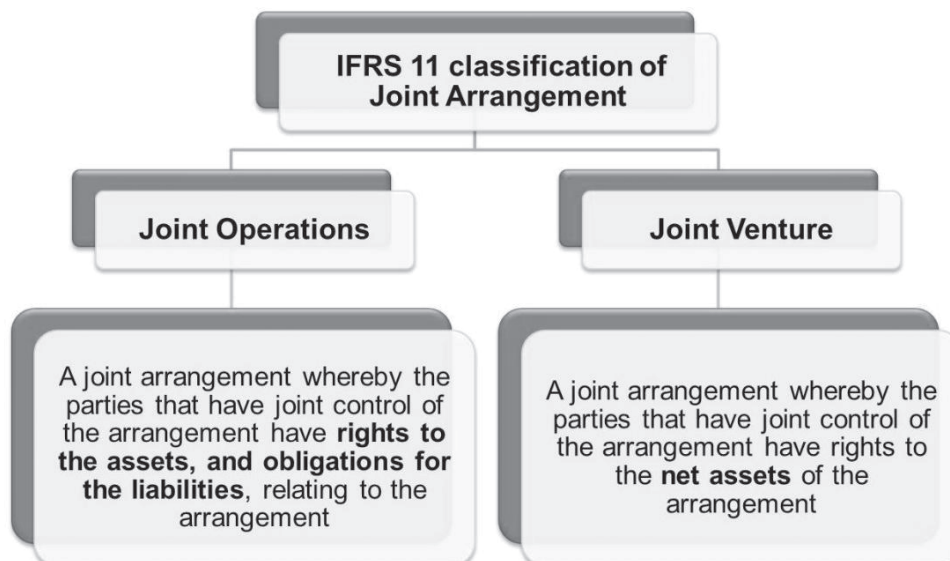
Test Yourself 5

Geeta and Anjali have entered into a contract to design and produce clothes for sale in a boutique. They have decided to contribute equally towards the capital and share profits or losses equally. However, it has been decided that Anjali will have the final say about the designs of the clothes.

Required:

Determine whether this activity is a joint venture.

Diagram 12: IFRS 11 Joint Arrangements identifies two different types of joint arrangements:



(a) Joint Operation

Joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement

(IFRS 11 appendix A)

In this type of joint arrangement, the venturers referred to as joint operators have rights over the assets and obligations for the liabilities relating to the joint arrangement.

Each joint operator may:

Use its own property, plant and equipment and carry its own inventories
Incur its own expenses and liabilities
Raise its own finance, which represents its own obligations

Or, each joint operator may have joint control and often the joint ownership of one or more assets:

Contributed to or acquired for the purpose of the joint arrangement; and
Dedicated to the purposes of the arrangement.

Each joint operator may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

The joint venture agreement usually states how the revenue from the sale of the joint product and any expenses incurred in common is to be shared among the joint operators.

Airship and Chelot enter into a contract to combine their operations, resources and expertise to manufacture and sell an aircraft. According to the contract:

Different parts of the manufacturing process are carried out by each of the venturers
Each venturer bears its own costs of manufacture
The common expenses and revenue from the sale of the aircraft to be split according to the proportion of direct expenses incurred

A joint arrangement of this type is a joint operation.

In the case of oil, gas and mineral extraction industry, a number of oil production companies jointly control and operate an oil pipeline.

Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline.

Accounting treatment

While accounting for its share in the joint operation, a joint operator recognises in its books:

its assets, including its share of any assets held jointly;
its liabilities, including its share of any liabilities incurred jointly;
its revenue from the sale of its share of the output of the joint operation;
its share of the revenue from the sale of the output by the joint operation; and
its expenses, including its share of any expenses incurred jointly.

A joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant IFRSs.

(b) Joint Venture

Definition

Joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

(IFRS 11 appendix A)

In this type of joint arrangements, the **venturers establish a corporation, partnership or other separate entity in order to undertake an economic activity**.

The entity operates in the same way as other entities.

The only distinguishing feature is that there exists a contract between the venturers in order to establish joint control over the financial and operating decisions relating to the activity.

Case Study

Prestige Ltd, company located in Tanzania has entered into an Tshs82 million arrangement with two Malaysian companies – Cosmo and MAH Steel Corp.

Their plan is to build a new domestic facility which will produce spiral welded pipe for the natural gas industry. This new venture is called Spiral Pipe LLC.

According to the agreement, unanimous consent of all the parties is required for decision making, and no party to the contract has proportionate interest in the assets or liabilities.

In the case study given above:

Spiral Pipe LLC is a joint venture. Prestige Ltd, Cosmo and MAH Steel Corp are referred to as the venturers.

Example

Milky Group, a real estate fund, has obtained an investment in entity T in a relatively undeveloped country. The in-country requirements for foreign ownership of T do not permit a local entity to be controlled by a foreign entity.

Milky Group therefore enters into a shareholders' agreement with a local investor B, whereby documents are drawn up showing that whilst voting control of the company is with investor B, all decisions will need to be ratified by Milky Group before B can proceed. The agreement also confirms that the assets of the arrangement are owned by the company. Neither party will be able to sell, pledge, transfer or otherwise mortgage the assets.

What kind of arrangement is this and how will it be accounted for in the consolidated accounts of Milky Group?

Answer:

Under IFRS 11, Milky Group needs to consider the type of joint arrangement. On the basis of the contractual rights and obligations, the arrangement would be considered a joint venture, as A has a right to the net assets of T. IFRS 11 requires all joint ventures to use the equity accounting method outlined in IAS 28.

Accounting treatment

Joint venture has to maintain its own accounting records and prepare and present financial statements in the same way as other entities according to the requirements of the International Financial Reporting Standards. Each venturer usually contributes cash or other resources to the joint venture. These contributions are included in the accounting records of the venturer and recognised in its financial statements as an **investment in the joint venture**.

Example

In the case study given above any cash or other resources given to the jointly controlled entity United Spiral Pipe LLC, by the venturers United States Steel Corp, Posco and Seah Steel Corp will be recorded in their individual financial statements as 'Investment in United Spiral Pipe LLC'.

A venturer should recognise its interest in a joint venture using the equity method.

(c) Equity method

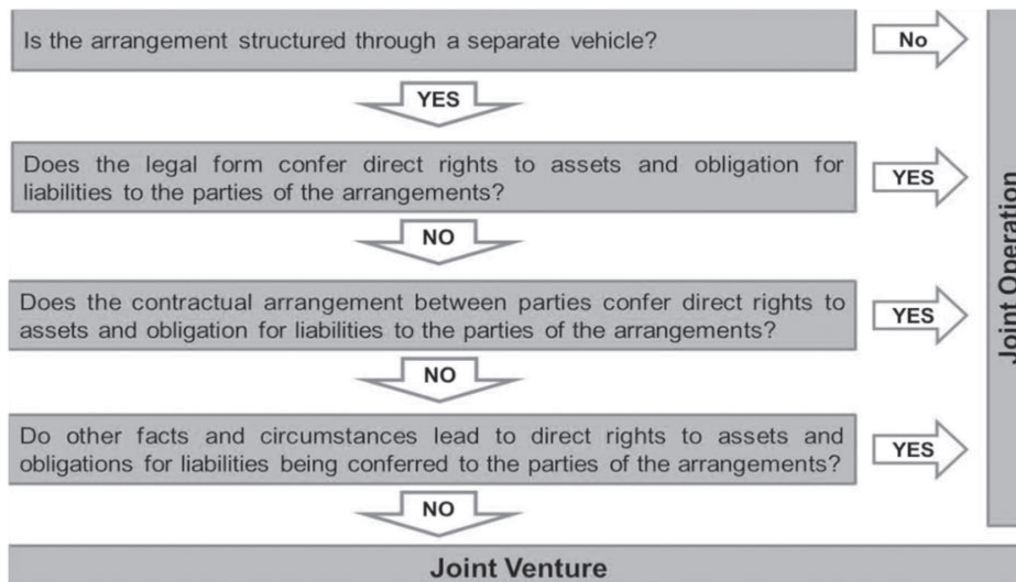
This has been discussed while explaining the consolidation of accounts of associates. The same procedure has to be followed while consolidating the accounts in case of joint control which are joint ventures.

(d) Guidance on classification of joint arrangements

A joint arrangement which is not in the form of a separate vehicle (generally a separate legal entity) will be compulsorily classified as a joint operation.

If the joint arrangement is in the form of a separate vehicle, following criteria are to be assessed

Diagram 13: Determine the classification of joint arrangements



(a) Legal form

If in accordance with the legal form, parties have rights to assets and obligation for liabilities - and not the entity - then the arrangement is a joint operation.

(b) Contractual arrangement

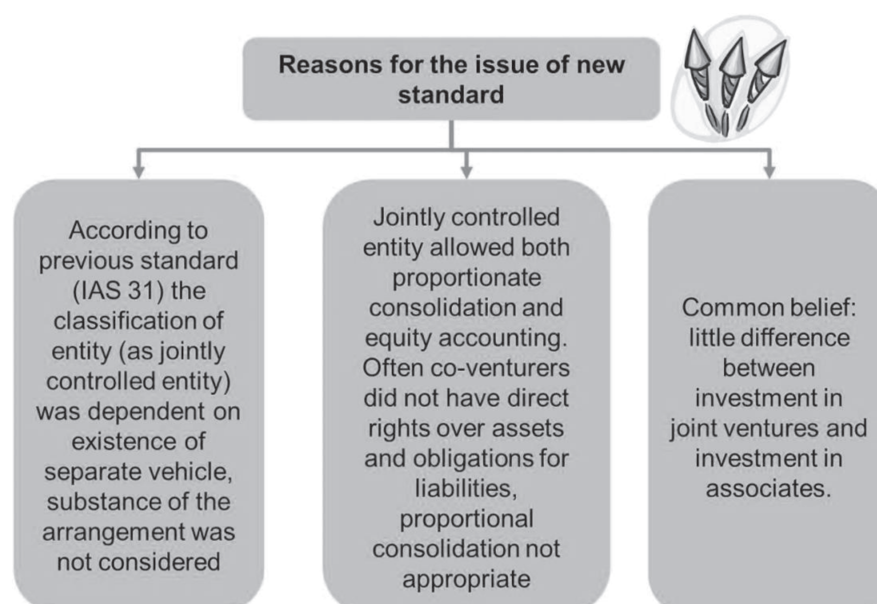
If in accordance with the contractual arrangement, parties have rights to assets and obligation for liabilities - and not the entity - then the arrangement is a joint operation.

(c) Other facts and circumstances

Even after considering the above criteria, if the distinction is not clear, verify other facts and circumstances. If they state that the parties are separately entitled to assets and liabilities and not the entity as a whole, then the arrangement is a joint operation.

If the joint arrangement is not a joint operation, it is a joint venture.

Diagram 14: Why new standard



Tip

See Self Examination Question 5 for accounting for joint arrangements

3.4 Accounting policies to be followed in consolidation process

Typically all the companies who follow IFRS / IAS disclose the basis of measurement of subsidiary, associates and joint operation. Tanzania migrated to IFRSs, IPSASs and ISAs with effect from 1st July, 2004 and therefore, every entity in the country, whether small or large, was required to prepare its financial statements in accordance with the IFRSs or IPSASs as the case may be.

An example of a disclosure regarding accounting policies followed during the consolidation will include the following disclosures:

ABC Group – Notes to consolidated financial statements

Business combination

The Group applies the acquisition method in accounting for business combinations. The consideration transferred by the Group to obtain control of a subsidiary is calculated at the fair value of consideration paid on the acquisition-date. Acquisition costs are expensed as incurred. The Group recognises identifiable assets acquired and liabilities assumed in a business combination regardless of whether they have been previously recognised in the acquiree's financial statements prior to the acquisition. Assets acquired and liabilities assumed are generally measured at their acquisition-date fair values. It is a groups' policy to measure non-controlling interests at the proportionate value of the net assets of the subsidiary acquired.

Goodwill from acquisition of a subsidiary is recognised as a separate identifiable intangible assets. It is calculated as the excess of the sum of fair value of consideration transferred plus the recognised amount of any non- controlling interest in the acquiree plus acquisition-dated fair value of any existing equity interest in the acquiree less acquisition-dated fair values of identifiable net assets. If the fair values of identifiable net assets exceed the sum calculated above, the excess amount is treated as a gain on a bargain purchase and is recognised in the statement of profit or loss immediately.

Investment in associates

Investments in associates are initially recognised at cost and subsequently accounted for using the equity method. Any goodwill or fair value adjustment attributable to the Group's share in the associate is not recognised separately and is included in the amount recognised as investment in associates.

Tip

In the exam, you will be examined on preparation of a consolidated statement of financial position or consolidated statement of profit or loss or consolidated statement of changes in equity. While doing this, remember the following summary of the accounting treatment:

Investment	Type	Accounting treatment
Investment > 50% -- Control	Subsidiary	Full consolidation
20% < Investment < 50% -- Significant influence	Associate	Equity method
In case of Joint control	Joint Venture	Equity method
In case of Joint control	Joint Operation	Share of assets, liabilities, income and expenses in a joint operation
20% < Investment and not a joint venture	None of the above	In accordance with IFRS 9

With the help of the above guidance, you will be able to identify circumstances a subsidiary, associate or joint venture. Further the detailed guidance given in IFRS 10, IAS 28 and IFRS 11 needs to be applied to identify a subsidiary, associate and a joint venture.

Additionally, you may refer Learning Outcome 1 of this Study Guide for detailed guidance on identifying situation of control and significant influence.

Let us set out the steps to be taken in preparing consolidated financial statements (to include a single subsidiary and an associated company or a joint venture)

1. Establish the relationship between the companies given in the question.

2. Carefully read the additional information given and link it to the items that need adjustment. Be careful some items in the individual financial statements may need more than one adjustment.

3. Read the requirements, prepare a proforma (suggested proforma given below) of the consolidated financial statements (consolidated statement of financial position or consolidated statement of profit or loss whichever is asked for), and write at least the main headings. The subheadings can be added to the extent shown by items in the individual financial statements given in the question.

4. Do not forget to add one line in the proforma for goodwill, one for non-controlling interest and for deferred tax liability / asset if acquired from subsidiary.

5. Prepare proforma of following workings:

   Goodwill
   Retained earnings
   Consideration in subsidiary (if not given directly in the question)
   Non-controlling interest

   The others depend upon the additional information given in the question, the common ones being:

   URP in inventory
   Goods / cash in transit
   Fair value adjustments

6. Read the items in the financial statements given in the question and also the relevant additional information, if any, one by one:

   Apply the correct IFRS provisions.
   Cancel any intra-group transactions and transfer balances to workings / consolidated financial statements if there are part-cancellation items.
   Link workings to the consolidated financial statements.
   Transfer the result of the workings to the financial statements.
   Mark the items in the question that have been dealt with up to this point.

7. Add the remaining like items from the individual financial statements and write them at the appropriate places in the consolidated financial statements.

8. Balance or total the individual components of the consolidated financial statements.

9. Cross-check with the other components where a link is expected e.g. consolidated statement of profit or loss to consolidated statement of financial position.

10. If the consolidated statement of financial position does not balance, quickly recheck whether all the items have been taken and/or calculated correctly.

Tip

In the exam, 9 times out of 10 your consolidated SOFP will not balance, probably because of a small mistake made somewhere. It is NOT WORTH spending time working out where this mistake is, as it will not get you many extra marks. It is better to go on to the next question, where you have a better chance of obtaining more marks! If you have time at the end of the paper, go back and check for the mistake.

The important working notes to be prepared are given below:

(a) Retained earnings

	Parent	Subsidiary	Associate
According to question	X	X	X
Less at acquisition		(X)	(X)
Post-acquisition profit		X	X
Less adjustments		(X)	(X)
Balance		X	X
Add share of Subsidiary (%)	X		
Add share of Associate (%)	X		
Less adjustments	(X)		
To consolidated SOFP	X		

(b) Goodwill

Proforma - Goodwill on purchase of shares in ___________	Tshs	Tshs
Consideration		X
Fair value of Non-controlling interest at the date of acquisition		X
		X
Less: net assets represented by		
Equity shares	X	
Share premium	X	
Fair value adjustments	X	
All other pre-acquisition reserves	X	
Deferred tax asset / (liability)	X/(X)	
Total	X	(X)
Goodwill on purchase of shares in ______________		X
Less: Impairment loss (if any)		(X)
To consolidated SOFP		X

Tip

Positive goodwill – recognise as intangible non-current asset in the consolidated SOFP.
Gain on bargain purchase goodwill – recognise as income in the consolidated SOPL.

(c) Non-controlling interest

Proforma - Non-controlling interest of ______________	Tshs	Tshs
Fair value/share in fair value of net assets (NCI's share) at the acquisition date	X	
Post-acquisition reserves (NCI's share)	X	
Total	**X**	**X**

Tip

Both the pre and post-acquisition portion of all the reserves of the subsidiary are included while determining the non-controlling share in the net assets and liabilities of the subsidiary.

(d) Consideration (if not given directly in the question)

Sometimes consideration is discharged by issuing shares of the parent company in exchange for the shares of the subsidiary company. In such a case, the amount of consideration should be calculated by using the exchange ratio given and the acquisition-date market value of the parent's shares.

Tip

The journal entry for this transaction is –

Dr	Investment	X	
	Cr Share capital		X
	Cr Share premium (if acquired at a premium)		X

Being investment in ____________ accounted for

Add any more workings according to the adjustments given in the question.

7. Evaluate and apply the knowledge of group accounting in situations of complex group structures.

[Learning Outcome g]

4.1 Complex group structures - indirect holdings

We have already discussed piecemeal acquisitions in Learning Outcome 2 of this Study Guide. It is essential that you are able to deal with indirect holdings in consolidated accounts.

The various important provisions of complex group structure are as follows:

1. The legal definition of a subsidiary includes the situation where a parent of one subsidiary is also the parent of a subsidiary of that subsidiary.

Example

If Andy Ltd is the parent of Bold Ltd, and Bold Ltd has its own subsidiary Cold Ltd, then Cold Ltd is a subsidiary of Andy Ltd.

This is because Andy Ltd must, by definition, exercise control over an undertaking that is controlled by another undertaking controlled by Andy Ltd.

2. If we assume, in the normal situation, that one share carries one vote,

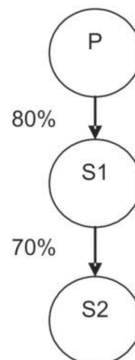
(a) the **first step** is to establish whether control is exercised. For this purpose you must consider the actual % of shares held by each investor company. Do not take account of shares held by associates of the parent.

(b) If control is exercised, the **second step** is to establish effective shares held by the ultimate parent company. Effective shares are relevant to the calculation of goodwill, non-controlling interest and consolidated retained earnings.

4.2 Vertical Group

In vertical group, the parent company (P) owns a subsidiary (S1) and the subsidiary also owns its own subsidiary (S2). Thus, parent company indirectly controls a company (S2) through its subsidiary (S1). Hence (S2) is described as a sub-subsidiary of parent (P).

Diagram 15: Vertical group



Example

A Ltd owns 80% of B Ltd and B Ltd owns 60% of C Ltd.

Is C Ltd a subsidiary of A Ltd group?

FIRST, establish whether or not the A Ltd group exercises control over C Ltd. Consider the A Ltd group holdings in C Ltd:

Held by A Ltd nil
Held by B Ltd 60%

As the A Ltd group owns 80% of B Ltd and B Ltd owns 60% of C Ltd, it can inferred that A Ltd holds more than 50% of the shares in C Ltd. **Therefore C Ltd is a subsidiary of the A Ltd group.**

SECOND, consider the effective share of the A Ltd group in C Ltd. This is 80% x 60% or 48%. The fact that this is less than 50% is irrelevant in determining whether C Ltd is a subsidiary of the A Ltd group. Use the effective percentage when you calculate goodwill, non-controlling interest and consolidated retained earnings.

For classification purposes, note that a subsidiary of a subsidiary will always be treated as a subsidiary of the parent of the first subsidiary.

Acquisition date in a vertical group

The acquisition date for a sub-subsidiary in a vertical group depends on whether:

- the holding company P acquired its shares in subsidiary S1 before S1 acquired its shares in the sub-subsidiary S2, or
- the holding company P acquired its shares in subsidiary S1 after S1 acquired its shares in the sub-subsidiary S2.

The rules are as follows:

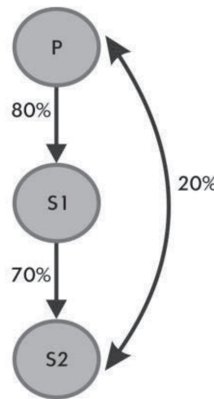
- If the holding company P acquired its shares in subsidiary S1 before S1 acquired its shares in the sub-subsidiary S2, the date that S2 becomes a member of the P Group is the date that S1 acquired the shares in S2.
- If the holding company P acquired its shares in subsidiary S1 after S1 acquired its shares in the sub-subsidiary S2, the date that S2 becomes a member of the P Group is the date that P acquired its shares in S1.

Pre-acquisition reserves and post-acquisition reserves are calculated for each subsidiary and sub-subsidiary from its date of acquisition.

4.3 Mixed Group

A mixed group is also called a D shaped group. Consider the following diagram and you will understand why it is called as D shaped group.

Diagram 16: Mixed group



Example

Mixed or D shaped group

A Ltd owns 55% of B Ltd and 30% of C Ltd. B Ltd owns 36% of C Ltd.

Is C Ltd a subsidiary of the A Ltd group?

FIRST establish whether the A Ltd group exercises control over C Ltd, first determine A Ltd group holdings in C Ltd:
Held by A Ltd 30%
Held by B Ltd 36%

As the A Ltd group owns more than 50% of the shares in C Ltd, C Ltd is a subsidiary of the A Ltd group.

SECOND, consider the effective share of the A Ltd group in C. This is 49.8% (30% + (55% x 36%)). The fact that this is less than 50% is irrelevant in determining whether C Ltd is a subsidiary of the A Ltd group.

Use the effective % when you calculate goodwill, non-controlling interest and consolidated retained earnings.

Example

Mixed or D shaped group

A Ltd owns 60% of B Ltd and 49% of C Ltd. B owns 45% of D Ltd and C Ltd owns 55% of D Ltd. A Ltd exercises significant influence over C Ltd.

Is D Ltd a subsidiary of the A Ltd group?

FIRST establish whether the A Ltd group exercises control over D Ltd, consider the A Ltd group holdings in D Ltd as follows:
Held by A Ltd Nil
Held by B Ltd 45%
Held by C Ltd not relevant as C Ltd is not a subsidiary of A Ltd

As the A Ltd group owns less than 50% of the shares of D Ltd, D Ltd is not a subsidiary of the A Ltd group and would not be consolidated into the A Ltd group consolidated accounts. The fact that the effective share of the A Ltd group is 53.95% ((60% x 45%) + (49% x 55%)) is more than 50% is irrelevant in determining whether or not the A Ltd group exercises control over D Ltd.

Tip

Note that in D shaped and Diamond shaped groups you will have more than one acquisition in the sub-subsidiary and may, therefore, have to use the piecemeal or step approach.

Example

Preparation of the consolidated statement of financial position of a vertical group

(Parent purchases first subsidiary before the first subsidiary purchased the second subsidiary)

Summarised statements of financial positions at 31 December 20X8 are provided as follows:

	A Ltd	B Ltd	C Ltd
	Tshs'000	Tshs'000	Tshs'000
Investment in B Ltd	720,000	-	-
Investment in C Ltd	-	300,000	-
Other sundry net assets	1,200,000	1,200,000	960,000
Total	**19,200,000**	**15,000,000**	**960,000**
Ordinary share capital	700,000	450,000	200,000
Retained profits	1,220,000	1,050,000	760,000
Total	**19,200,000**	**15,000,000**	**960,000**

The following information is available:

(i) A Ltd purchased 60% of the ordinary shares of B Ltd when B Ltd.'s retained earnings stood at Tshs400 million.

(ii) At a later date, B Ltd purchased 70% of the ordinary shares of C Ltd when C ltd.'s retained earnings stood at Tshs120 million.

(iii) Goodwill is capitalised at acquisition. One-quarter of the goodwill paid for B Ltd and one-third of the goodwill paid for C Ltd has been impaired up to 31 December 20X8.

(iv) Non-controlling interest is determined at acquisition as share of fair value of identifiable net assets at acquisition.

Required:

Prepare the consolidated Statement of Financial Position of the A Ltd group at 31 December 20X8 together with supporting working schedules.

Answer

A Ltd Group - Consolidated Statement of Financial Position at 31 December 20X8

	Tshs'000
Unimpaired goodwill (Tshs157,000 + Tshs30,400) (W1)	187,400
Other sundry net assets (Tshs1,200,000 + Tshs1,200,000 + Tshs960,000)	3,360,000
	3,547,400
Ordinary share capital	700,000
Retained earnings (W3)	1,810,600
Non-controlling interest (W2)	1,036,800
	3,547,400

Note the procedures employed above. An indirect holding affects the calculation of goodwill. Remember to take the group share of the cost in the indirect subsidiary group share is by reference to what the group owns in the subsidiary that owns shares in the indirect subsidiary.

Note also the impact (deduction) in determining the non-controlling interest in the subsidiary that owns shares in the indirect subsidiary.

Continued on the next page

Workings

W1 Goodwill "partial"

		Tshs'000
B Ltd	**Consideration**	720,000
	Add: NCI share of FV net assets acquired ((Tshs450,000 + Tshs400,000) x 40%)	340,000
		1,060,000
	Less: Fair value of net assets acquired	(850,000)
	Impairment (1/4)	(53,000)
	Unimpaired	**157,000**
C Ltd	Cost – indirect 60% x 300	180,000
	Add: NCI share of FV net assets acquired (Tshs200,000 + Tshs120,000) x 58%	185,600
		365,600
	Less: Fair value of net assets acquired	(320,000)
		45,600
	Impairment (1/3)	(15,200)
	Unimpaired	**30,400**

W2 Non-controlling interest

		Tshs'000	Tshs'000
B Ltd	40% x (Tshs450,000 + Tshs1,050,000)	600,000	
	Less: NCI in B share of cost of C (40% x Tshs300,000)	(120,000)	480,000
C Ltd	58% x (Tshs200,000 + Tshs760,000)		556,800
			1,036,800

W3 Retained earnings

		Tshs'000
A Ltd		1,220,000
B Ltd	60% x (Tshs1,050,000 – Tshs400,000)	390,000
C Ltd	42% x (Tshs760,000 – Tshs120,000)	268,800
		1,878,800
	Less: Impairment of goodwill (Tshs53,000 + Tshs15,200)	(68,200)
		1,810,600

Test Yourself 6

Preparation of the consolidated statement of financial position of a vertical group

(Parent purchases the first subsidiary after the first subsidiary purchases the second subsidiary)

The draft statement of financial positions of P, S and SS as at 31 December 2008 is as follows:

	P	S	SS
	Tshs'000	**Tshs'000**	**Tshs'000**
Cost of shares in S	120,000	-	-
Cost of shares in SS	-	80,000	-
Sundry net assets	180,000	80,000	80,000
Total	**300,000**	**160,000**	**80,000**
Ordinary share capital (shares of Tshs1,000 each)	200,000	100,000	50,000
Retained earnings	100,000	60,000	30,000
Total	**300,000**	**160,000**	**80,000**

Continued on the next page

(i) S acquired 40,000 Tshs1,000 ordinary shares in SS on 1 January 20X7 when the retained earnings of SS amounted to Tshs15 million.

(ii) P acquired 75,000 Tshs1,000 ordinary shares in S on 30 June 20X8 when the retained earnings of S amounted to Tshs40 million and the retained earnings of SS amounted to Tshs25 million.

(iii) One third of the goodwill paid for S and one half of the goodwill paid for SS is impaired up to 31 December 20X8.

(iv) Non-controlling interest is determined at acquisition as share of fair value of identifiable net assets at acquisition.

Required:

Prepare the Consolidated Statement of Financial Position of the P Group at 31 December 20X8 and show workings for your calculations for consolidation goodwill, non-controlling interests and consolidated retained earnings.

Test Yourself 7

Preparation of the consolidated statement of financial position of a vertical and D shaped group

(All acquisitions on the same date)

The summarised statement of financial positions of P, A, B and C as at 31 December 20X8 are as follows:

	P	A	B	C
	Tshs'000	**Tshs'000**	**Tshs'000**	**Tshs'000**
Cost of shares in A	200,000	-	-	-
Cost of shares in B	40,000	100,000	-	-
Cost of shares in C	-	160,000	-	-
Sundry net assets	1,000,000	450,000	600,000	780,000
	1,240,000	**710,000**	**600,000**	**780,000**
Ordinary share capital (shares of Tshs1,000 each)	500,000	100,000	100,000	100,000
Retained earnings	740,000	610,000	500,000	680,000
	1,240	**710,000**	**600,000**	**780,000**

P acquired 75% of the ordinary shares of A and 25% of the ordinary shares of B on 1 January 20X4. At that date A's the balance in the retained earnings amounted to Tshs100 million and B's retained earnings amounted to Tshs30 million.

On the same date, A acquired 80% of the ordinary shares of C and 40% of the ordinary shares of B. The retained earnings of C on 1 January 20X4 amounted to Tshs80 million.

One half of goodwill paid for each acquisition is determined to be impaired up to 31 December 20X8. Non-controlling interest is determined at acquisition as share of fair value of identifiable net assets at acquisition.

Required:

Prepare the Consolidated Statement of Financial Position of the P Group at 31 December 20X8 and show workings for your calculations for consolidation goodwill, non-controlling interest and consolidated retained earnings.

Our next exercise deals with an indirect holding in an associate.

Test Yourself 8

Extracts from the statement of financial positions of P, S and A at 31 December 20X8 are provided as follows:

	P	S	A
	Tshs'000	**Tshs'000**	**Tshs'000**
Sundry net assets	120,000	225,000	25,000
Cost of 80% of the share capital of S	130,000	-	-
Cost of 30% of the share capital of A	-	5,000	-
	250,000	**230,000**	**25,000**
Share capital	100,000	100,000	10,000
Retained profits	150,000	130,000	15,000
	250,000	**230,000**	**25,000**

(i) P acquired 80% of the ordinary shares of S when S retained earnings were Tshs50 million and S purchased 30% of the shares in A when A retained earnings were Tshs5 million. S purchased shares in A after P purchased shares in S.

(ii) Capitalise goodwill at acquisition.

(iii) One half of the goodwill paid for S and one quarter of the goodwill paid for A is impaired up to 31 December 20X8.

(iv) Non-controlling interest is determined at acquisition as share of fair value of identifiable net assets at acquisition.

Required:

Prepare a summarised consolidated statement of financial position of the P group including its associate A at 31 December 20X8.

Complex groups – Full goodwill method

Preparing financial statements under full goodwill method and partial goodwill method may differ in the following aspects:

Computation of goodwill on acquisition date
Valuation of non-controlling interest
Treatment of impairment of goodwill subsequently

Let us understand this with the help of an example.

Example

The following financial statements relate to the J Group as at 31 December 2008.

	Diamond Ltd	Gold Ltd	Silver Ltd
	Tshs'000	**Tshs'000**	**Tshs'000**
Investment in Gold Ltd	8,250		
Investment in Silver Ltd		5,500	
Sundry net assets	6,750	3,500	7,500
Total	**15,000**	**9,000**	**7,500**
Equity			
Share capital	10,000	6,250	5,000
Retained earnings	5,000	2,750	2,500
Total	**15,000**	**9,000**	**7,500**

Continued on the next page

Diamond Ltd acquired shares in Gold Ltd on 1 January 2007. Gold Ltd acquired shares in Silver Ltd on 31 December 2007.

The following were the balances in the retained earnings and non-controlling interest:

	Gold Ltd	Silver Ltd
	Tshs'000	Tshs'000
Retained earnings		
1 January 2007	1,000	500
31 December 2007	1,750	800
Non-controlling interest		
1 January 2007	2,000	4,000
31 December 2007	2,400	5,000

The goodwill of Gold Ltd is impaired as at 31 December 2007 by Tshs1,250,000.

Required:

Prepare consolidated statement of financial position of the group for the year ended 31 December 2008 using partial and full goodwill method.

Answer

Note:

The acquisition of Gold Ltd happened before acquisition of Silver Ltd.
The effective share of Diamond Ltd is 80% x 60% = 48%

Full goodwill method

Diamond Group - Consolidated statement of financial position as at 31 December 2008

	Tshs'000
Net assets (excluding goodwill) (Tshs6,750 + Tshs3,500 + Tshs7,500)	17,750
Goodwill	5,350
Total	**23,100**
Equity	
Share capital	10,000
Retained earnings(W3)	6,216
	16,216
Non-controlling interest (W2)	6,884
Total	**23,100**

W1 Goodwill

	Gold Ltd	Silver Ltd
	Tshs'000	Tshs'000
Fair value of consideration paid	8,250	5,500
Indirect holding of Silver belonging to NCI of Gold (20% of Tshs5,500)	-	(1,100)
Fair value of NCI	2,000	5,000
	10,250	**9,400**
Less: Fair value of net assets acquired		
Gold Ltd (Tshs6,250 + Tshs1,000)	(7,250)	-
Silver Ltd (Tshs5,000 + Tshs800)		(5,800)
	3,000	**3,600**

Continued on the next page

Post impairment. The total goodwill at 31 December 2008 is Tshs3,000,000 + Tshs3,600,000 - Tshs1,250,000 = Tshs5,350,000

W2 Non-controlling interest

	Gold Ltd	Silver Ltd
	Tshs'000	Tshs'000
Fair value of NCI at acquisition	2,000	5,000
Indirect holding in Silver belonging to NCI of Gold (20% of Tshs5,500)		(1,100)
Post-acquisition profit attributable to NCI:		
- Silver Ltd: 20% of (Tshs2,750 - Tshs1,000)	350	
- Gold Ltd: 52% of (Tshs2,500 - Tshs800)		884
Impairment of goodwill attributable to NCI of Gold Ltd (20% of Tshs1,250)	(250)	
	2,100	**4,784**

Total non-controlling interest is Tshs2,100,000 + Tshs4,784,000 = Tshs6,884,000

W3 Consolidated retained earnings

	Tshs'000
Retained earnings of Diamond	5,000
Post-acquisition profit of Gold (80% of (Tshs2,750 - Tshs1,000)	1,400
Post-acquisition profit of Silver (48% of (Tshs2,500 - Tshs800)	816
Impairment of goodwill attributable to Parent (80% of Tshs1,250)	(1,000)
	6,216

Partial goodwill method

Diamond Group - Consolidated statement of financial position as at 31 December 2008

	Tshs'000
Net assets (excluding goodwill) (Tshs6,750 + Tshs3,500 + Tshs7,500)	17,750
Goodwill (W1)	2,816
Total	**20,566**
Equity	
Share capital	10,000
Retained earnings(W3)	5,966
	15,966
Non-controlling interest (W2)	4,600
Total	**20,566**

W1 Goodwill

	Gold Ltd	Silver Ltd
	Tshs'000	Tshs'000
Fair value of consideration paid	8,250	5,500
Indirect holding of Silver belonging to NCI of Gold (20% of Tshs5,500)	-	(1,100)
	8,250	**4,400**
Less: Fair value of net assets acquired		
Gold Ltd 80% of (Tshs6,250 + Tshs1,000)	(5,800)	-
Silver Ltd 48% of (Tshs5,000 + Tshs800)		(2,784)
	2,450	**1,616**

Continued on the next page

Post impairment. The total goodwill at 31 December 2008 is Tshs2,450,000 + Tshs1,616,000 - Tshs1,250,000 = Tshs2,816,000

W2 Non-controlling interest

	Gold Ltd	Silver Ltd
	Tshs'000	**Tshs'000**
NCI at acquisition date - proportionate		
- Gold Ltd (20% of Tshs7,250)	1,450	
- Silver Ltd (52% of Tshs5,800)		3,016
Indirect holding in Silver belonging to NCI of Gold (20% of Tshs5,500)		(1,100)
Post-acquisition profit attributable to NCI:		
- Silver Ltd: 20% of (Tshs2,750 - Tshs1,000)	350	
- Gold Ltd: 52% of (Tshs2,500 - Tshs800)		884
	1,800	**2,800**

Total non-controlling interest is Tshs1,800,000 + Tshs2,800,000 = Tshs4,600,000

W3 Consolidated retained earnings

	Tshs'000
Retained earnings of Diamond	5,000
Post-acquisition profit of Gold (80% of (Tshs2,750 - Tshs1,000)	1,400
Post-acquisition profit of Silver (48% of (Tshs2,500 - Tshs800)	816
Impairment of goodwill attributable to Parent (100% of Tshs1,250)	(1,250)
	5,966

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8. Apply the principles of group accounting in preparation of group statements of cash flows. [Learning Outcome h]

5.1 Group statement of cash flows

In the A level and B level Papers you must have already studied preparation of statement of cash flow for a single entity. In order to prepare a group statement of cash flow you need to follow the same principles as required for single entity. The group cash flow question is examined from time to time.

At Paper C1 statement of cash flows examined would include group complications. Paper C1 questions on cash flows could include any or all of the following:

dealing with a subsidiary acquired during the period
dealing with a subsidiary disposed of during the period
dealing with overseas subsidiaries
dividends received from associates
dividends paid to non-controlling interests

The following points will help you to prepare a group statement of cash flow:

1. **If you get an acquired or sold subsidiary** situation the question must provide you with the following information:

(a) separate assets and liabilities of the subsidiary on the date of its acquisition or sale
(b) any non-controlling interest therein
(c) details of consideration, including cash, paid or received

You will have to incorporate this information in reconciling consolidated statement of financial position movements to determine cash flows arising.

2. **If you get an overseas subsidiary** the question must provide you with the following information:

(a) The consolidation stage exchange difference arising for the current year.
(b) A breakdown of this exchange difference relating to the separate assets and liabilities of the overseas subsidiary.

You will have to incorporate the exchange differences on separate assets and liabilities of the overseas subsidiary when reconciling consolidated statement of financial position movements to determine cash flows arising.

Refer to Self-Examination Question 7, for an illustration of the procedures involved.

3. Dividends received from associates

Dividend received from associate can be determined from the investments in associates in the consolidated statement of financial position:

	Tshs		Tshs
Balance b/f	X	Share of tax	X
Additions at cost:		Goodwill impaired in the period	X
- cash paid	X	Dividends received from associates (Balancing figure)	X
- non-cash consideration	X		
Profits: share of pre-tax profits	X	Balance c/f	X
Total	**X**	**Total**	**X**

4. Dividends paid by subsidiaries to non-controlling interest

Dividend paid by the subsidiaries to non-controlling interest can be determined from non-controlling interest in the consolidated statement of financial position:

	Tshs		Tshs
		Balance b/f	X
NCI share of net assets of **disposed** of subsidiary on the date of its disposal	X	NCI share of net assets of **acquired** subsidiary on the acquisition date	X
NCI share of the consolidation stage **exchange loss** for the current year where the accounts of a foreign operation are translated into the presentation currency of the consolidated accounts	X	NCI share of the consolidation stage **exchange gain** for the current year where the accounts of a foreign operation are translated into the presentation currency of the consolidated accounts	X
Dividends paid by subsidiaries to NCI (Balancing figure)	X	Profits: NCI share in the current year's profit of subsidiaries	X
Balance c/f	X		
Total	**X**	**Total**	**X**

5.2 Using cash flow as a measure of performance

Cash flow is increasingly seen as a measure that can be used both in assessing value and performance.

Reasons given for focusing on cash flow rather than profit or earnings include:

1. Cash flow is the **theoretically correct starting point** for valuations. The value of any asset can be regarded as the present value of expected future cash flows.
2. Cash flow is **not affected by different accounting policies** and is, therefore, more comparable particularly on a cross-border basis.
3. Cash flow is **not affected by income smoothing techniques** that can reduce the reliability of profit measures.
4. Cash flow can be a **more comprehensive measure** than profit as it allows for changes in working capital and fixed asset investment.
5. The ability to generate cash is a **vital aspect of business performance**. Generating profit does not necessarily translate into increased cash flow.

5.3 Use cash flow as a measure of performance with caution

Whilst cash flow can be an important measure of performance, it should be used with caution particularly when focusing on the cash flow for a single period.

Problems associated with cash flow measures include:

1. Cash flow is **not intended to be a measure of performance** as it is not based on the matching of income and expenditure it does not follow the accruals concept.
2. Cash flow **does not necessarily reflect the underlying economic performance** of a company.
3. **Not all transactions are reflected** in a statement of cash flows.
4. Cash flow **can be smoothed much more easily** than profit by simply altering the timing of cash receipts and payments.
5. There is **no universally accepted method for defining cash flow** for purposes of performance measurement.

5.4 Cash flow per share

1. Cash flow per share is used in the same way as earnings per share as a measure of performance and as a basis for valuations. The number of shares used in the calculation is the weighted average number as determined for the earnings per share calculation.
2. No generally accepted measure of cash flow is used in calculating cash flow per share. Cash earnings, operating cash flow and free cash flow could all be used for this purpose.

Test Yourself 9

The draft statement of financial positions and statement of profit or loss and other comprehensive income of Proserpina group are as follows:

Proserpina group - Consolidated statement of financial position

	31 October 20X8	31 October 20X7
	Tshs'000	Tshs'000
Tangible non-current assets		
Property, plant and equipment	10,969	7,642
Investments	2,100	2,100
Current assets		
Inventories	7,245	6,100
Trade receivables	6,410	7,211
Cash at bank and in hand	953	165
	27,677	**23,218**
Capital and reserves		
Ordinary share capital	5,000	5,000
Share premium account	3,000	3,000
Retained earnings	11,150	7,003
	19,150	15,003
Non-controlling interests	2,519	1,997
	21,669	17,000
Current liabilities		
Trade payables	1,920	1,690
Dividend payable by Proserpina Plc	267	240
Dividend payable by subsidiaries to NCI	75	60
Tax payable	2,744	2,818
Non-current liabilities		
Loans	1,002	1,410
	27,677	**23,218**

No property, plant or equipment has been disposed of during the year to 31 October 20X8. The depreciation charge for the year ended 31 October 20X8 was Tshs1,977,000. There were no payables in respect of property, plant and equipment at either year-end. Trade receivables as at 31 October 20X8 include called up share capital not paid of Tshs1,235,000 (20X7: Tshs2,746,000).

Continued on the next page

Proserpina group - Draft statement of consolidated profits or loss for the year ended 31 October 20X8

	Tshs'000
Group operating profit	6,955
Income from non-group non-current investments	64
Finance cost	(174)
Group profit before tax	6,845
Tax expense	(2,846)
Group profit after tax	**3,999**
Share of profit attributable to:	
Parent	3,773
Non-controlling interest	226
	3,999

Share of profit of parent	3,773
Dividends paid and payable	(600)
Profit retained for the year ended 31/10/20X8	**3,173**
Movements on reserves during the year to 31/10/20X8 are indicated below. The exchange difference included in reserves in respect of the net investment is broken down as arising on the retranslation of the separate assets and liabilities of the overseas entity.	
	Tshs'000
Total reserves brought forward at 1 November 20X7	7,003
Profit retained for the year ended 31 October 20X8: excluding exchange differences	3,173
Exchange gain on translation of overseas subsidiaries see below	1,356
Exchange loss on group overseas loans separately identified	(382)
Total reserves carried forward at 31 October 20X8	**11,150**

The exchange gain arising on the retranslation of net investments in overseas subsidiaries, for the year ended 31 October 20X8 is made up as follows:

Particulars	Tshs'000
Arising on retranslation of:	
Property, plant and equipment	1,228
Inventories	393
Trade receivables	211
Cash	39
Trade payables	(63)
NCI share of the total	(452)
	1,356

Required:

Prepare the statement of cash flows for the Proserpina Group for the year ended 31 October 20X8 so as to comply with the accounting standard on statement of cash flows.

Answers to Test Yourself

Answer to TY 1

(i) If Delta Ltd holds majority of shares in Eagle Ltd: Delta's voting rights are substantive because it can make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before the investor can exercise its voting rights does not stop Delta from having the current ability to direct the relevant activities from the moment it acquires the shareholding. Hence, Delta Ltd has power over Eagle Ltd.

(ii) If Delta Ltd is party to a forward contract to acquire the majority of shares in Eagle Ltd and the forward contract's settlement date is in 25 days: the existing shareholders are unable to change the existing policies over the relevant activities because a special meeting cannot be held for at least 30 days, at which point the forward contract will have been settled. Thus, Delta Ltd has rights that are essentially equivalent to the majority shareholder. Hence, Delta Ltd has power over Eagle Ltd.

(iii) **If Delta Ltd is party to a forward contract to acquire the majority of shares in Eagle Ltd and the forward contract's settlement date is within the next 6 months:** Delta Ltd does not have the current ability to direct the relevant activities. The existing shareholders have the current ability to direct the relevant activities because they can change the existing policies over the relevant activities before the forward contract is settled. Hence, Delta Ltd has no power over Eagle Ltd.

Answer to TY 2

In this case, Wonder cannot conclude on the basis of its holding and the relative size of the other shareholdings in comparison to its shareholding to determine whether it has sufficient power to control the investee.

However, after considering its contractual right to appoint, remove and set the remuneration of management, it may conclude that it **has power over the investee**. The fact that Wonder might not have exercised this right or the likelihood of it exercising its right to select, appoint or remove management shall not be considered when assessing whether Wonder has power.

Answer to TY 3

An entity must consider the potential impact of all outstanding options, convertibles, warrants etc. when classifying investments in terms of the exercise of control or significant influence. For Wan Chai, the exercise of the outstanding option to Lai King will reduce its voting rights, assuming that shares have equal votes, in Po Lam to 46%.

Further, it would appear that Lai King has sole discretion as to whether to exercise the option or not. It is probable that Lai King will exercise its option as there is zero consideration and Po Lam is making profits.

A subsidiary is defined as an enterprise over which an investor has control. This is normally evidenced when a company has the power to govern the financial and operating policies of the investee. This is usually the case when a company has more than half of the voting rights of that particular enterprise. When a reporting entity has less than half of the voting rights in an enterprise, control is usually evidenced with the existence of the following:

power over more than half of the voting rights by virtue of an agreement with other investors;
power to appoint or remove the majority of the members of the board of directors;
power to cast the majority of votes at meetings of the board of directors; or
power to govern the financial and operating policies of the enterprise under a statute or an agreement.

You should consider whether Wan Chai has control over Po Lam after the exercise of the option by Lai King. If control does not exist after considering the criteria above, Po Lam should not be treated as a subsidiary and should not be consolidated even though Wan Chai has a current ownership of 51% in Po Lam.

However, if control continues to be the case in spite of the option, Wan Chai should consolidate the results of Po Lam at the current percentage of ownership of 51%.

You should also consider the recognition of a provision in respect of the option. It appears to be an onerous contract. Lai King will exercise its option and Wan Chai will suffer a loss when the option is exercised. Therefore, Wan Chai should provide for this future loss in its financial statements as at and for the year ended 30 November 20X8.

Answer to TY 4

(a) Full goodwill

Consideration paid plus full fair value of Non-controlling interest less fair value of identifiable net assets

Tshs2,000 million + Tshs1,300 million – Tshs3,000 million = Tshs300 million

Non-controlling interest recognised at acquisition Tshs1,300 million

(b) Partial goodwill

Consideration paid plus fair value of proportion of identifiable net assets attributable to Non-controlling interest less fair value of identifiable net assets.

Tshs2,000 million + (40% x Tshs3,000 million) – Tshs3,000 million = Tshs200 million

Answer to TY 5

A joint arrangement requires all contracting parties to have equal control. All the decisions related to relevant activities have to be taken with unanimous consent. In this case there exists a contract between two parties to undertake an economic activity. However as Anjali has more control over the decisions related to relevant activities, this activity cannot be called a joint arrangement.

Answer to TY 6

SS is a subsidiary of a subsidiary and therefore a subsidiary of P.

Accounting percentages are as follows:

GROUP:		
Direct	75%	-
Indirect: through S – 75% x 80%	-	60%
Non-controlling interest	25%	40%

P Ltd Group - Consolidated Statement of Financial Position at 31 December 20X8

	Tshs'000
Goodwill (W1) (Tshs10,000 + Tshs7,500)	17,500
Sundry net assets (Tshs180,000 + Tshs80,000 + Tshs80,000)	340,000
	357,500
Ordinary share capital	200,000
Retained earnings (W3)	105,500
	305,500
Non-controlling interest (W2)	52,000
	357,500

Working

W1 Goodwill

Paid for S

	Tshs'000
Consideration paid	120,000
Add: NCI share 25% x (Tshs100,000 + Tshs40,000)	35,000
	155,000
Less: FV of net assets acquired (Tshs100,000 + Tshs40,000	(140,000)
	15,000
Impairment loss (1/3)	(5,000)
Carrying value	**10,000**

Paid for SS

Note that pre-acquisition profits are the profits of SS when SS becomes a subsidiary of the P Group i.e., in this exercise, the profits of SS on the date that P purchases S 25,000.

	Tshs'000
Cost – indirect – through S (75% x Tshs80,000)	60,000
Add: NCI share 40% x (Tshs50,000 + Tshs25,000)	30,000
	90,000
Less: FV of net assets acquired (Tshs50,000 + Tshs25,000)	(75,000)
	15,000
Less: Impairment loss (1/2)	(7,500)
Carrying value	**7,500**

W2 Non-controlling interest

	Tshs'000
In S:	
25% x Tshs160,000	40,000
Less: NCI in S share of the cost of SS (25% x Tshs80,000)	(20,000)
	20,000
In SS:	
40% x Tshs80,000	32,000
	52,000

W3 Retained earnings

	Tshs'000
P	100,000
S (75% x (Tshs60,000 – Tshs40,000))	15,000
SS (60% x (Tshs30,000 – Tshs25,000))	3,000
	118,000
Less: Impairment of goodwill (Tshs5,000 + Tshs7,500)	(12,500)
	105,500

Be careful with dates of acquisition by the group when you determine pre-acquisition profits.

Answer to TY 7

Group structure

A is a 75% subsidiary of P.
B is 25% owned by P and 40% owned by A (a subsidiary of P) the P group has 65% (25% + 40%) of the shares of B and B is also a subsidiary of the P group.
C is a subsidiary of a subsidiary of P and is therefore also a subsidiary of the P group.

Accounting percentages are as follows:

	A	B	C
Group:			
Direct	75%	25%	-
Indirect – through A			
- 75% x 80%	-	-	60%
- 75% x 40%	-	30%	-
	75%	55%	60%
Non-controlling interests	25%	45%	40%

P Group - Consolidated Statement of Financial Position at 31 December 20X8

	Tshs'000
Goodwill (W1)	52,750
Sundry net assets (Tshs1,000,000 + Tshs450,000 + Tshs600,000 + Tshs780,000)	2,830,000
	2,882,750
Ordinary share capital	500,000
Retained earnings (W3)	1,688,250
	2,188,250
Non-controlling interest (W2)	694,500
	2,882,750

Workings

W1 Goodwill

	Tshs'000	Tshs'000
Paid for A:		
Cost: direct	200,000	
Add: NCI share 25% x (Tshs100,000 + Tshs100,000)	50,000	
	250,000	
Less: FV of net assets acquired (Tshs100,000 + Tshs100,000)	(200,000)	50,000
Paid for B:		
Cost: direct	40,000	
indirect – through A (75% x Tshs100,000)	75,000	
Add: NCI share 45% x (Tshs100,000 + Tshs30,000)	58,500	
	173,500	
Less: FV of net assets acquired (Tshs100,000 + Tshs30,000)	(130,000)	43,500
Paid for C:		
Cost: indirect – through A (75% x Tshs160,000)	120,000	
Add: NCI share 40% x (Tshs100,000 + Tshs80,000)	72,000	
	192,000	
Less: FV of net assets acquired (Tshs100,000 + Tshs80,000)	(180,000)	12,000
		105,500
Impairment loss		(52,750)
Carrying value		**52,750**

W2 Non-controlling interest

	Tshs'000	Tshs'000
In A: 25% x Tshs710,000	177,500	
Less:		
NCI in A share of the cost of B (25% x Tshs100,000)	(25,000)	
NCI in A share of the cost of C (25% x Tshs160,000)	(40,000)	112,500
In B: 45% x Tshs600,000		270,000
In C: 40% x Tshs780,000		312,000
		694,500

W3 Retained earnings

	Tshs'000
P	740,000
A (75% x (Tshs610,000 – Tshs100,000))	382,500
B (55% x (Tshs500,000 – Tshs30,000))	258,500
C (60% x (Tshs680,000 – Tshs80,000))	360,000
	1,741,000
Less: Impairment of goodwill	(52,750)
	1,688,250

Answer to TY 8

Consolidated Statement of Financial Position at 31 December 20X8

	Tshs'000
Unimpaired goodwill - S (W1)	5,000
Investment in associate (W2)	6,300
Sundry net assets (Tshs120,000 + Tshs225,000)	345,000
Total assets	**356,300**
Share capital	100,000
Retained earnings (W4)	211,300
non-controlling interest (W3)	45,000
Total liabilities	**356,300**

Workings

W1 Goodwill

In case of S	**Tshs'000**
Cost	130,000
Add: NCI share (20% of (Tshs100,000 + Tshs50,000))	30,000
	160,000
Less: FV of net assets acquired (Tshs100,000 + Tshs50,000)	(150,000)
	10,000
Impairment up to 31 December 20X8 (1/2)	(5,000)
Unimpaired at 31 December 20X8	5,000
In case of A	**Tshs'000**
Cost	
Direct	-
Indirect (80% x Tshs5,000)	4,000
	4,000
Less: 24% x (Tshs10,000 + Tshs5,000)	(3,600)
Impairment up to 31 December 20X8 (1/4 x Tshs400)	(100)
Unimpaired at 31 December 20X8	**300**

W2 Investment in associates

	Tshs'000
Share of net assets (24% x 25,000)	6000
Add: Unimpaired goodwill	300
	6,300

W3 Non-controlling interest

	Tshs'000
In S ltd - 20% x Tshs230,000	46,000
Less: NCI share of cost of A (20% x Tshs5,000)	(1,000)
	45,000

W4 Retained earnings

	Tshs'000
P	150,000
S 80% x (Tshs130,000 – Tshs50,000)	64,000
A 24% x (Tshs15,000 – Tshs5,000)	2,400
	216,400
Less: Impairment of goodwill (Tshs5,000 + Tshs100)	(5,100)
	211,300

Answer to TY 9

Prosperpina Plc Group - Statement of Cash Flows for the year ended 31 October 20X8

	Tshs'000	Tshs'000
Group operating profit	6,955	
Add: Depreciation	1,977	
Less: (Increase) in inventories	(752)	
Less: (Increase) in trade receivables	(499)	
Add: Increase in trade payables	167	
Cash flow equivalent of operating profit	7,848	
Finance cost	(174)	
Tax paid	(2,920)	
Cash flow from operating activities		**4,754**
Investing activities		
Purchase of property, plant and equipment (W1)	(4,076)	
Investment income	64	
Cash flow from investing activities		**(4,012)**
Financing activities		
Cash received on called up share capital (Tshs2,746 – Tshs1,235)	1,511	
Loans redeemed (W8)	(790)	
Dividends paid by parent (W5)	(573)	
Dividends paid by subsidiaries to NCI (W6)	(141)	
Cash flow from financing activities		**7**
Increase in cash and cash equivalents in the period		749
Cash and cash equivalents brought forward		165
Exchange gain on cash and cash equivalents		39
Cash and cash equivalents carried forward		**953**

Important

In questions involving overseas entities you need to take account of exchange differences in determining group cash flows and it is for this reason that the question must break down the consolidation stage exchange difference as arising on the retranslation of the separate assets and liabilities of the overseas entity. Use T accounts if you prefer.

Workings

W1 Property, plant and equipment

Dr			Cr
	Tshs'000		**Tshs'000**
Balance b/f	7,642	Charge for the year	1,977
Exchange gain	1,228	Balance c/f	10,969
Additions during the year	4,076		
	12,946		**12,946**

W2 Inventories

Dr			Cr
	Tshs'000		**Tshs'000**
Balance b/f	6,100		
Exchange gain	393		
Increase during the year	752	Balance c/f	7,245
	7,245		**7,245**

W3 Trade receivables

Trade receivable Account

Dr	Tshs'000		Tshs'000 Cr
Balance b/f (7,211 – 2,746)	4,465		
Exchange gain	211		
Increase during the year	499	Balance c/f (6,410 – 1,235)	5,175
	5,175		**5,175**

W4 Trade payables

Trade Payable Account

Dr	Tshs'000		Tshs'000 Cr
		Balance b/d	1,690
		Exchange difference	63
		During the year	167
Balance c/f	1,920		
	1,920		**1,920**

W5 Dividend paid by the parent

Dividend payable Account

Dr	Tshs'000		Tshs'000 Cr
Paid	573	Balance b/d	240
		Proposed dividend	600
Balance c/f	267		
	840		**840**

W6 Dividend paid by subsidiaries to non-controlling interest (amounts in Tshs'000)

B/f NCI Interest in FV of net assets + b/f dividend payable + NCI share of net exchange gain + NCI share in profit for the current year = Tshs1,997 + Tshs60 + Tshs452 + Tshs226 = Tshs2,735

c/f NCI Interest in FV of net assets + c/f dividend payable =Tshs2,519 + Tshs75.= Tshs2,594

Dividend paid Tshs141(Tshs2,735 – Tshs2,594).

W7 Tax paid

Tax Payable Account

Dr	Tshs'000		Tshs'000 Cr
Cash paid	2,920	Balance b/d	2,818
		Tax charge for the year	2,846
Balance c/f	2,744		
	5,664		**5,664**

W8 Loans

Loan Account

Dr	Tshs'000		Tshs'000 Cr
Cash paid	790	Balance b/d	1,410
		Exchange difference	382
Balance c/f	1,002		
	1,792		**1,792**

Quick Quiz

1. How would you measure the cost of a business combination?

2. How can an associate be differentiated from a subsidiary?

3. List two reasons why an entity's investor would focus on the cash flow per share rather than revenue and profit figures.

4. What is a mixed group? How is it different from a vertical group?

5. The acquisition date is the date on which the acquirer obtains _____________. Fill the blanks with the appropriate phrase.

Answers to Quick Quiz

1. The cost of a business combination is measured as the aggregate of the following fair values, at the date of exchange, the assets given, liabilities incurred and equity instruments incurred by the acquirer in exchange for control.

2. An associate's investor can control between 20% and 50% of the voting power of the associate while the parent of the subsidiary owns 50% or more of the subsidiary's voting power. In addition, the accounts of the subsidiary are consolidated with the parent's, while the investor's investment in the associate is accounted for using the equity method.

3. Investors would choose to focus on cash flows per share rather than profits because of the following reasons:

   (a) Cash flows are not affected by different accounting policies and can therefore be compared on a cross-border basis.
   (b) The value of an asset can be regarded as the present value of future expected cash flows.
   (c) The statement of cash flows shows changes in working capital. Any significant fluctuations in working capital can be immediately identified.

4. A mixed group, also called a D-shaped group, is when in addition to an indirect interest held in a sub-subsidiary, through a subsidiary, the parent entity also holds a direct interest in the sub-subsidiary (subsidiary). In a vertical group, the parent has no direct interest in the sub-subsidiary and only holds voting power indirectly in the sub-subsidiary through its direct subsidiary.

5. Control in the acquiree.

Self Examination Questions

Question 1

DBP is considering acquiring an 80% interest in the equity of Halong Bay Holdings (HBH). The shares of HBH are 100% owned by Hue Imperial Property (HIP). Following a Sale and Purchase Agreement, DBP purchases an option from HIP to purchase 80% of the HIP holding in HBH.

The option was purchased at a cash consideration of Tshs40 million. The agreement was entered into on 5 May 20X8 and included an exercise price of Tshs30 million at any time from the signing of the Agreement to a specified date – the Completion Date – that should not be more than 12 months from the Agreement Date.

IF DBP does not exercise the option by the Completion Date, HIP must repay Tshs40 million to DBP. During the period between the Agreement Date and the Completion Date, DBP has the right to appoint half of the directors of HBH. DBP estimated that the fair value of the identifiable net assets of HBH was Tshs45 million on the Agreement Date.

Required:

The internal auditors have asked you to explain how to account for the above information in the consolidated financial statements of DBP at and for the year ended 31 December 20X8.

Question 2

You have recently been appointed financial accountant of Northbrook and have been presented with the draft statement of financial positions of the company and its newly acquired subsidiary, Sian Sian. Both companies are public limited companies.

Statement of financial position as at 30 September 20X8 for the two companies are as follows:

Particular	Northbrook	Sian Sian (SS)
	Tshs'000	**Tshs'000**
Tangible non-current assets	4,512	1,777
Investment in subsidiary	1,950	-
Inventories	1,891	829
Receivables	1,077	600
Bank and cash	57	500
	9,487	**3,706**
Share capital	1,000	250
Retained earnings	6,968	2,085
Payables	1,519	1,371
	9,487	**3,706**

You are provided with the following further information:

1. Northbrook acquired 80% of the share capital of Sian Sian on 1 June 20X8. The consideration for the acquisition was Tshs1,950,000 payable in cash on 1 June 20X8 and a further cash sum of Tshs250,000 payable on 1 June 20Y0. The present value of this amount is approximately Tshs207,000 on 1 June 20X8. In addition, a further sum of variable amount is payable on 1 November 20Y1 if profits before tax of Sian Sian, for the three years ending 30 September 20Y1, exceeded Tshs3,250,000. There is a present obligation to pay the Tshs250,000 on 1 June 20Y0 but there is some uncertainty as to the amount payable in respect of the contingent consideration payable in 20Y1 as noted above.

   The directors of Northbrook assessed the fair value of this contingent consideration to be Tshs350,000 at 1 June 20X8 and reassessed the fair value at 30 September 20X8 as amounting to Tshs300,000. Northbrook can borrow funds at the rate of 10% per annum. You need to comply with the requirements of the accounting standard on provisions in this respect and also with the recently issued IFRS 3.

2. The draft accounts indicate that the net assets of Sian Sian increased by Tshs620,000 during the period from 1 June to 30 September 20X8.

3. Sian Sian paid an interim dividend of Tshs105,000 on 1 April 20X8 based upon directors' expectations of profits for the year ended 30 September 20X8. The company paid a final dividend of Tshs375,000 in September 20X8. No entry has been made in either company's books to reflect this final dividend and you are to adjust the accounts accordingly. Time-apportion relevant dividends.

   Prior to the acquisition, the directors of Northbrook were aware that certain costs would be incurred reorganising the business of Sian Sian and these have now been assessed at Tshs225,000. In addition, Sian Sian traded with a new customer for the first time in August 20X8 and now expects a bad debt of Tshs20,000 to arise from the transaction. Neither of these matters has been reflected in the accounts of Sian Sian Ltd and the directors wish to establish the provision in the accounts of Sian Sian Ltd at acquisition rather than post-acquisition, if appropriate. There was no formally agreed plan for the reorganisation of Sian Sian on the date of its acquisition.

4. An impairment review for goodwill was undertaken at 30 September 20X8 which concluded that there were no impairment losses at this year-end.

5. Northbrook has assets that were acquired on 1 October 20X5 under leases that had all the characteristics of finance leases but which had been treated as operating leases in its accounts as the present value test of the accounting standard on leases was not met. The assets had an original cost of Tshs1,250,000 and would have been subject to depreciation at 25% on the reducing balance method had they been capitalised. Repayments totalling Tshs1,800,000 are being made over 5 years and, to date, these amount to Tshs1,080,000 with equal annual payments being made, in arrears, each year.

Bearing in mind recent proposals for lessee companies to capitalise all non-cancellable leases, the directors wish to follow this treatment in the accounts for the year to 30 September 20X8. Any prior year effect is to be charged in the year ended 30 September 20X8 and finance charges are to be allocated to past periods using the sum of the digits method. You are not required to identify a prior year adjustment.

6. Inventories of Northbrook include an amount of Tshs750,000 in respect of a construction contract that has been in progress for more than one year and that will be completed in December 20X8. Information as to this contract is as below. Use the cost method to determine % complete and for stage profit determination.

	Tshs'000
Costs to 30 September 20X8	750
Estimated further costs to completion	200
Contract value	1,200

Required:

(a) Prepare the Consolidated Statement of Financial Position of Northbrook and its subsidiary Sian Sian at 30 September 20X8.

(b) Calculate the goodwill paid on acquisition and the unimpaired goodwill on 30 September 20X8. Comply with all relevant accounting standards. Deal with the dividends paid by the subsidiary using the traditional approach of time-apportionment. Calculate goodwill on the basis of "partial goodwill" as permitted by IFRS 3. Explain your calculations

(c) Prepare the journal entries to adjust the accounts of Northbrook to comply with the accounting standard on construction contracts.

(d) On the basis that the fair value of the 20% non-controlling interests at 1 June 20X8 amounted to Tshs380,000, calculate goodwill on the basis of "full goodwill" as permitted by IFRS 3 and indicate the impact that this alternative calculation would have on the consolidated statement of financial position you prepared in (a) above.

Question 3

IAS 28 investments in associates and joint arrangements and IAS 31 Financial reporting of interests in joint ventures deal with associates and joint ventures respectively. The method of accounting for interests in joint ventures depends on whether they are interests in jointly ventures or joint operations.

The following financial statements relate to Baden, a public limited company:

Baden Ltd - Statement of profit or loss for the year ended 31 December 20X8

	Tshs'000
Revenue	212,000
Cost of sales	(170,000)
Gross profit Distribution	42,000
costs Administrative	(17,000)
expenses Other	(8,000)
operating income	12,000
Finance cost - Interest payable	(4,000)
Profit before tax	**25,000**
Income tax expense	(5,000)
	20,000
Extraordinary loss (net of tax of Tshs2 million)	(8,000)
Profit for the year	**12,000**

Baden Ltd - Extracts of statement of changes in equity for the year ended 31 December 20X8

	Tshs'000
Profit for the year	12,000
Less: Ordinary dividend paid	(4,000)
Retained profit for the year	**8,000**

Baden Ltd - Statement of financial position as at 31 December 20X8:

	Tshs'000	Tshs'000
Assets		
Non-current tangible assets		37,000
Current assets		31,000
		68,000
Equity and liabilities		
Equity		
Ordinary shares of Tshs1,000	10,000	
Share premium account	4,000	
Retained earnings	32,000	46,000
Non-current liabilities		10,000
Current liabilities		12,000
		68,000

Additional Information:

1. Cable, a public limited company, acquired 30% of the ordinary share capital of Baden at a cost of Tshs14 million on 1 January 20X7. The share capital of Baden has not changed since acquisition when the retained earnings were Tshs9 million.

2. At 1 January 20X7 the following fair values were attributed to the net assets of Baden but were not incorporated in its accounting records. Fair values are to be taken into account when assessing any goodwill arising on acquisition.

Particulars	Tshs'000
Tangible non-current assets (carrying value Tshs20,000)	30,000
Current assets	31,000
Current liabilities	20,000
Non-current liabilities	8,000

3. Guy, an associated company of Cable, holds a 25% interest in the ordinary share capital of Baden. This was acquired on 1 January 20X8.

4. During the year to 31 December 20X8, Baden sold goods to Cable to the value of Tshs35 million. The inventory of Cable at 31 December 20X8 included goods purchased from Baden on which the company made a profit of Tshs10 million.

5. The policy of Cable in its consolidated accounts is to recognise impairment losses as they arise. At 31 December 20X8, the investment is impaired to the extent of Tshs2.05 million.

6. Depreciate tangible non-current assets at 20% per annum straight-line.

Required:

(a) Explain the criteria that distinguish an associate from an ordinary investment in a non-current asset.

(b) Explain the principal differences between a joint venture and a joint operation.

(c) Show how the investment in Baden would be stated in the consolidated statement of financial position and consolidated profit for the year of the Cable Group under IAS 28 Investments in Associates and Joint Ventures for the year ended 31 December 20X8 on the assumption that the Cable Group exercises significant influence over Baden.

Question 4

Trim Ruth Rathbone (TRR) is expanding its operations by entering into joint venture arrangements in the Asia-Pacific region.

Tianchen: joint venture with Sino Products Limited

TRR has entered into an agreement with Sino Products Limited ("Sino") a party in the People's Republic of China (PRC) to form a separate legal entity, Tianchen Petro Tank Company (Tianchen), to construct and manage an oil tank. TRR's contribution represents an 80% interest in the joint venture that has a term of 23 years from the date of issue of the operation permit. The construction period for the oil tank is three years.

Under the Articles of Association of Tianchen, TRR can appoint seven of the nine directors on the board of directors of Tianchen. Decisions of the board will be passed by a simple majority and must be approved by at least one director from each party.

With regard to the share of profits, Sino offers TRR two options

Option A	TRR will be entitled to 80% of the profits after taxation from the first year to the twentieth year of operation of the oil tank. Sino will guarantee TRR a minimum return (10%) on its investment for each year during the operation period.
Option B	TRR will be entitled to a fixed return of 20% on its investment for each year during the period of operation. Any balance of profit will be passed to Sino.

Given the 80% interest in the joint venture, the board of directors of TRR believes that the investment should be accounted for by TRR as a subsidiary.

TRR proposes to invest further in the PRC as follows

Xiao Xiao Chun (XXC): joint venture with Shenzhen Development Properties Limited

TRR and Shenzhen Development Properties Limited, a company incorporated in the PRC, will form an equity joint venture, XXC in Shanghai. XXC will be in the business of developing residential properties in Shanghai. TRR and its PRC joint venture partner are required to contribute capital 7:3 respectively and are to share the profits of the joint venture in that ratio. The equity joint venture will run for a term of 20 years.

The board of directors of XXC will comprise 7 directors and TRR will appoint 5 directors to the board while the remaining 2 directors represent the PRC joint venturer. Simple majority will pass decisions of the board. The Chairman of TRR will be the legal representative of the equity joint venture and the General Manager is to be appointed by TRR.

Au and Au Limited: joint venture with HK Property Development Limited

TRR and HK Property Development Limited will form a separate legal entity in Hong Kong, Au and Au Limited, to develop a large-scale residential project in Tsing Yi. TRR's contribution represents an 85% interest in the legal entity. The term of the joint venture is 30 years. Under the Articles of Association, TRR can appoint 8 out of 10 directors to be members of the board of directors of Au and Au. Decisions of the board will be passed by simple majority and must be approved by at least one director from each party.

Required:

(a) Without considering the two options above, explain in accordance with generally accepted accounting principles, whether the investment in Tianchen should be accounted for by TRR as a subsidiary, a joint venture, or an associate.

(b) Explain the need to consider the two options regarding share of profits in Tianchen, in determining the kind of business structure that TRR is operating and, for each option, identify and explain what kind of business structure TRR is operating.

(c) Describe, for TRR, under each of the profit-sharing options in the question, and in both its individual and consolidated financial statements, how its investment in Tianchen should be accounted for.

(d) Explain whether there should be any difference in the accounting treatment by TRR for the two proposed joint ventures in Xiao Xiao Chun and Au and Au.

Question 5

X, a public limited company, acquired 100,000 ordinary shares of Tshs1,000 each in Y, also a public limited company on 1 April 20X5 when the retained earnings of Y were Tshs120 million. Y acquired 45 million ordinary shares of Tshs1 each in Z, also a public limited company, on 1 April 20X3 when the retained earnings of Z were Tshs10 million.

On 1 April 20X3, there were no material differences between the book values and the fair values of Z. On 1 April 20X5, the retained earnings of Z were Tshs20 million. Y acquired 30% of the ordinary shares of W, a limited company, on 1 April 20X5 for Tshs50 million when the retained earnings of W were Tshs7 million. Y is in a position to exercise significant influence over W and there were no material differences between the book values and the fair values of W at that date.

There had been no share issues since 1 April 20X3 by any of the four companies. The following statements of financial information relate to the four companies as at 31 March 20X8.

	X	Y	Z	W
	Tshs'000	Tshs'000	Tshs'000	Tshsm
Non-current tangible assets	900,000	100,000	30,000	40,000
Non-current intangible assets	-	30,000	-	-
Investment in Y	320,000	-	-	-
Investment in Z	-	90,000	-	-
Investment in W	-	50,000	-	-
Net current assets	640,000	360,000	75,000	73,000
Non-current liabilities	(200,000)	(150,000)	(15,000)	(10,000)
	1,660,000	**480,000**	**90,000**	**103,000**
Ordinary shares of Tshs1,000 each	360,000	150,000	50,000	80,000
Share premium account	250,000	120,000	10,000	6,000
Retained earnings	1,050,000	210,000	30,000	17,000
	1,660,000	**480,000**	**90,000**	**103,000**

1. The following fair value table sets out the book values and fair values of certain assets and liabilities of Y and Z together with any accounting policy adjustments to ensure consistent group policies at 1 April 20X5.

	Book value		Accounting policy adj.		Fair value adj.		Net book amount	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
	Y	Z	Y	Z	Y	Z	Y	Z
Non-current tangible assets	90,000	20,000	-	-	30,000	10,000	120,000	30,000
Non-current intangible assets	30,000	-	(30,000)	-	-	-	-	-
Inventory	20,000	12,000	2,000	-	(8,000)	(5,000)	14,000	7,000
Provision for bad debts	(15,000)	-	-	-	(9,000)	-	(24,000)	-

2. Non-controlling interest at acquisition date is too measured at the non-controlling interest's share of the fair value of the identifiable net assets of acquirees at this date.

3. During the year ended 31 March 20X8, Z had sold goods to X and Y. At 31 March 20X5, there were Tshs44 million of these goods in the inventory of X and Tshs16 million in the inventory of Y. Z had made a profit of 25% on selling price of the goods. The non-controlling interest is charged with any intra-group profits incorporated into subsidiaries' financial statements.

4. On 1 June 20X5, an amount of Tshs36 million was received by Y from an arbitration award against Q. This receipt was secured as a result of an action against Q prior to Y's acquisition by X but was not included in the assets of Y at 1 April 20X5.

5. The group charges depreciation on all tangible non-current assets on the straight-line basis at 10% per annum. Goodwill is capitalised at acquisition and becomes impaired, evenly, over 11 years.

Required:

(a) Prepare a Consolidated Statement of Financial Position as at 31 March 20X8 for the X Group and its associated company.

(b) Prepare a schedule to arrive at a total for Consolidated Retained Earnings for the consolidated statement of financial position.

Tip

You may wish to proceed as follows:

(i) Establish effective percentages for accounting purposes.

(ii) Calculate goodwill paid for the purchases in Y, Z and W respectively and determine unimpaired amounts at the current year-end.

(iii) Calculate any provision for URP required and establish amounts to be charged against consolidated retained earnings and non-controlling interest respectively.

(iv) Calculate additional depreciation to be charged in the consolidated accounts on fair value adjustments at acquisition and establish the amounts to be charged against consolidated retained earnings and non-controlling interest respectively.

(v) Calculate the non-controlling interest for the consolidated statement of financial position.

(vi) Calculate the carrying value of the associate for the consolidated statement of financial position.

Question 6

You are presented with the summarised consolidated accounts of the **Platini Group** as follows. Included in the group accounts are the results and net assets of associated companies accounted for using the equity method of accounting for investments, an overseas subsidiary translated using the closing rate / net investment method and a subsidiary purchased during the year consolidated using the acquisition or purchase method of consolidation.

Statement of financial position as on 30 June 20X8 together with comparatives as at 30 June 20X7:

Particulars	20X8	20X7
	Tshs million	**Tshs million**
Non-current assets		
Tangible assets	9,731	8,357
Investments in associates	525	510
Current assets		
Inventories	3,432	2,705
Receivables	4,149	3,056
	17,837	**14,628**
Equity and liabilities		
Share capital and share premium	3,680	3,191
Revaluation reserve	186	186
Exchange difference reserve	116	69
Retained earnings	3,153	2,459
Non-controlling interest	302	266
	7,437	**6,171**
Non-current liabilities		
Debenture loans	3,097	2,903
Deferred tax	216	147
	3,313	**3,050**
Current liabilities		
Bank overdraft	1,922	1,620
Payables	4,224	3,434
Provision for tax	941	353
	7,087	**5,407**
	17,837	**14,628**

Profits for the year ended 30 June 20X8

Particulars	Tshs million
Group operating profit	2,179
Share of pre-tax profits of associates	87
Taxation	(1,008)
Profit for the year	**1,258**
Share of profit attributable to:	
Owner of the parent	1,198
Non-controlling interest	60
	1,258

Dividend paid during the year amount to Tshs504 million

Further information, relevant to an appreciation of changes in financial position, is provided as follows:

1. Movements on the cost / valuation of non-current assets during the year ended 30 June 20X8 included Tshs236 million uplift on the retranslation of the opening non-current assets of the overseas subsidiary, Tshs2,202 million of additions (including additions arising on the acquisition of a subsidiary during the year) and Tshs950 million of disposals.

2. Movements on the depreciation of non-current assets during the year ended 30 June 20X8 included Tshs120 million uplift on the retranslation of the opening depreciation of the overseas subsidiary, depreciation charge for the year ended 30 June 20X5 of Tshs684 million and depreciation eliminated on disposals of non-current assets of Tshs690 million.

3. The proceeds of disposals of non-current assets amounted to Tshs250 million and the loss on disposals has been charged against profit on ordinary operations.

4. The taxation charge for the year ended 30 June 20X8 consists of:

Particulars	Tshs million
Group:	
Current	900
Under provision in previous year	30
Deferred	37
Share of tax of associates	41
	1,008

5. The net assets of the subsidiary acquired during the year ended 30 June 20X8, on the date its acquisition, consisted of:

Particulars	Tshs million
Non-current assets	255
Inventory	120
Receivables	225
Payables	(135)
Taxation	(30)
Bank overdraft	(22)
	413

The consideration for the 100% purchase of the shares of the subsidiary was settled by the issue of ordinary shares to the value of Tshs466 million.

6. The movement on the exchange difference reserve represents the group's share (100%) of exchange differences arising at the consolidation stage on the retranslation of the net assets and results of the overseas subsidiary and relates to the following items in the consolidated statement of financial position as on 30 June 20X8:

Particulars	Tshs million
Non-current assets: per notes 1 and 2	116
Inventory	41
Receivables	34
Payables	(54)
Bank overdraft	(3)
Debenture loans	(87)
	47

7. All goodwill arising on acquisition has been eliminated, given impairment, as at 30 June 20X8.

Required:

Prepare a statement of cash flows for the Platini Plc group for the year ended 30 June 20X8 together with a note reconciling profit with operating cash flow.

Question 7

The statement of financial positions of P Ltd and S Ltd and S_1 Ltd at 31 December 20X8 are summarised as:

Particulars	P Ltd	S Ltd	S_1 Ltd
	Tshs'000	Tshs'000	Tshs'000
First acquisition in S Ltd: cost	30,000	-	-
Second acquisition in S Ltd: cost	150,000	-	-
First and only acquisition in S_1 Ltd: cost	100,000	-	-
Sundry net assets	340,000	300,000	350,000
	620,000	**300,000**	**350,000**
Share capital (Tshs1,000 each)	300,000	20,000	80,000
Retained earnings	320,000	280,000	270,000
	620,000	**300,000**	**350,000**

The first acquisition of S was for 25% of its ordinary shares and the second acquisition of S was for a further 55% of its ordinary shares. The first acquisition gave P significant influence and the second acquisition gave P control over S.

The fair value of the sundry net assets of S Ltd exceeded their book value by Tshs5 million on the date of first acquisition and by Tshs40 million on the date of the second acquisition. S Ltd has not recorded these fair values in its own accounts.

The fair value of the first investment in S, immediately before the second acquisition, amounted to Tshs85 million.

The retained earnings of S Ltd stood at Tshs60 million on the date of the first acquisition and Tshs150 million on the date of the second acquisition.

There is no difference between the book value and fair value of the sundry net assets of S_1 Ltd.

The first and only acquisition in S_1 Ltd was 60% of its ordinary share capital when the retained earnings of S_1 Ltd stood at Tshs45 million.

All goodwill is calculated on a "partial" basis as permitted by IFRS 3. There are no impairment losses

Required:

Prepare the consolidated statement of financial position of P Ltd at 31 December 20X8, applying the required treatment of international standards for step acquisitions.

Answers to Self Examination Questions

Answer to SEQ 1

IFRS 10 Consolidated Financial Statements requires potential voting rights to be taken into account in determining whether or not an investor exercises control over its investee at a year-end: if they are substantive. At the year-end, 31 December 20X8, DBP does not own any of the equity of HBH. It does not control the composition of the Board of directors. HBH is not, legally, a subsidiary of DBP.

The call option to purchase 80% of the equity of HBH from HIP, represents potential voting rights. The options are currently exercisable (from 5 May 20X8). The question is whether they will be exercised by DBP. There is a pay-back clause, without cost to DBH, and this has a bearing on the probability of exercise. There is a material premium to be paid on acquisition. The total cost of the purchase would be Tshs70 million (Tshs40 million + Tshs30 million). The FV of HBH assets at the Agreement date is Tshs36 million (80% x Tshs45 million). Goodwill is Tshs34 million compared with identifiable net assets of HBH of Tshs36 million.

We have to consider the possibilities.

If the exercise of the options is considered likely, despite the material premium to be paid on acquisition, 80% potential voting rights should be taken into account in determining whether DBP exercises control over HBH at 31 December 20X8. In this case, HBH would fall to be classified as a subsidiary and would be consolidated by DBP at 31 December 20X8. A trade payable would be recognised for the Tshs30 million payable on assumed exercise of the options and goodwill, as calculated above, recognised. Controlling interests and non-controlling interest percentages must be based on actual holdings at the year-end. The non-controlling interest in HBH at 31 December 20X5 is 100%.

If the exercise of the options is considered unlikely, the purchase price of Tshs40 million falls to be treated as a financial instrument asset under IFRS 39. The right to appoint half of the directors on the HBH Board may indicate the exercise of significant influence. You may consider that, if the exercise of the options is unlikely, DBP would get back the Tshs40 million. This will result in the loss of the right to appoint members on the HBH Board and would therefore have no continuing involvement. Consequently there is no significant influence.

Answer to SEQ 2

(a) Consolidated Statement of Financial Position at 30 September 20X8

Northbrook - Consolidated Statement of Financial Position as at 30 September 20X8

	Tshs'000	Tshs'000
Non-current assets		
Intangible – Goodwill (W1)	1,135	
Tangible (Tshs4,512 + Tshs1,777 + Tshs527(W3))	6,816	7,951
Current assets		
Inventory (Tshs1,891+ Tshs829 – Tshs750 (W4))	1,970	
Amounts due from contract customer (W4)	947	
Receivables (Tshs1,077 + Tshs600 – Tshs20)	1,657	
Cash (Tshs500 + Tshs57 – Tshs375 + Tshs300)	482	5,056
Total assets		**13,007**
Equity and liabilities		
Share capital	1,000	
Retained earnings (W6)	7,425	
Non-controlling interest (W5)	343	8,768
Non-current liabilities		
Trade payables – lease liability (W4)		323
Current liabilities		
Trade payables (Tshs1,519 + Tshs1,371 + Tshs287 (W4))	3,177	
Provisions (Tshs214 (W1) + Tshs300 + Tshs225(W2))	739	3,916
Total equity and liabilities		**13,007**

Contingent consideration

Workings (Amounts in Tshs'000)

W1 Calculation of goodwill paid and unimpaired goodwill: Partial goodwill

The consideration includes a deferred and contingent consideration payable.

Deferred consideration payable on 1 June 20Y0 is certain to be paid and must be provided for on the date of the acquisition of Sian Sian Ltd. IFRS 3 requires such a provision to be established at the PV of the amount payable using the rate at which the acquirer can borrow funds. Therefore discount the consideration using the rate at which the acquirer can borrow funds.

Tshs250,000 x $1/(1.1)^2$ = Tshs207,000 (rounded off).

When a provision is established at present value, interest or finance cost needs to be recognised each year. This is sometimes referred to as the unwinding of the discount. Interest for the 4 months to 30 September 20X8 is: Tshs7,000 (Tshs207,000 x 10% x 4/12) (rounded off)

On 1 June 20X8

			Tshs	**Tshs**
Dr		Cost of Sian Sian	207,000	
	Cr	Provision for deferred consideration		207,000

On 30 September 20X8

			Tshs	**Tshs**
Dr		SOPL - Y/e 30/09/20X8	7,000	
	Cr	Provision for deferred consideration		7,000

The provision for deferred consideration for inclusion in the consolidated statement of financial position at 30 September 20X8 is Tshs214,000 (Tshs207,000 + Tshs7,000). Further provision is made, at 1 June 20X8, for the fair value of Tshs350,000 for the contingent consideration payable in 20Y1. The fall in the fair value of this contingent consideration of Tshs50,000 must, per IFRS 3 be recognised in statement of profit or loss and other comprehensive income for the year ended 30 September 20X8.

By way of further explanation:

The reorganisation provision is treated as post-acquisition and excluded from the fair value exercise at acquisition according to IFRS 3 and IAS 37. To qualify for recognition as an identifiable liability on the date of acquisition of the subsidiary, the provision must relate to a plan affecting the operations and employees of the subsidiary, the main features of which were announced on or before the date of acquisition. There was no announcement prior to acquisition date.

The write-off of the bad debt is treated as a charge against post-acquisition reserves on the basis that it relates to a post-acquisition trade receivable.

The dividend paid after acquisition is allocated, in the traditional way, to pre-acquisition and post-acquisition profits, on a time-apportioned basis.

Contingent consideration - Where the consideration includes a contingent consideration arrangement, then that contingent element shall be measured at fair value and included as part of the consideration transferred.

The goodwill calculation is as follows:

	Tshs'000	**Tshs'000**
Cash paid	1,950	
Provision for deferred consideration	207	
Provision for contingent consideration	350	2,507
Add: FV of NCI (20% of (250 + 1,215))		293
Less: Dividend received from Sian Sian Ltd out of pre-acquisition profit80% x 375 x 8/12		(200)
		2,600
Less: FV of net assets acquired (250 + 1,215)		(1,465)
Unimpaired goodwill at the year-end		**1,135**

W2 Calculation of Pre-acquisition and Post-acquisition profits

The reserves of Sian Sian Ltd can be divided as follows:

	Pre-acquisition Tshs'000	Post-acquisition Tshs'000
At the date of acquisition (2,085 – 620)	1,465	
After acquisition		620
Provision for reorganisation		(225)
Trade receivables written off		(20)
Dividend paid after acquisition = 375 – time apportioned 8 months:4 months	(250)	(125)
	1,215*	**250****

Note: if you calculate goodwill on a "partial" basis under IFRS 3, the amount of goodwill will be the same as under the old standard for business combinations.

W3 Capitalisation of the leased assets by Northbrook Plc

Cost of the leased asset is,1,250.

Depreciation would be calculated as follows:

		Tshs'000
Y/e 30/09/20X6	25% x 1,250	313
Y/e 30/09/20X7	25% x (1,250 – 313)	234
Y/e 30/09/20X8	25% x (1,250 – 313 – 234)	176
		723

The net book value of the assets at the year-end would be (Tshs1,250 – Tshs723) i.e. Tshs527.

Total finance charges = Tshs1,800 – Tshs1,250 = Tshs550.

The finance charges would be allocated using the sums of digit method as follows:

	Tshs'000
Y/e 30/09/20X6 (5/15 x 550)	183
Y/e 30/09/20X7 (4/15 x 550)	147
Y/e 30/09/20X8 (3/15 x 550)	110
Y/e 30/09/20X9 (2/15 x 550)	73
Y/e 30/09/20Y0 (1/15 x 550)	37
	550

Finance charges for the year ended 30/09/20X9 = Tshs73.

Rentals paid for the 3 years to 30/09/20X8 = (Tshs360 x 3) = Tshs1,080.

Lease liability (Trade payables) at 30/09/20X8 amounts to

	Tshs'000
Cost of asset	1,250
Add: Lease interest due	440
Less: Rentals paid for 3 years	1,080
Lease liability as at 30/09/20X8	**610**

The above lease liability is divided into current and non-current:

Current trade payable = Tshs360 – Tshs73 = Tshs287 and

Non-current trade payable is the balance = Tshs610 - Tshs287 = Tshs323.

Correcting Journal Entry

		Tshs'000	Tshs'000
Dr	Non-current assets	527	
Dr	Retained earnings: depreciation	723	
Dr	Retained earnings: finance charges	440	
	Cr Retained earnings: rentals paid		1,080
	Cr Trade payables (Tshs287 + Tshs323)		610

W4 Adjustments required in respect of the construction contract

Percentage of completion to date (on the basis of costs) = 750/950 x 100 = 78.95%.

	Calculation	Tshs'000
Revenue	78.95% of Tshs1,200	947
Cost of sales	78.95% of Tshs950	750
Stage profit		**197**

Amount due from customers

	Tshs'000
Cost to date	750
Add: Stage profit recognised	197
Amount due from customers	**947**

Reduce inventory in the statement of financial position by Tshs750.

Refer the following journal entry

Dr	Amount due from customer	Tshs947	
	Cr Profit from construction contract (IS)		Tshs197
	Cr Inventory		Tshs750

W5 Non-controlling interest

	Tshs'000
NCI proportion of SC and Pre-acquisition reserve (20% of 250 + 1,215)	293
Post-acquisition profits (20% of Tshs250)	50
NCI	**343**

W6 Retained earnings

	Tshs'000
Northbrook	6,968
Dividend received from Sian Sian out of post-acquisition profit	
Tshs375 x 80% = 300 x 4/12	100
Sian Sian share of retained post-acquisition profit = 80% x 250**	200
	7,268
Depreciation	(723)
Finance charges	(440)
Lease rentals	1,080
Stage profit recognised on the construction contract	197
Finance charge on provision for deferred consideration	(7)
Decrease in fair value of contingent consideration	50
	7,425

(b) Refer Working Note 1

(c) Refer Working Note 4

(d) Calculation of goodwill - "Full goodwill"

For "full goodwill", the calculation under IFRS 3 is, as defined in the standard.

	Tshs'000
The consideration transferred (refer W1 in a)	2,307
Fair value of the NCI at acquisition date	380
	2,687
Less: Net assets acquired (refer W1 in a)	(1,465)
Goodwill	**1,222**

"Full goodwill" is greater than "partial goodwill" (Tshs1,222 – Tshs1,135) by Tshs87,000.

The non-controlling interest under "full goodwill" will also change (increase) by Tshs87,000.

Under "full goodwill" non-controlling interest in SOFP is calculated as follows

	Tshs'000
Fair value of NCI	380
Add: Share in post-acquisition profits (20% of Tshs250)	50
NCI	**430**

Non-controlling interest under "partial goodwill" was Tshs343,000. The difference is (increase) Tshs87,000 (Tshs430,000 – Tshs343,000).

Answer to SEQ 3

(a) Distinguishing an associate from an ordinary non-current asset investment

An investor exercises no influence over an ordinary non-current asset investment. The investment is not substantial usually less than 20% of the votes and the investment are usually held for the purpose of dividend income. The investor does not exercise significant influence and the investment is included in the accounts of the investor and, if any, in its consolidated accounts using the "cost method". Value in the statement of financial position is at cost less any impairment losses and income in the profit for the year is dividends received.

An investment in an associate is defined in terms of significant influence. In order that such influence is exercised it follows that the investment must be substantial. This is normally assumed where at least 20% of the voting equity is held though regard should be had to the disposition of the other shareholdings. Thus it is possible that no significant influence is exercised where more than 20% of the votes are held and significant influence may be exercised with a holding of less than 20%.

Other factors such as board representation, provision of technology and significant trading relationships have a bearing on an assessment of whether or not significant influence is exercised. Significant influence may be exercised indirectly i.e. through subsidiaries. The exercise of significant influence is reflected, in the consolidated accounts through the use of the equity method see part (c).

(b) Different types of joint arrangements

According to IFRS 11, joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. In this type of joint arrangements, the venturers establish a corporation, partnership or other separate entity in order to undertake an economic activity.

A joint arrangement which is not in the form of a separate vehicle (generally a separate legal entity) will be compulsorily classified as a joint operation.

If the joint arrangement is in the form of a separate vehicle, following criteria are to be assessed:

(c) Legal form

If in accordance with the legal form, parties have rights to assets and obligation for liabilities - and not the entity - then the arrangement is a joint operation.

(d) Contractual arrangement

If in accordance with the contractual arrangement, parties have rights to assets and obligation for liabilities - and not the entity - then the arrangement is a joint operation.

(e) Other facts and circumstances

Even after considering the above criteria, if the distinction is not clear, verify other facts and circumstances. If they state that the parties are separately entitled to assets and liabilities and not the entity as a whole, then the arrangement is a joint operation.

If the joint arrangement is not a joint operation, it is a joint venture.

(f) Including Baden in the consolidated accounts of Cable using the equity method

(All numbers are in Tshs million)

The Cable group owns 30% of Baden. In the consolidation process, the holdings of Guy Ltd in Baden Ltd will not be considered. The reason being that we do not include investments held through other associates.

The profit on the inter-company sale is Tshs10 million. The group's share of this is 30% of Tshs10 million = Tshs3 million. Since the sales transaction is an upstream transaction, the URP of Tshs3 million would be applied to reduce the share of profit of the associate in profit and credited to inventory in the consolidated statement of financial position.

Dr Share of profit in assciates Tshs3 million
Cr Group inventory Tshs3 million
Being elimination of URP in inventory

Goodwill in Baden Ltd

	Tshs'000	Tshs'000
Cost of acquisition		14,000
Fair value of net assets acquired (Tshs30,000 + Tshs31,000 - Tshs20,000 - Tshs8,000)	33,000	
Proportionate value (30% of Tshs33,000)		9,900
Goodwill		4,100
Less: Impairment of goodwill (given)		(2,050)
Unimpaired goodwill		**2,050**

Additional depreciation based on fair value adjustments to be charged against the share of the post-acquisition profits of the associate amounts to 20% x (Tshs30,000 – Tshs20,000) x 2 years = Tshs4,000

Share of associate in additional depreciation = 30% of Tshs4,000 = Tshs1,200 or Tshs600 in each of the years to 31 December 20X7 and 20X8.

The carrying value of Baden for the Cable consolidated SOFP at 31 December 20X8 is:

	Tshs'000	Tshs'000
Fair value of net assets at acquisition as given (Tshs30,000 + Tshs31,000 – Tshs20,000 – Tshs8,000)	33,000	
Increase in net assets since acquisition:		
post-acquisition profits (Tshs32,000 – Tshs9,000)	23,000	
additional depreciation charged against post-acquisition profits	(4,000)	
	52,000	
Share of fair value of equity at the end of the reporting period (Tshs52,000 x 30%)		15,600
Add:		
Unimpaired goodwill as determined above		2,050
		17,650

The group's share of the post-acquisition profits of the associate would be included in consolidated retained earnings in the consolidated statement of financial position.

The following points are relevant to the inclusion of the associate in the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8:

An associate's earnings are not consolidated and no part of its revenue and operating expenses will be included under these headings in the consolidated profit for the year.

No adjustment is made to consolidated revenue and consolidated cost of sales in respect of the inter-company sale of Tshs35,000.

URP has to be charged in arriving at the consolidated profit for the year. As the associate made the sale and the profit the group's share of the URP 3 as determined above will be deducted from the group's share of the operating profit of the associate.

The group's share of the operating profit of the associate, less additional depreciation, less share of URP, to be shown in the consolidated statement of profit or loss is

30% of Tshs29,000 = Tshs8,700 - Tshs600 less Tshs3,000 = Tshs5,100.

Impairment losses of Tshs2,050 would be charged against total operating profit. This should be by reducing the share of profit of the associate.

The group's share of interest or finance cost Tshs0.9 million (30% of Tshs3 million) million will be shown in finance cost in the consolidated consolidated statement of profit or loss. Share of tax Tshs1.5 million (30% of Tshs5 million) will be shown in tax.

Extraordinary items are now abolished under IFRS. The extraordinary amount should be reclassified as ordinary and dealt with accordingly. The share of profits of the associate and the share of tax would reduce accordingly.

Note that the accounting standard on associates would require additional disclosure of the separate assets, liabilities, revenue and expenses of the associate if these were relevant to the group.

Answer to SEQ 4

(a) Classification of TRR's investment in Tianchen

A subsidiary is defined as an enterprise that is controlled by another enterprise. The key element is control and this means the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

Accounting standards dealing with subsidiaries essentially expand the definition of a subsidiary by looking at the actual control relationship that is exercised by the parent over the subsidiary, irrespective of shareholdings that may or may not bestow control.

Even though TRR has an 80% interest in Tianchen, decisions must be approved by at least one director from each of the two joint venturers. TRR cannot in this circumstance obtain the power to govern the financial and operating policies of Tianchen and Tianchen should not, therefore, be considered by TRR as a subsidiary.

The contractual arrangement for joint control makes the investment in Tianchen a joint venture within the scope of the accounting standard on joint ventures. This characteristic of joint control clearly differentiates this investment from other investment scenarios where the investor may exercise unilateral control (as in a subsidiary) or over which the investor merely has the ability to exercise significant influence (as in an associate).

(b) Effect of the two profit-sharing options in determining business structure

In classifying an investment as a joint venture, we need to consider more than the degree of joint activity that TRR can exert on the operating and financial policies of Tianchen. It is also essential to consider the degree to which TRR's returns are dependent on the results of Tianchen.

Control has been defined in (a) above as the power to govern or direct the financial and operating policies of an enterprise so as to obtain benefits from it. If the arrangement is such that the venturer's input cannot affect the level of benefits that it obtains for with.

For example, if the return is a fixed amount or a variable amount that is unconnected with the results of the venture – the arrangement does not allow the venturer any control. It is for this reason that the options with regard to the share of profits should be considered to determine the type of business structure that will be operating and the accounting treatment required.

Under Option A, even though a minimum return is guaranteed, joint control can still be exercised to increase that return. The investment is more than a mere financing arrangement. As the joint venture is a separate legal entity it should be accounted for in line with the accounting standard dealing with joint ventures.

Under Option B, even though there is allowance for input into financial and operating policies, that power cannot be exercised to obtain economic benefits for TRR as the returns are fixed.

The substance of the arrangement is that TRR lends money at a fixed rate and will not share in the future profits of the joint venture. The investment should be accounted for as a financing arrangement.

(c) Accounting for Tianchen under each of the two profit-sharing options

Option A

In the individual financial statements of TRR, the interest in the joint venture should be carried at cost less any impairment loss. This amount should be amortised over the life of the joint venture as the investment contribution will not revert back to TRR at the end of the joint venture period. Amortisation should be charged on a systematic basis to match the profit distribution generated from the investment.

In the consolidated financial statements, the investment would be included under the equity method. There is one further point here. If TRR's share of profit were not sufficient to achieve a return of 10%, it would be appropriate to treat the investment as a financing arrangement (see below) as it is likely that the guarantee will have to be invoked.

Option B

The investment should be included in both the individual accounts and consolidated accounts of TRR as a receivable at cost less provision for any decline in recoverable amount.

The fixed guaranteed return should be apportioned between an interest element and a capital repayment element so as to provide a constant rate of return on the outstanding balance.

Tip

The principles involved in this area are fairly straightforward but their application to actual investment situations is sometimes unclear.

You should always look into the substance of the relationship to determine the accounting treatment required.

(d) The difference in the accounting treatment for the two proposed joint ventures

XXC, the equity joint venture in the PRC, should be classified as a subsidiary by TRR and consolidated as TRR:

i. owns a 70% majority interest in XXC, and
ii. can appoint 5 out of 7 directors and, therefore, control the board, and
iii. has effective control over XXC as the Legal Representative and General Manager are both appointed by TRR.

Au and Au

Even though TRR has an 85% interest in the legal entity, decisions must be approved by at least one director of each party. This constitutes a contractual arrangement whereby the two joint venturers undertake an economic activity that is subject to their common control.

The investment should be classified as a joint venture. The accounting would be the same as for the joint venture with Tianchen if Option A as to profit-sharing were the adopted option.

Answer to SEQ 5

X Ltd - Consolidated Statement of Financial Position as at 31 March 20X8

	Tshs'000	Tshs'000
Non-current assets		
Tangibles (Tshs900,000 + Tshs100,000 + Tshs30,000 – Tshs9,000 (W3) + Tshs30,000 (FV adjustment) + Tshs10,000 (FV adjustments) – Tshs3,000 (W3))	1,058,000	
Investment in associate per (W5)	31,000	
Intangibles (goodwill after imapirment) (W1)	40,000	1,129,000
Current assets (Tshs640,000 + Tshs360,000 + Tshs75,000 – Tshs15,000)		1,060,000
Total assets		**2,189,000**
Equity and liabilities		
Ordinary share capital	360,000	
Share premium account	250,000	
Retained earnings (W6)	1,071,000	
Non-controlling interest (W4)	143,000	1,824,000
Non-current liabilities (Tshs200,000 + Tshs150,000 + Tshs15,000)		365,000
		2,189,000

Group structure

X owns 100 million shares our of the 150 million shares of Y or 2/3 of Y. The non-controlling interest in Y is 1/3.

Y owns 45 million shares out of the 50 million shares in Z or 90% of Z. The X group share of Y is 2/3 x 90% = 60%. The non-controlling interest in Y is 40%.

Note that Z becomes a X group company only after X purchases Y. Pre-acquisition reserves of Z for the X group consolidation are its reserves on 1 April 20X5.

Y owns 30% of W. The X group share of W is (2/3 x 30%) 20%.

Workings (Amounts in Tshs'000)

W1 Goodwill

Paid for Y

	Tshs'000	Tshs'000
Cost: direct		320,000
Add: Value of NCI (1/3 of Tshs411,000)		137,000
		457,000
Less: Fair value of net assets acquired		
- Share Capital	150,000	
- Share premium	120,000	
- Retained earnings (at acquisition date)	120,000	
- Fair value adjustment of non current asset	30,000	
- Accounting policy adjustment for intangible asset	(30,000)	
- Fair value + accounting policy adjustment to inventory (Tshs2,000 – Tshs8,000	(6,000)	
- Fair value adjustment - Provision for bad debts	(9,000)	
- Arbitration award	36,000	411,000
		46,000

Paid for Z

	Tshs'000	Tshs'000
Cost – indirect – through Y – 2/3 x Tshs90,000		60,000
Add: value of NCI		34,000
		94,000
Less: Fair value of net assets acquired		
- Share Capital	50,000	
- Share premium	10,000	
- Retained earnings (at acquisition date i.e 1 April 20X5)	20,000	
- Fair value adjustment of non current asset	10,000	
- Fair value adjustment to inventory	(5,000)	85,000
		9,000

	Tshs'000	Tshs'000
Total goodwill paid for subsidiaries (Tshs46,000 + Tshs9,000)		55,000
Impairment up to 31 March 20X8 – (Tshs55,000 x 3 years /11 years)		(15,000)
Unimpaired and included in intangibles in the SOFP		**40,000**

Paid for W

	Tshs'000	Tshs'000
Cost: indirect – through y – 2/3 x Tshs50,000	33,000	
Less: 20% x (Tshs80,000 + Tshs6,000 + Tshs7,000)	(18,600)	14,400
Impairment up to 31 March 20X8 – (Tshs14,000 x 3 years /11 years)		(4,000)
Unimpaired and included in CV of associate in the SOFP		**10,400**

Since W is an associate of Y Ltd, the goodwill in W Ltd will not be consolidated separately under goodwill. However it forms part of the cost of investment in the associate.

W2 Inter-company sales

Goods in inventory of X and Y Tshs60,000 (Tshs44,000 + Tshs16,000). All sales made by Z (MI = 40%). URP Tshs15,000 (25% x Tshs60,000) eliminated by debiting consolidated retained earnings (60%) Tshs9,000, debiting non-controlling interest in Z (40%) Tshs6,000 and crediting inventory in the statement of financial position Tshs15,000.

W3 Additional depreciation

Additional depreciation charged by Y is 10% x Tshs30,000 x 3 years = Tshs9,000.

			Tshs'000	Tshs'000
Dr		Consolidated retained earnings (2/3)	6,000	
Dr		NCI in Y (1/3)	3,000	
	Cr	Non-current assets		9,000

Additional depreciation charged by Z is 10% x Tshs10,000 x 3 years = Tshs3,000.

			Tshs'000	Tshs'000
Dr		Consolidated retained earnings (60%)	2,000	
Dr		NCI in Z (40%)	1,000	
	Cr	Non-current assets		3,000

W4 Non-controlling interest

	Tshs'000	Tshs'000
In Y		
Share of equity 1/3 (Tshs480,000 + Tshs30,000 – Tshs30,000)	160,000	
Less: NCI in Y share of cost of Z and W – 1/3 x (Tshs90,000 + Tshs50,000)	(47,000)	
Less: Additional depreciation per (W3)	(3,000)	110,000
In Z		
Share of equity 40% x (Tshs90,000 + Tshs10,000)	40,000	
Less: NCI share of URP per W2	(6,000)	
Less: Additional depreciation per (W3)	(1,000)	33,000
		143,000

W5 Carrying value of associate (SOFP)

	Tshs'000
Share of equity: (20% x Tshs103,000)	20,600
Unimpaired goodwill per (W1)	10,400
	31,000

W6 Consolidated retained earnings

	Tshs'000
X	1,050,000
Y: 2/3 x (Tshs210,000 – Tshs120,000 – Tshs2,000 + Tshs8,000 + Tshs9,000 – Tshs36,000) the last 4 numbers were dealt with as adjustments to pre-acquisition profits as the assets no longer exist in the statement of financial position the other side of the entry is here in post-acquisition profits	46,000
Z: 60% x (Tshs30,000 – Tshs20,000 + Tshs5,000) the last number was dealt with as an adjustment to pre-acquisition profits as the asset no longer exists in the statement of financial position the other side of the entry is here in post-acquisition profits	9,000
W: 20% x (Tshs17,000 – Tshs7,000)	2,000
	1,107,000
Less: Consolidation adjustments	
URP attributable to the group per (W2)	(9,000)
Additional depreciation per (W3) (Tshs6,000 + Tshs2,000)	(8,000)
Impairment of goodwill per (W1) (Tshs15,000 + Tshs4,000)	(19,000)
	1,071,000

Answer to SEQ 6

Platini Group - Statement of cash flows for the year ended 30 June 20X8

	Tshs million	Tshs million
Group operating profit (W1)	2,232	
Add: Depreciation	684	
Add: Loss on sale of non-current assets	10	
Changes in working capital		
Less: (Increase) in inventory	(566)	
Less: (Increase) in receivables	(834)	
Add: Increase in payables	601	
Cash flow from operations	2,127	
Less: Tax paid	(340)	
Cash flow from Operating activities		**1,787**
Investing activities		
Dividends received from associates (W4)	31	
Non-current assets purchased	(1,947)	
Proceeds of sale of non-current assets (W2)	250	
Purchase of subsidiary	(22)	
Cash flow from investing activities		**(1,688)**
Financing activities		
Shares issued for cash (W10)	23	
Loans issued for cash (W9)	107	
Dividends paid by parent	(504)	
Dividends paid by subsidiaries to NCI	(24)	
Cash flow from financing activities		**(398)**
Decrease in cash and cash equivalents during the period		(299)
Cash and cash equivalents brought forward		(1,620)
Exchange difference		(3)
Cash and cash equivalents carried forward		**(1,922)**

Workings (All amounts in Tshs million)

W1 Group operating profit

	Tshs million
As given	2,179
Add: Goodwill written off on acquisition (Tshs466 million - Tshs413 million)	53
As per SOFP	**2,323**

W2 Property plant and equipment

Dr			Cr
	Tshs million		**Tshs million**
Balance b/d	8,357	Cost of asset disposed of	950
Exchange gain on retranslation of opening NCA of overseas subsidiary	236	Depreciation for the year	684
Cash (including additions on acquisition of subsidiary) of subsidiary)	2,202	Depreciation on gain on retranslation of opening NCA of overseas subsidiary retranslation of opening NCA of overseas subsidiary NCA of overseas subsidiary	120
Depreciation on disposed of assets	690	Balance c/f	9,731
	11,485		**11,485**

W3 Loss on disposal of NCA

Sales proceeds – (Cost of NCA – Accumulated depreciation on NCA) = Tshs250,000 – (Tshs950,000 - Tshs690,000) = (Tshs10,000)

W4 Investment in associates

Dr			Cr
	Tshs million		**Tshs million**
Balance b/d	510	Cash (dividend received) bal. fig.	31
Share of pre-tax profits of associates	87	Share of tax of associates	41
		Balance c/f	525
	597		**597**

W5 Inventories

Dr			Cr
	Tshs million		**Tshs million**
Balance b/d	2,705		
Exchange gain on retranslation	41		
Addition on acquisition	120	Balance c/f	3,432
Increase in inventory	566		
	3,432		**3,432**

W6 Trade receivables

Dr			Cr
	Tshs million		**Tshs million**
Balance b/d	3,056		
Exchange gain on retranslation	34		
Addition on acquisition	225		
Increase in trade receivables	834	Balance c/f	4,149
	4,149		**4,149**

W7 Trade payables

Dr			Cr
	Tshs million		**Tshs million**
		Balance b/d	3,434
		Exchange loss on translation	54
		Addition on acquisition	135
Balance c/f	4,224	Increase in trade payables	601
	4,224		**4,224**

W8 Tax paid

Dr			Cr
	Tshs million		**Tshs million**
Cash paid (balancing fig.)	340	Balance b/d	
		Tax	353
Balance c/f		Deferred tax	147
Tax	941	charge for the year	967
Deferred tax	216	On acquisition	30
	1,497		**1,497**

W9 Debenture loans

Dr			Cr
	Tshs million		**Tshs million**
		Balance b/d	2,903
		Exchange loss on translation	87
		Loans issued for cash	107
Balance c/f	**3,097**		**3,097**

W10 Share capital and share premium

Dr			Cr
	Tshs million		**Tshs million**
		Balance b/d	3,191
		Investment in subsidiary	466
		Shares issued for cash (balancing fig.)	23
Balance c/f	**3,680**		**3,680**

W11 Non-controlling interests

Dr			Cr
	Tshs million		**Tshs million**
Dividend paid to NCI (balancing fig.)	24	Balance b/d	266
Balance c/f	302	Share of profit of subsidiary	60
	326		**326**

Answer to SEQ 7

P Ltd Group – Consolidated Statement of Financial Position at 31 December 20X8

	Tshs'000
Non-current assets	
Goodwill (W2)	92,000
Sundry net assets (Tshs340,000 + Tshs300,000 + Tshs40,000 + Tshs350,000)	1,030,000
Total assets	**1,122,000**
Equity and liabilities	
Share capital (Tshs1,000 each)	300,000
Retained earnings (W4)	614,000
Non-controlling interest (W3)	208,000
Total equity and liabilities	**1,122,000**

Workings (All amounts in Tshs'000)

W1 Treatment of investment

First consider S which is an associate up to the date of the second acquisition. It will have been included in the P consolidated accounts using the equity method. The carrying amount of the investment in the consolidated statement of financial position can be explained as:

	Tshs'000
Cost	30,000
Share of retained post-acquisition profits 25% of (Tshs150,000 – Tshs60,000)	22,500
	52,500

The fair value of this investment immediately before the second acquisition is Tshs85 million. IFRS 3 requires to to revalue the investment to Tshs85 million and to recognise a gain in consolidated profit or loss) Tshs32.5 million (Tshs85 million – Tshs52.5 million). We can now calculate goodwill arising for the business combinations with S and S1:

W2 Calculation of goodwill

	S	S1
	Tshs'000	Tshs'000
Consideration transferred	150,000	100,000
NCI measured as proportion of fair value of identifiable net assets		
- 20% of (Tshs20,000 + Tshs150,000 + Tshs40,000)	42,000	
- 40% of (Tshs80,000 + Tshs45,000)		50,000
Fair value of the acquirer's previously held equity interest in S (W1)	85,000	
	277,000	150,000
Less:		
Fair value of identifiable net assets at acquisition date		
(Tshs20,000 + Tshs150,000 + Tshs40,000)	(210,000)	
(Tshs80,000 + Tshs45,000)		(125,000)
Goodwill paid	**67,000**	**25,000**

W3 Calculation of non-controlling interest

	Tshs'000	Tshs'000
At acquisition	42,000	50,000
Increase since acquisition		
20% of (Tshs280,000 – Tshs150,000)	26,000	
40% of (Tshs270,000 – Tshs45,000)		90,000
	68,000	**140,000**

W4 Consolidated retained earnings

	Tshs'000
P	320,000
S	
- 25% of (Tshs150,000 – Tshs60,000)	22,500
- 80% of (Tshs280,000 – Tshs150,000)	104,000
S1 60% of (Tshs270,000 – Tshs45,000)	135,000
Gain on step acquisition (W1)	32,500
	614,000

SECTION D

FINANCIAL STATEMENTS OF GROUP OF ENTITIES

D2

STUDY GUIDE D2: CONTINUING AND DISCONTINUED INTERESTS

Get Through Intro

In Study Guide E1 we have discussed step acquisitions during the year. What happens when there are both acquisitions and disposals in the same period? How is it reflected in the consolidated financial statements of the group?

For example: The following transactions took place during the year to 31 December 20X7.
Hermione Co acquired shares in Hamlet Co in the following stages:

15% on 1 April 20X7
25% on 1June 20X7
20% on 1 July 20X7
On 1 November 20X7, Hermione Co sold all the shares that it had acquired on 1 April 20X7.

Sometimes subsidiaries are acquired only with the intention of selling them at a later date. This could be done with a view to earning profits by acquiring the subsidiary when the share price is low and selling them when the share price increases.

In this Study Guide we shall discuss the accounting treatment when there are step acquisitions and disposals and cases when subsidiaries are acquired with an intention to sell at a later date. This knowledge will be very helpful in your professional life because such transactions are very common in the corporate world.

Learning Outcomes

a) Calculate from given data and information the amounts to be included in a group's consolidated financial statements arising from existing, new or discontinuing activities or interests in subsidiaries, associates or joint ventures in accordance with IFRSs and local regulations.
b) Apply the requirements of International Financial Reporting Standards with the regards to the treatment of a subsidiary which has been acquired exclusively with a view to subsequent disposal.

1. Calculate from given data and information the amounts to be included in a group's consolidated financial statements arising from existing, new or disposal of interests in subsidiaries, associates or joint ventures in accordance with IFRSs and local regulations. [Learning Outcome a]

Case Study

Profit on the disposal of subsidiaries and associates

The profit on the disposal of subsidiary and associated undertakings of Posiden, a manufacturing conglomerate comprises the following

	Tshs million	
	20X4	**20X3**
Finland	221	43
Sweden	275	-
Norway	253	-
Malaysia	-	710
Other small operations	(38)	(95)
Profit on disposal before tax	711	658
Tax credit / (charge) on profit on disposal (also includes previous year's tax credit benefits against the same year's disposals for 20X4)	(42)	(184)
Profit on disposal after tax	**669**	**474**

The above extract from the consolidated financial statements of Posiden group will give you an idea of how often disposals of subsidiaries occur in the corporate world where the entire globe has become one corporate village. This Study Guide will help you account for such transactions correctly and in accordance with the International Financial Reporting Standards.

This Study Guide deals with continuing and discontinued interests and follows on from Study Guide E2. Study Guide E1 dealt, in the main, with acquisitions and the expanding group. Study Guide E2 deals, in the main, with disposals and the contracting group. We continue to be concerned with IFRS 3 Business Combinations. We are also here concerned with IFRS 10 Consolidated Financial Statements.

The main point to be noted is in relation to accounting for disposals. The new IFRS 10 clearly distinguishes between situations where control is retained and where control is lost. The main questions are whether a gain / loss should be determined on the sale, how to calculate any gain / loss arising, is there any subsequent impact on goodwill and where to recognise any gain / loss in the statement of profit or loss.

You need to consider changes in the composition of a group, including step acquisitions, acquisitions following the acquisition of control (increase in control holding), indirect holdings, associates and the equity method of accounting, overseas entities, group reorganisation and group statement of cash flows.

This Study Guide starts with an explanation of the required accounting where an investor who already has control (controlling interest) purchases a further interest.

There was no guidance under the old IFRS 3 and a variety of accounting responses developed to deal with this situation. IFRS 3 Business Combinations provides clarity and lays down the required basis for accounting; however, there are dissenting opinions.

The objective of IFRS 10 Consolidated Financial Statements is to enhance the relevance, reliability and comparability of the information that a parent entity provides in its separate financial statements and in its consolidated financial statements for a group of entities under its control.

The Standard specifies

the circumstances in which an entity must consolidate the financial statements of another entity;
the accounting for changes in the level of ownership interest in a subsidiary;
the accounting for the loss of control of a subsidiary; and

IFRS 10 prescribes that a parent shall consolidate its investment in subsidiaries in accordance with the standard.

The standard also prescribes certain exceptions which are discussed below.

Exemption from preparing consolidated financial statements

A parent can be exempted from preparing consolidated financial statements, only if **all the four conditions** mentioned below **are fulfilled**

(a) **The parent itself is a wholly or partially-owned subsidiary of another entity, and its other owners** (including those who are not otherwise entitled to vote) have been informed, and do not object to, the parent not presenting consolidated financial statements.

(b) **The ultimate or any intermediate parent of the parent produces consolidated financial statements** available for public use that comply with International Financial Reporting Standards.

Example

Pacific Inc is the parent of Atlantic Inc; Atlantic Inc is the parent of Arctic Co.

Atlantic Inc need not prepare consolidated financial statements if

Its other owners (including those who are not otherwise entitled to vote) have been informed, **and do not object to**, the parent not presenting consolidated financial statements.

Pacific Inc produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

(There **are two more conditions** which **Atlantic Inc has to fulfil before it can be exempted from preparing consolidated financial statements.** These conditions are explained later).

Atlantic Inc is **exempted from preparing consolidated financial statements because**

Pacific Inc is the ultimate parent of Arctic Co (by indirect control).

The consolidated financial statements prepared by Pacific Inc will include the accounts of both Atlantic Co and Arctic Co.

Any information needed by the users of financial statements of Atlantic Co can be obtained from the consolidated financial statements of Pacific Inc.

(c) **The parent's debt or equity instruments are not traded in a public market** (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

(d) **The parent has not filed, nor is it in the process of filing, its financial statements** with a securities commission or other regulatory organisation **for the purpose of issuing any class of instruments in a public market.**

Example

In the above example, Atlantic Inc can be exempted from preparing its consolidated financial statements only if it satisfies the following two conditions as well

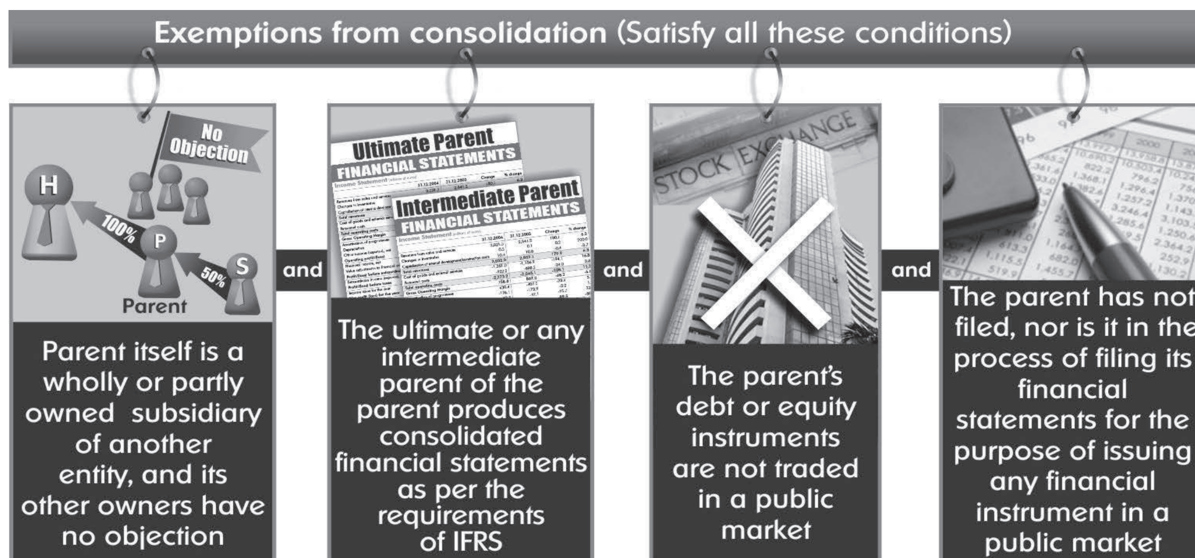
Atlantic Inc's debt or equity instruments are not traded in a public market.

Atlantic Inc has not filed, nor is it in the process of filing its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

Atlantic Inc is **exempted from preparing consolidated financial statements** because

The general public is not concerned with the financial position of Atlantic Inc. The owners of Atlantic Inc would be limited in number, and would probably have direct access to the accounts of Atlantic Inc.

Diagram 1: Exclusion from consolidation



The exceptions to consolidation are strictly limited and cannot be generalized from the situations described above. A subsidiary is not excluded from consolidation because its business activities are dissimilar from those of other entities within the group.

Relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated accounts about the different business activities of subsidiaries for example, the disclosures required by IFRS 8 Operating Segments help to explain the significance of different business activities within the group.

A subsidiary cannot be excluded from consolidation simply because the investor is a venture capital organization, mutual fund, unit trust, or similar entity

Temporary control situations subsidiary purchased with a view to subsequent disposal are dealt in Learning Outcome 2 later in this Study Guide.

1. Changes in ownership interest - without loss of control

(a) Purchase by a controlling interest of a non-controlling interest

IFRS 10 states that changes in a parent's ownership that do not result in a loss of control are accounted for as equity transactions (i.e. transactions with owners in their capacity as owners).

A parent may increase its ownership interest in a subsidiary by

(i) purchasing additional shares
(ii) having the subsidiary purchase its own shares from the non-controlling interest
(iii) having the subsidiary issue new shares to the controlling interest

Similarly, a controlling interest may reduce its ownership interest without losing control. Such situations are dealt with in (b) below.

Whether there is a purchase the carrying amounts of controlling and non-controlling interests are adjusted to reflect the change in respective ownership interests. To the extent that the consideration payable for the increase in interest exceeds the carrying value of the relevant non-controlling interest, it is recognised directly in equity attributable to the controlling interest.

This method of accounting applies regardless of the option chosen to measure non-controlling interest when control was obtained.

Example

A parent owns an 80% interest in a subsidiary which has identifiable net assets of Tshs8 million. The carrying amount of the non-controlling interest is Tshs1.6 million. This means that non-controlling interest was identified at acquisition as the non-controlling interest share of identifiable net assets of the subsidiary at acquisition date and goodwill recognised on consolidation is that attributable to the controlling interest only.

The parent acquires an additional 10% interest from the non-controlling interest for Tshs1 million. The transaction is accounted for directly in equity as follows

			Tshs	Tshs
Dr		Equity non-controlling interest (Tshs1.6 million / 2)	0.8 million	
Dr		Equity controlling interest (Bal. figure)	0.2 million	
	Cr	Cash (paid by parent to NCI)		1 million

Should we make a transfer, within equity, out of non-controlling interest to controlling interest?

The standard is silent. However, we no longer take a "proprietary view" when we prepare consolidated financial statements; we take an "entity" view and, under this view, with two equity participants, it is right to account for the transaction as outlined above. Therefore, no gain or loss from these changes should be recognised in profit or loss. Furthermore, no change in the carrying amounts of the subsidiary's assets and liabilities should be recognised. There should be no change in the carrying amount of goodwill.

(b) Disposal of interest - If there is no loss of control

IFRS 10 follows the economic entity approach while preparing consolidated financial statements. The old IAS 27 adopted the parent company approach in which the financial statements were prepared with the perspective of the parent company's shareholders. Under the economic entity approach all providers of share capital are treated as shareholders of the entity, even when they are not shareholders in the parent company. Therefore if there is a disposal of a partial interest in which the parent company retains the control, this does not result in gain or loss, but in an increase or decrease in equity under the economic entity approach.

The carrying amounts of the controlling and non-controlling interests should be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which non-controlling interest are adjusted and the fair value of the consideration received shall be recognised directly in equity and attributed to the owners of the parent.

2. Changes in ownership interest - if there is loss of control

(a) **Derecognise the assets (including goodwill) and liabilities** of the subsidiary at their carrying amounts at the date when control is lost.

(b) Derecognise the carrying amount of any non-controlling interest in the subsidiary that is sold, at the date control is lost.

(c) Recognise the fair value of the **consideration received**.

(d) Recognise any **investment retained in the former subsidiary at its fair value** at the date when control is lost.

(e) If the transaction, event or circumstances that resulted in the loss of control involve a distribution of shares of the subsidiary to the owners in their capacity as owners, recognise that distribution.

(f) Recognise any difference as **gain or loss in profit or loss** attributable to the parent.

(g) The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the **fair value on initial recognition** of a financial asset in accordance with IFRS 9 or, when appropriate, the **cost on initial recognition** of an investment in an associate or jointly controlled entity.

(h) Reclassify to profit or loss, or transfer directly to retained earnings if required by other IFRSs, the amounts recognised in other comprehensive income in relation to the subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities, as follows

(i) if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment)

(ii) if a revaluation surplus previously recognised in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary

The gain or loss on disposal is therefore calculated as follows

Fair value of consideration received	XX
Add: Fair value of retained NCI in the subsidiary at the date when control is lost	XX
Add: Carrying value of NCI in the former subsidiary at the date when control is lost	XX
Less: Carrying value of net assets of subsidiary at the date when control is lost	(XX)
Add / Less: Any amounts included in OCI relating to subsidiary, that would be required to be reclassified to profit and loss if the parent had disposed of the related assets and liabilities	XX / (XX)
Gain or loss on disposal	**XXX**

Example

Alpha Ltd has an 80% controlling interest in Beta Ltd on 31 December 2006.

The carrying value of Beta's net assets in Alpha's consolidated financial statement is Tshs125 million and that of non-controlling interest is Tshs10 million (this includes share of accumulated other comprehensive income).

On 1 January 2007, Alpha sells 70% of the share in Beta to Gamma Ltd for Tshs150 million cash. This results in loss of control over Beta. However it retains 10% non-controlling interest having a fair value of Tshs12 million on 1 January 2007.

The gain on sale of 70% is calculated as follows

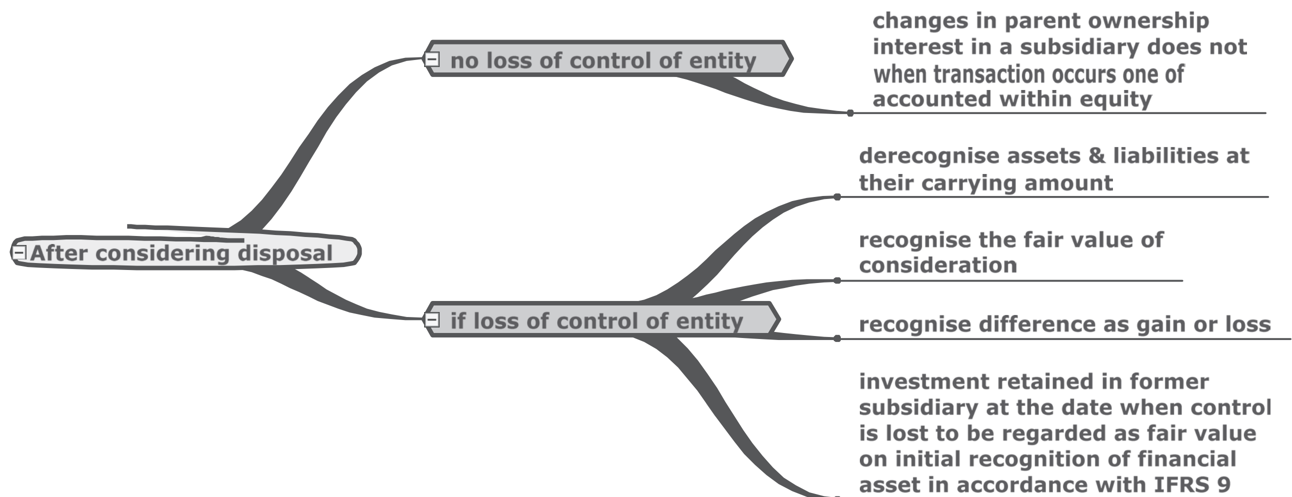
	Tshs'000	Tshs'000
Cash proceeds	150,000	
Add: FV of NCI retained	12,000	
Add: Carrying value of NCI	10,000	172,000
Less: Carrying value of Beta's net assets		(125,000)
Gain on disposal		**47,000**

Tip

Full disposal - There will be no non-controlling interest or investment in the statement of financial position.

Partial disposal - The retained investment (the investor now turns into non-controlling interest) in the former subsidiary is shown either as an associate or an investment under IFRS 9 Financial Instruments.

SUMMARY



This illustrative question deals with goodwill calculations, purchase of non-controlling interest, disposal with no loss of control, disposal with loss of control.

Example

The summarised statement of financial positions of three companies, P Ltd, Sub 1 Ltd and Sub 2 Ltd, made up to 31 December 20X8, are provided as follows:

	P Ltd	Sub 1 Ltd	Sub 2 Ltd
	Tshs'000	Tshs'000	Tshs'000
Tangible non-current assets	10,000	8,000	7,000
Cost of the 75% holding in Sub 1 Ltd	4,000	-	-
Cost of the 80% holding in Sub 2 Ltd	3,500	-	-
Net current assets	6,500	7,000	5,000
Total assets	**24,000**	**15,000**	**12,000**
Equity and liabilities Share Capital (Tshs1,000) Reserves:	6,000	2,000	2,500
accumulated profits	16,500		
- at acquisition		1,500	500
- post-acquisition b/f at 1 January 20X8		10,000	7,000
- profit for the y/e 31 December 20X8 (refer summary below)	1,500	1,500	2,000
Total equity and liabilities	**24,000**	**15,000**	**12,000**

The summarised statement of profit or loss and the change in retained earnings for the three companies for the year ended 31 December 20X5 are provided as follows

	P Ltd	Sub 1 Ltd	Sub 2 Ltd
	Tshs'000	Tshs'000	Tshs'000
Operating profit before tax	5,000	4,000	4,500
Tax on profits	(1,500)	(2,000)	(1,500)
	3,500	2,000	3,000
Dividends paid on 15 December 20X8	(2,000)	(500)	(1,000)
Retained profit for the y/e 31 December 20X8	1,500	1,500	2,000

P Ltd has taken credit for dividends received from Sub 1 Ltd and Sub 2 Ltd. These dividends are included in the operating profit before tax of P Ltd above.

All profits arise evenly through the year.

Continued on the next page

The statement of financial position and statement of profit or loss above do not reflect either the sale of shares or the sale proceeds.

Goodwill, at 75%/80% acquisition dates was calculated on a partial basis i.e. non-controlling interest at acquisition date is measured on the basis of proportionate share of the identifiable net assets of acquiree at acquisition date.

Goodwill, on the basis set above, amounts to Tshs1,375,000 for the 75% acquisition in Sub 1 and Tshs1,100,000 for the 80% acquisition in Sub 2. There is no impairment of goodwill following acquisition.

Ignore any tax on the gain on sale.

Consider the 3 situations given below

Situation 1	The controlling interest in Sub 1 with P Ltd purchases 10% of the shares in Sub 1 from the non-controlling interest in Sub 1 so that, after the purchase the holding in Sub 1 is 85% to the controlling interest and 15% to the non-controlling interest. The purchase took place on 1 January 2008 and P paid the non-controlling interest in Sub 1 Tshs950,000.
Situation 2	The controlling interest in Sub 1 sells 10% of the shares in Sub 1 to the non-controlling interest in Sub 1 on 1 January 2008 for Tshs950,000. The respective holdings in Sub 1, after the disposal, are 65%/35% controlling and non-controlling interest respectively. In addition, the controlling interest in Sub 2 sells one quarter of its interest in Sub 2 to the non-controlling interest in Sub 2. The sale takes place on 1 January 2008 and P receives Tshs3,000,000 for the sale. The respective holdings in Sub 2, after the disposal, are 60%/40% controlling and non-controlling interest respectively.
Situation 3	There is no change in the interest in Sub 1. On 1 January 20X8, P sells 35% of the shares of Sub 2 to the old non-controlling interest in Sub 2 for Tshs6,400,000. The respective holdings in Sub 2, after the disposal, are 45% by P and 55% by the outside shareholders. You may assume that P has significant influence in respect of its remaining investment in Sub 2. The fair value of the remaining stake is Tshs1,700,000 higher than its book value on the date control is lost.

Required:

Prepare the consolidated statement of financial position and statement of profit or loss and other comprehensive income for the P Group for the year ended 31 December 20X8 so as to comply with IFRS 3 and IFRS 10.

Note: Assume that consideration received / paid in all the above cases is to be added to / deducted from current assets.

Answer

Situation 1- further purchase of 10%

P Group - Consolidated Statement of Financial Position at 31 December 2008

	Tshs'000	Tshs'000
Non-current assets		
Intangible: unimpaired goodwill (Tshs1,375 + Tshs1,100) W1	2,475	
Tangible (Tshs10,000 + Tshs8,000 + Tshs7,000)	25,000	27,475
Net current assets (Tshs6,500 - Tshs950 + Tshs7,000 + Tshs5,000)		17,550
Total assets		**45,025**
Equity and liabilities		
Share Capital	6,000	
Retained earnings (W3)	34,375	
Non-controlling interest (W2)	4,650	45,025
Total equity and liabilities		**45,025**

Continued on the next page

P Group - Consolidated Statement of Profit or Loss and other comprehensive income for the year ended 31 December 2008

	P	Sub 1	Sub 2	CIS
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Operating profit before tax	5,000	4,000	4,500	13,500
Less: Dividend from Sub 1 (85% x Tshs500)	(425)			(425)
Less: Dividend from Sub 2 (80% x Tshs1,000)	(800)			(800)
Profit before tax				12,275
Tax expense	(1,500)	(2,000)	(1,500)	(5,000)
Profit for the year				**7,275**
Share of profit attributable to -				
Owner of the parent (balancing figure)				6,375
NCI (15% of Tshs2,000) and (20% of Tshs3,000)		300	600	900
				7,275

Workings

W1 Goodwill

	Sub 1	Sub 2
	Tshs'000	Tshs'000
Fair value of consideration	4,000	3,500
Add: Proportionate NCI		
Sub1 (25% of Tshs3,500)	875	
Sub2 (20% of Tshs3,000)		600
	4,875	4,100
Less: Fair value of net assets acquired	(3,500)	(3,000)
	1,375	**1,100**

W2 Non-controlling interest

	Tshs'000
Sub 1	
At acquisition 25% x (Tshs2,000 + Tshs1,500)	875
From acquisition to 31 December 2007 25% x Tshs10,000	2,500
For the year ended 31 December 2008 15% x Tshs1,500	225
Reduction in the NCI (Tshs875 + Tshs2500) /25 x 10	(1350)
Sub 2	
At acquisition 20% x (Tshs2,500 + Tshs500)	600
Since acquisition 20% x (Tshs7,000 + Tshs2,000)	1,800
	4,650

W3 Consolidated retained earnings

	P	Sub 1	Sub 2	CIS
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Profit for the year – as calculated in SOPL				6,375
Dividends paid				(2,000)
Profit retained for the year				4,375
Consolidated profits b/f				
P (Tshs18,000 – Tshs1,500)	16,500			16,500
Sub 1: (75% x Tshs10,000)		7,500		7,500
Sub 2: (80% x Tshs7,000)			5,600	5,600
				33,975
Gain on purchase of NCI (Tshs1,350 - Tshs950)				400
				34,375

You must eliminate inter-company dividends on consolidation

Continued on the next page

Situation 2

P retains a controlling interest in both Sub 1 and Sub 2 at 31 December 20X8.

P Group - Consolidated Statement of Financial Position at 31 December 2008

	Tshs'000	Tshs'000
Non-current assets		
Intangible: unimpaired goodwill (Tshs1,375 + Tshs1,100)	2,475	
Tangible (Tshs10,000 + Tshs8,000 + Tshs7,000)	25,000	27,475
Net current assets (Tshs6,500 + Tshs950 + Tshs3,000 + Tshs7,000 + Tshs5,000)		22,450
Total assets		**49,925**
Equity and liabilities		
Ordinary shares	6,000	
Retained earnings (W3)	33,875	
Non-controlling interest (W2)	10,050	49,925
Total equity and liabilities		**49,925**

P Group - Consolidated Statement of Profit or Loss and other comprehensive income for the year ended 31 December 2008

	P	Sub 1	Sub 2	CIS
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Operating profit before tax	5,000	4,000	4,500	13,500
Less: Dividend from Sub 1 (65% x Tshs500)	(325)			(325)
Less: Dividend from Sub 2 (60% x Tshs1,000)	(600)			(600)
Profit before tax				12,575
Tax expense	(1,500)	(2,000)	(1,500)	(5,000)
Profit for the year				**7,575**
Profit attributable to:				
Owner of the parent				5,675
NCI (35% of Tshs2,000) and (40% of Tshs1,500)		700	1,200	1,900
				7,575

Working

W1 Goodwill

Refer to calculations of goodwill in Situation 1

W2 Non-controlling interest

	Tshs'000	Tshs'000
Sub 1		
At acquisition 25% x (Tshs2,000 + Tshs1,500)	875	
From acquisition to 31 December 20X7 (25% x Tshs10,000)	2,500	
For the year ended 31 December 20X8 (35% x Tshs1,500)	525	
Increase in the NCI (Tshs875 + Tshs2500) /25 x 10	1350	5,250
Sub 2		
At acquisition (20% x (Tshs2,500 + Tshs500))	600	
From acquisition to 31 December 20X8 (20% x Tshs7,000)	1,400	
For the year ended 31 December 20X8 (40% x Tshs2,000)	800	
Increase in the NCI (Tshs600 + Tshs1,400) /20 x 20	2,000	4,800
		10,050

Continued on the next page

W3 Retained earnings

	P	Sub 1	Sub 2	CIS
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Profit for the year – as calculated above				5,675
Less: Dividends paid				(2,000)
Profit retained for the year				3,675
Consolidated profits b/f				
P (Tshs18,000 – Tshs1,500)	16,500			16,500
Sub 1 (75% x Tshs10,000)		7,500		7,500
Sub 2 (80% x Tshs7,000)			5,600	5,600
				33,275
Disposal to NCI				
-loss in Sub1 (Tshs1,350 - Tshs950)				(400)
- gain in Sub2 (Tshs3,000 - Tshs2,000)				1,000
				33,875

Note: You must eliminate intercompany dividends on consolidation

Situation 3

P Group - Consolidated Statement of Financial Position at 31 December 2008

	Tshs'000
Non-current assets:	
Intangible: unimpaired goodwill: Sub 1 only	1,375
Tangible Tshs10,000 + Tshs8,000	18,000
Investment in associate (W4)	7,719
Net current assets (Tshs6,500 + Tshs6,400 + Tshs7,000)	19,900
Total assets	**46,994**
Equity and liabilities	
Share Capital	6,000
Retained earnings (see workings below)	37,244
Non-controlling interest: Sub 1 (only 25% x Tshs15,000)	3,750
Total equity and liabilities	**46,994**

P Group - Consolidated Statement of Profit or Loss and other comprehensive income for the year ended 31 December 2008

Tshs4,500 x 45%

	P	Sub 1	Sub 2	CIS
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Operating profit before tax	5,000	4,000	2,025	11,025
Less: Dividend from Sub 1 and Sub 2 75% x Tshs500	(375)			(375)
45% x Tshs1,000	(450)			(450)
Gain on disposal (loss of control) (refer above for calculation)				4,119
Profit before tax				14,319
Tax expense Sub 2 (45% x 1,500)	(1,500)	(2,000)	(675)	(4,175)
Profit for the year				**10,144**
Share of profit attributable to -				
Owners of the parent (balancing figure)				9,644
NCI Sub 1: 25% of Tshs2,000		500		500
				10,144

Continued on the next page

W1 Goodwill

	Sub 1
	Tshs000
Fair value of consideration	4,000
Add: Proportionate NCI	
Sub1 (25% of Tshs3,500)	875
Sub2 (20% of Tshs3,000)	
	4,875
Less: Fair value of net assets acquired	(3,500)
	1,375

W2 Non-controlling interests

	Tshs'000
Sub 1	
At acquisition 25% x (Tshs2,000 + Tshs1,500)	875
From acquisition to 31 December 20X7 (25% x Tshs10,000)	2,500
For the year ended 31 December 20X8 (25% x Tshs1,500)	375
	3,750

W3 Retained earnings

	P	Sub 1	Sub 2	CIS
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Profit as above				9,644
Less: Dividends paid				(2,000)
Profit retained for the year				7,644
Consolidated profits b/f				
P (18,000 – Tshs1,500)	16,500			16,500
Sub 1: 75% x Tshs10,000		7,500		7,500
Sub 2: 80% x Tshs7,000			5,600	5,600
				37,244

You must eliminate inter-company dividends on consolidation.

W4 Changes in holdings - profit and the CV -Sub 2

Investment in associates

	Total	Sold	Retained
	Tshs'000	Tshs'000	Tshs'000
	100%	35%	45%
Equity on the date of change			
Share capital	2,500		
Reserves on acquisition	500		
Reserves post acquisition , but before 1 January 2008	7,000		
	10,000	3,500	4,500
Goodwill (Refer to working note made above)	1,100	481	619
Subsequent change	2,000		900
Fair value change (given in question)		(1,700)	1,700
Net value		**2,281**	**7,719**
Sale proceeds		6,400	
Gain on disposal		**4,119**	

Note: goodwill can also be calculated as proportionate consideration (Tshs3,500 x 45/80) minus proportionate net assets at the date of acquisition (Tshs2,500 + Tshs500) x 45% i.e. Tshs1,969 - Tshs1,350 = Tshs619

The gain on sale can be calculated as the proceeds of sale less the net assets representing the shares sold, including goodwill.

Test Yourself 1

Alpha acquired 80% of the shares of Beta for Tshs810 million on 1 April 2010. At that date Beta's retained earnings balance stood at Tshs450 million. The financial statements of both the companies at 31 March 2013 are given below.

	Alpha	Beta
	Tshs'000	Tshs'000
Assets		
Non-current assets	900,000	675,000
Investment in Beta	810,000	-
Current assets	925,000	925,000
Total assets	**2,635,000**	**1,600,000**
Equity and liabilities		
Share capital (Tshs1,000 each)	1,350,000	450,000
Retained earnings	1,035,000	900,000
Current liabilities	250,000	250,000
Total equity and liabilities	**2,635,000**	**1,600,000**

Extracts of Statements of profit or loss	Alpha	Beta
	Tshs'000	Tshs'000
Profit before tax	382,500	315,000
Less: Tax expense	(112,500)	(90,000)
Profit for the year	**270,000**	**225,000**

Note:

Assume that profits accrue evenly throughout the year.
It is the group’s policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary’s identifiable net assets.
Ignore taxation.

Required:

Prepare the consolidated statement of financial position and statement of profit or loss as at 31 March 20X8 in each of the following circumstances.

1. **Situation A:** Alpha sells its entire holding in Beta for Tshs1,625 million on 31 March 2013.

2. **Situation B:** Alpha sells 1/4th of its holding in Beta for Tshs400 million on 31 December 2012.

3. **Situation C:** Alpha sells 50% of its holding in Beta for Tshs1,062.5 million on 31 December 2012, and the remaining 30% holding is to be dealt with as an associate. The fair value of remaining holding is Tshs791,250 million)

2. Apply the requirements of International Financial Reporting Standards with the regards to the treatment of a subsidiary which has been acquired exclusively with a view to subsequent disposal.

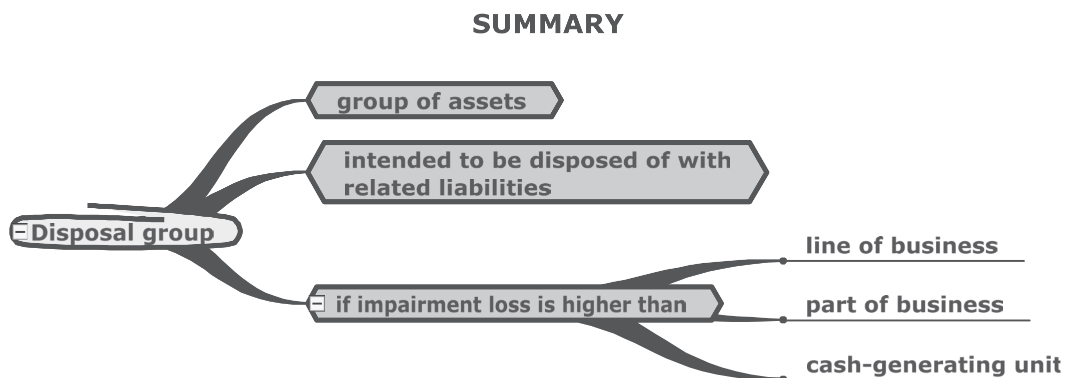
[Learning Outcome b]

Before discussing discontinued operations in depth, it is necessary to know what a disposal group is.

2.1 Disposal group

A disposal group refers to a group of assets which are intended to be disposed of along with related liabilities such as a separate line of business or a part of a business or a cash generating unit and can include current assets as well as non-current assets and their related liabilities. In the case of individual assets or businesses, classification as a disposal group depends upon the sale being part of a single coordinated disposal plan as well as meeting a number of other criteria.

SUMMARY



2.2 Discontinued operations

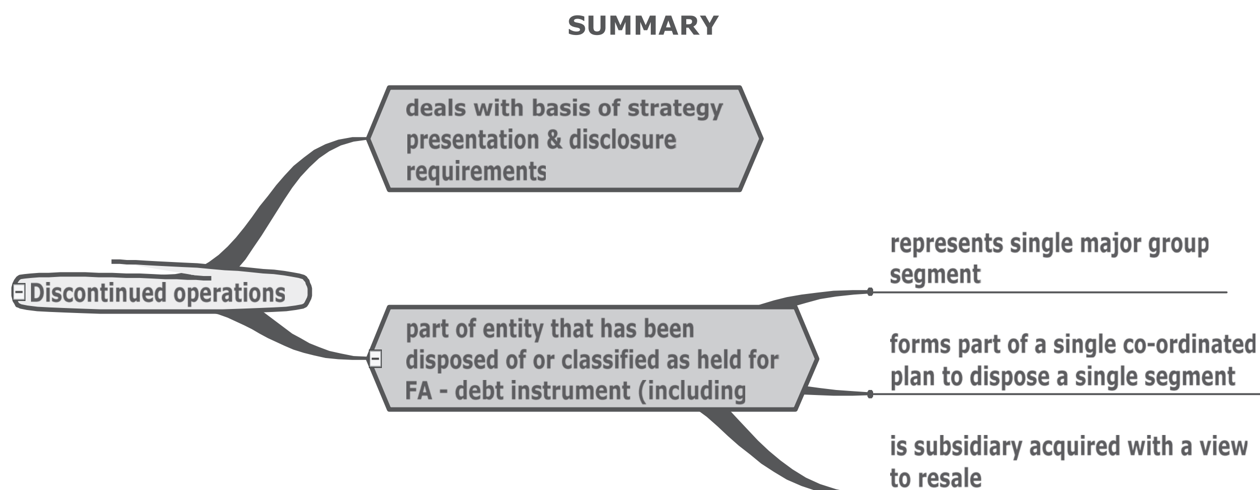
A discontinued operation is, in simple terms, a disposal group that meets certain criteria. Discontinued operations are disposal groups with different presentation and disclosure requirements.

A discontinued operation would be a disposal group that is a major segment of the entity or a subsidiary acquired exclusively with a view to resale that is held for sale as part of a disposal plan.

IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations classifies a discontinued operation as that part of an entity that has either been disposed of by the entity or classified as held for sale **AND** fulfils the following criteria:

1. it represents a separate major line of business or geographical area of operations;
2. it is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of Operations; or
3. it is a subsidiary acquired exclusively with a view to resale.

SUMMARY



2.3 Assets or disposal groups held for sale

In order to classify a disposal group or a non-current asset as held for sale, all of the following conditions must be met

1. The disposal group or asset must be available for immediate sale in its present condition.
2. The sale of the asset must be highly probable.
3. The asset must be actively marketed at a reasonable price when compared to its current fair value.
4. The sale must be completed, or expected to be so, within a year from the date of the classification.
5. The actions required to complete the planned sale must have been made.
6. It is unlikely that the plan will be significantly changed or withdrawn.

2.4 Measurement of assets held for sale

Non-current assets and disposal groups classified as 'held for sale' are measured at the lower of its

1. carrying amount; and
2. fair value less costs to sell (also referred to as net realisable value)

If the asset or disposal group is acquired as part of a business combination, it shall be measured at fair value less costs to sell. When the sale is expected to occur beyond one year, the costs to sell are measured at present value. Any increase in the present value of the costs to sell that arises from the passage of time is recorded as a financing cost.

Impairment principles have already been discussed in Study Guide C1. However recognition of initial impairment loss for a business combination differs slightly from the normal rule specified in IAS 36. Accordingly an impairment loss should be recognised where fair value less cost to sell is lower than the carrying amount of the asset acquired under a business combination.

2.5 Presentation of discontinued operations

An entity should present and disclose information that enables users to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups).

The following disclosures are required

1. **An entity shall disclose a single amount in the statement of profit or loss and other comprehensive income, comprising the total of**

(a) the post-tax profit of discontinued operations and
(b) the post-tax gain or loss recorded on the measurement to 'fair value, less costs to sell', or on the disposal of the assets or disposal group's constituting the discontinued operation.

2. **Further an analysis of the above single amount into**

(a) the revenue, expenses and pre-tax the profit or loss of discontinued operations
(b) the related income tax expense
(c) the gain or loss recorded on the measurement to 'fair value, less costs to sell' or on the disposal of the assets, or the discontinued operation; and
(d) the related income tax expense

The analysis may be presented in the notes, or on the face of the statement of profit or loss and other comprehensive income. If it is presented on the face of the statement of profit or loss, it shall be presented in a section identified as 'discontinued operations', separately from continuing operations.

3. **An entity should also disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations.**

These disclosures may be presented either in the notes, or on the face of the financial statements. Disclosures for the period presented cover all operations that have been discontinued.

Important

The analysis of single amount presented in SOPL and disclosures of net cash flows from various activities in the statement of cash flows are not required for newly-acquired subsidiaries that are 'held for sale'.

2.6 Presentation of a non-current asset or disposal group classified as 'held for sale'

Presentation of a non-current asset or disposal group classified as 'held for sale' has been discussed in Study Guide C1.

For a newly-acquired subsidiary that is 'held for sale' on acquisition, disclosure of the major classes of assets and liabilities is **not** required.

Example

Camelot Co is a construction conglomerate based in Egypt. In the last financial year, it acquired all of the share capital of another Egyptian Construction group, Pharaoh Co. Pharaoh Co, however, contained a wholly owned Chinese subsidiary, Mask Co, which unlike its parent was into the business of extracting steel. As on the date of acquiring Pharaoh, Mask's assets amounted to Tshs2 million while Mask's liabilities amounted Tshs1.9 million.

Since Camelot's primary business is the construction of residential and commercial complexes for the Egyptian market, which is different from Mask's line of business i.e. steel extraction, it was decided by the group's management to dispose of Mask Co.

This decision was properly documented by management and all the criteria according to IFRS 5 that classify an asset as held for sale were met. In this case, Mask would be recognised in Camelot's accounts at fair value less costs to sell as at the date of acquisition.

It would be classified as a disposal group held for sale and consolidated in Camelot's statement of financial position under "**Non-current assets held for sale**" with the related liabilities appearing under "**Liabilities associated with non-current assets held for sale**".

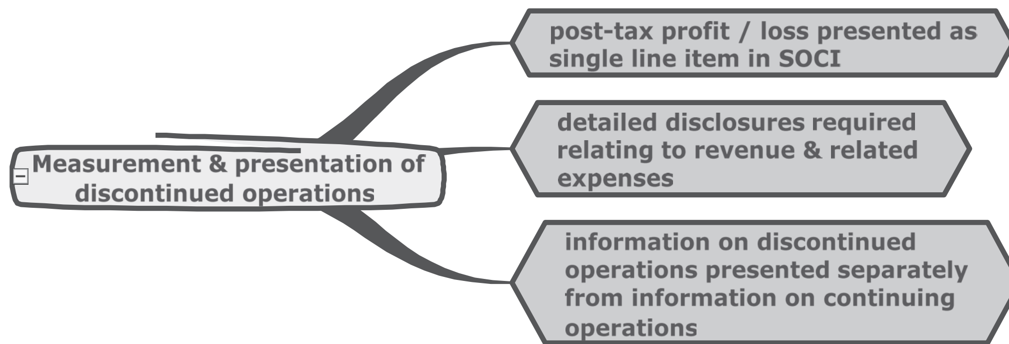
The above is a shortcut method permitted by IFRS 5. Another alternative is full line by line consolidation as usual, which is not preferred by many.

Illustration

The following illustration is from the implementation guidance to IFRS 5.

	2012	2011
	Tshs'000	**Tshs'000**
Revenue	X	X
Cost of sales	(X)	(X)
Gross Profit	XX	XX
Other income	X	X
Distribution costs	(X)	(X)
Administration expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit from associates	X	X
Profit before tax	XX	XX
Income tax expense	(X)	(X)
Profit for the year from continuing operations	**XX**	**XX**
Discontinued operations		
Profit for the year from discontinued operations	X	X
Profit for the year	**XX**	**XX**
Profit attributable to		
Owners of the parent	X	X
Non-controlling interests	X	X
	XX	**XX**

SUMMARY



Test Yourself 2

Bert Co acquired its competitor, Ernie Co, on 1 January 2012. Ernie Co contains a subsidiary, Kermit Co, which is acquired by Bert Co with a view to resale, with the exception of one of its brands, Sesame Clothing. Due to management disagreement, Bert Co had not drawn up a concrete sale plan as of 31 December 2012.

Required:

Would the intended sale of Kermit be treated as a subsidiary held-for-sale?

Answer to Test Yourself

Answer to TY 1

Situation A: Complete disposal at year end (80% to 0%)

Consolidated statement of financial position as at 31 March 2013

	Tshs'000
Assets	
Non-current assets	900,000
Current assets (Tshs925,000 + Tshs1,625,000)	2,550,000
Total assets	**3,450,000**
Equity and liabilities	
Share Capital (Tshs1,000 each)	1,350,000
Retained earnings (W2)	1,850,000
Current liabilities	250,000
Total equity and liabilities	**3,450,000**

Consolidated statement of profit or loss for the year ended 31 March 2013

	Tshs'000
Profit before tax (Tshs382,500 + Tshs315,000)	697,500
Profit on disposal (W1)	455,000
Less: Tax expense (Tshs125,500 + Tshs90,000)	(202,500)
Profit for the year	**950,000**
Share of profit attributable to	
Owners of the parent	905,000
Non-controlling interest (20% × Tshs225,000(refer SOPL of Beta)	45,000
	950,000

Workings

W1 Profit on disposal of Beta

	Tshs'000	Tshs'000
Fair value of consideration received		1,625,000
Less: share of consolidated carrying value when control lost:		
- net assets (Tshs1,350,000 × 80%)	1,080,000	
- goodwill	90,000	
		(1,170,000)
		455,000

Note on goodwill calculation

	Tshs'000
Consideration transferred	810,000
Less: Acquired: 80% × (Tshs450,000 + Tshs450,000)	(720,000)
	90,000

W2 Retained earnings carried forward

	Tshs'000
Alpha per question	1,035,000
Beta: 80% × (Tshs900,000 - Tshs450,000)	360,000
Profit on disposal (W1)	455,000
	1,850,000

Situation B: Partial disposal: subsidiary to subsidiary (80% to 60%)

Consolidated statement of financial position as at 31 March 2013

	Tshs'000
Assets	
Non-current assets (Tshs900,000 + Tshs675,000)	1,575,000
Goodwill (part (a))	90,000
Current assets (Tshs925,000 + Tshs400,000 + Tshs925,000)	2,250,000
Total assets	**3,915,000**
Equity and liabilities	
Share capital (Tshs1,000 each)	1,350,000
Retained earnings (W2)	1,525,000
Non-controlling interest (40% × Tshs1,350,000)	540,000
Current liabilities (Tshs250,000 + Tshs250,000)	500,000
Total equity and liabilities	**3,915,000**

Consolidated statement of profit or loss for the year ended 31 March 2013

	Tshs'000
Profit before tax (Tshs382,500 + Tshs315,000)	697,500
Less: Tax expense (Tshs112,500 + Tshs90,000)	(202,500)
Profit for the period	**495,000**
Share of profit attributable to:	
Owners of the parent	438,750
Non-controlling interest	
20% × Tshs225,000 × 9/12	33,750
40% × Tshs225,000 × 3/12	22,500
	495,000

Workings

W1 Adjustment to parent's equity on disposal of 20% of Beta

	Tshs'000
Fair value of consideration received	400,000
Less: increase in NCI in net assets at disposal 20% × (Tshs1,350,000 – (3/12 × Tshs225,000))	(258,750)
	141,250

W2 Group retained earnings

	Alpha	Beta 60% sold	Beta 20% sold
	Tshs'000	**Tshs'000**	**Tshs'000**
Per question/at date of disposal (Tshs900,000 – (Tshs225,000 × 3/12))	1,035,000	900,000	843,750
Adjustment to parent's equity on disposal (W1)	141,250		
Retained earnings at acquisition		(450,000)	(450,000)
		450,000	**393,750**
Beta: share of post acqn. earnings (60% of Tshs450,000)	270,000		
Beta: share of post acqn. earnings (20% of Tshs393,750)	78,750		
	1,525,000		

Situation C: Partial disposal: subsidiary to associate (80% to 30%)

Consolidated statement of financial position as at 31 March 2013

	Tshs'000
Assets	
Non-current assets	900,000
Investment in associate (W3)	808,125
Current assets (Tshs925,000 + Tshs1,062,500)	1,987,500
Total assets	**3,695,625**
Equity and liabilities	
Share capital (Tshs1,000 each)	1,350,000
Retained earnings (W2)	2,095,625
Non-controlling interest	
Current liabilities	250,000
Total equity and liabilities	**3,695,625**

Consolidated statement of profit or loss for the year ended 31 March 2013

	Tshs'000
Profit before tax (Tshs382,500 + 9/12 × Tshs315,000)	618,750
Profit on disposal (W1)	728,750
Add: Share of profit of associate (Tshs225,000 × 3 months /12 months× 30%)	16,875
Less: Tax expense (Tshs112,500 + (9/12 × Tshs90,000)	(180,000)
Profit for the period	**1,184,375**
Share of profit attributable to:	
Owners of the parent	1,150,625
Non-controlling interest (20% × Tshs225,000 × 9/12)	33,750
	1,184,375

Workings

W1 Profit on disposal in Alpha

	Tshs'000	Tshs'000
Fair value of consideration received		1,062,500
Fair value of 30% investment retained		791,250
Less share of consolidated carrying value when control lost 80% × ((Tshs1,350,000 – (Tshs225,000 × 3/12))	1,035,000	
Goodwill (Refer Situation A for working)	90,000	(1,125,000)
		728,750

W2 Group retained earnings

	Alpha Tshs'000	Beta 30% Tshs'000	Beta 50% sold Tshs'000
Per question/at date of disposal (Tshs900,000 – (Tshs225,000 × 3/12))	1,035,000	900,000	843,750
Group profit on disposal (W1)	728,750		
Retained earnings at acquisition		(450,000)	(450,000)
		450,000	**393,750**
Beta: share of post-acquisition. earnings (30% of Tshs450,000)	135,000		
Beta: share of post-acquisition (50% of Tshs393,750)	196,875		
	2,095,625		

W3 Investment in associate

	Tshs'000
Fair value at date control lost (new 'cost')	791,250
Add: Share in post-acquisition RE (Tshs225,000 × 3/12 × 30%)	16,875
	808,125

Answer to TY 2

Subsidiaries form a part of disposal groups, and as disposal groups they too need to fulfil the criteria specified in the IFRS for held for sale assets. There should be management commitment towards the sale, a concrete plan should be drawn up and an active programme to locate a buyer should be in place. Since there is no concrete plan drawn in regard to the sale, the subsidiary will not be treated as held for sale.

Quick Quiz

1. What are the different arrangements a company can enter into in order to dispose of its investment without actually selling its shares?

2. How will the parent account for a subsidiary in which its investment has been sold off in order to recognise it as a trade investment?

3. Thanda group contains a wholly owned subsidiary, Garam Co, which like Thanda Co, its parent company, is in the business of manufacturing high quality paper, operates in India, and closes its books of accounts on March 31 every year with the financial statements being finalised in June. On 1 January 20X2, due to union problems, the board of Thanda Co unanimously decided to sell Garam Co.

   The sale is considered highly probable and is actively marketed in order to complete it within the next one year. However, in May 20X2, a court order is passed, the plan to dispose of the subsidiary is shelved and instead the subsidiary is liquidated.

   In light of the above situation, can Garam still be recognised as a disposal group held for sale?

Answers to Quick Quiz

1. Deemed disposals could occur in the following cases

   (a) The subsidiary sells its shares to a third party.

   (b) The group does not take up all the subsidiary's rights shares issued to it.

   (c) A third party increases its stake in the group more than the parent company.

2. The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9 or, when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

3. Thanda Group would still recognise Garam as a disposal group held for sale as it meets the held for sale criteria as at the year end.

   The management decision to wind up the company after the year-end does not apply as it is not possible for management to predict the future outcomes when classifying assets and liabilities. After May, this classification would not apply.

Self Examination Question

Question 1

The following are the summarised statement of financial positions and statement of profit or loss of Pudong, a limited company, and its subsidiaries and associate, all limited companies, as at and for the year ended 31 December 20X8.

Statements of financial position

	Pudong	Shanghai	Huangpu	Grand Theatre (GT)
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Tangible non-current assets	3,805,000	1,200,000	1,100,000	1,450,000
Non-current asset investments at cost				
Subsidiaries and associate				
Shanghai	800,000			
Huangpu		450,000		
Grand Theatre (GT)	480,000			
Net current assets	350,000	550,000	650,000	220,000
	5,435,000	**2,200,000**	**1,750,000**	**1,670,000**
Share Capital (Tshs1,000 each share)	1,060,000	300,000	300,000	200,000
Retained earnings	4,375,000	1,900,000	1,360,000	1,350,000
10% Bonds	-	-	90,000	120,000
	5,435,000	**2,200,000**	**1,750,000**	**1,670,000**

Extracts of Statement of profit or loss for the year ended 31 December 20X8

	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Revenue	5,000,000	4,700,000	3,200,000	1,950,000
Cost of sales	(1,400,000)	(2,500,000)	(1,200,000)	(850,000)
Other operating expenses	(1,100,000)	(800,000)	(800,000)	(500,000)
Operating profit	2,500,000	1,400,000	1,200,000	600,000
Dividend received from Shanghai	160,000			
Dividend received from Grand Theatre	45,000			
Income taxes	(700,000)	(450,000)	(600,000)	(200,000)
Profit after tax	**2,005,000**	**950,000**	**600,000**	**400,000**
Dividends paid	(900,000)	(200,000)	-	(150,000)
Profit retained for the year	**1,105,000**	**750,000**	**600,000**	**250,000**

Additional information is provided as follows

1. Investment in Shanghai

Pudong acquired 80% of the ordinary share capital of Shanghai in 2005, at a cost of Tshs800 million, when the accumulated profits of Shanghai amounted to Tshs95 million. The fair value of tangible non-current assets exceeded their book value on the date of the subsidiary's acquisition by Tshs250 million. Ignore additional depreciation thereon.

Impairment testing of goodwill indicates an impairment loss for goodwill paid for Shanghai of Tshs50 million up to 31 December 2007 and a further amount of Tshs75 million during the year ended 31 December 20X8.

Inter*company sales during the year ended 31 December 20X8 were: Pudong to Shanghai Tshs300 million and Shanghai to Pudong Tshs370 million. All inter-company sales are at original cost to the selling company plus 20%. One-half of inter-company purchases remains in the inventory of the buying company at the year end.

The policy of the group is to eliminate unrealised profit on inter-company sales between group companies in full and to charge non-controlling interest their share only when a subsidiary makes the sale and the profit.

2. Investment in Huangpu

Shanghai acquired 75% of the ordinary share capital of Huangpu on 1 January 2006 at a cost of Tshs2,000 per share. At this date, the accumulated profits of Huangpu amounted to Tshs600 per share.

There have been no changes in the issued ordinary share capital of Huangpu since that date and there was no significant difference between the book values and fair values of the net assets of Huangpu on the date of its acquisition by Shanghai.

An impairment loss for the goodwill paid by the Pudong Group for Huangpu of Tshs30 million was recognised up to 31 December 2007. Impairment testing indicated that there was no further impairment loss for this goodwill during the year to 31 December 20X8.

3. Investment in Grand Theatre

Pudong acquired 30% of the ordinary share capital of Grand Theatre (GT) on 1 January 20X8 for Tshs480 million when the retained earnings of Grand Theatre was Tshs1,100 million. Impairment testing indicated an impairment loss of Tshs25 million for this goodwill during the year ended 31 December 20X8.

Inter-company sales between Pudong and Grand Theatre (GT) during the year ended 31 December 20X8 were as follows: Pudong to Grand Theatre (GT) Tshs110 million and Grand Theatre (GT) to Pudong Tshs230 million. All of these sales were made at a gross profit margin of 30% and all of these inter-company purchases remained in inventory of the buying companies at 31 December 20X8.

Unrealised profit on inter-company sales to or by an associate is to be eliminated per the rules of IAS 28.

4. Other information

(a) All shares, in each of the 4 companies above, carry one vote each. It is presumed that control is exercised where more than one-half of the votes are held and that significant influence is exercised where 20% or more of the votes are held.

(b) All dividends were paid in December 20X8 and Pudong has taken credit for all dividends received in its statement of profit or loss above.

(c) For the purpose of any deferred tax adjustments, assume a tax rate of 15%.

(d) Non-controlling interest is measured at proportionate share in fair value of net assets identified by subsidiaries at acquisition date.

Required:

Prepare a consolidated statement of financial position for the year for the Pudong Group for the year ended 31 December 2008 so as to comply with all applicable International Standards.

Answer to Self Examination Question

Answer to SEQ 1

The Pudong group and its associate Grand Theatre (GT)

The **consolidated statement of financial position** of the Pudong Group, including its associate, at 31 December 20X8, is presented as follows

	Tshs'000	Tshs'000
Non-current assets		
Tangible (Tshs3,805,000 + Tshs1,200,000 + Tshs250,000 + Tshs1,100,000)	6,355,000	
Intangible: Goodwill for subsidiaries (W1)	231,000	
Investment: in associate (W2)	520,100	7,106,100
Net current assets (Tshs350,000 + Tshs550,000 + Tshs650,000)	1,550,000	
Less: URP adjustments		
Pudong to Shanghai (Tshs300,000 x ½ x 1/6 = Tshs25,000)	(25,000)	
Shangahi to Pudong (Tshs370,000 x ½ x 1/6 = Tshs30,833)	(30,833)	
Grand Theatre to Pudong (Tshs230,000 x 30% x 30% = Tshs20,700)	(20,700)	1,473,467
		8,579,567
Equity and liabilities		
Share capital	1,060,000	
Retained earnings (W4)	6,353,774	
Non-controlling interest NCI (W3)	1,051,258	8,465,032
Non-current liabilities		
10% Bonds	90,000	
Deferred tax	24,535	114,535
		8,579,567

Note:

Pudong holds 80% shares in Shanghai and therefore the non-controlling interest is 20%.

Pudong has an indirect holding in Huangpu through Shanghai. The effective share in Huangpu is 60% (80% x 75%) and the non-controlling interest is therefore 40%.

Pudong holds 30% shares in Grand Theatre and therefore Grand Theatre is an associate of Pudong Group.

Workings

W1 Goodwill

	Tshs'000	Tshs'000
Shanghai		
Purchase consideration	800,000	
Add: Value of NCI (20% of Tshs607,500)	121,500	921,500
Less: Fair value of net assets acquired		
- Share capital	300,000	
- Retained earnings	95,000	
- Fair value adjustment	250,000	
- DTL on FV adjustment (W6)	(37,500)	(607,500)
Goodwill		314,000
Impairment losses (Tshs50,000 + Tshs75,000)		(125,000)
Goodwill after impairment		**189,000**

	Tshs'000	Tshs'000
Huangpu		
Purchase consideration (80% of (75% of 300,000 x Tshs2,000)	360,000	
Add: Value of NCI (40% of Tshs480,000)	192,000	552,000
Less: Fair value of net assets acquired		
- Share capital	300,000	
- Retained earnings (300,000 x Tshs600)	180,000	480,000
Goodwill		72,000
Impairment losses		(30,000)
Goodwill after impairment		42,000

Total goodwill = Tshs189,000 + Tshs42,000 = Tshs231,000

	Tshs'000	Tshs'000
Grand Theatre		
Purchase consideration		480,000
Less: Fair value of net assets		
- Share capital	200,000	
- Retained earnings	1,100,000	
	1,300,000	
30% of Tshs1,300,000		390,000
		90,000
Impairment losses		(25,000)
Unimpaired goodwill		**65,000**

Since Grand Theatre is an associate, the goodwill pertaining to it will not be consolidated. However it will be included in the investment in associate.

W2 CV of associate in the CBS

	Tshs
Share of equity at the end of the reporting date (30% x Tshs1,550,000)	465,000
Add: Unimpaired goodwill (W1)	65,000
Less: URP Pudong to GT (Tshs110,000 x 30% x 30%)	(9,900)
	520,100

W3 Non-controlling interest

	Tshs'000	Tshs'000
In S		
20% x (Tshs2,200,000 + Tshs250,000 – Tshs37,500)	482,500	
Less: NCI in S (Share of cost of H (20% x Tshs450,000))	(90,000)	
Less: Share of NCI in URP, net of DT (S to P) (20% of Tshs26,208 (W6))	(5,242)	
		387,258
In H (40% x Tshs1,660,000)		664,000
		1,051,258

W4 Retained earnings

	Tshs'000	Tshs'000
P		4,375,000
S 80% x (Tshs1,900,000 – Tshs95,000)		1,444,000
H 60% x (Tshs1,360,000 – Tshs180,000)		708,000
GT 30% x Tshs250,000		75,000
Impairment losses (Tshs125,000 + Tshs30,000 + Tshs25,000)		(180,000)
URP, net of DT (W6)		
- P to S	(21,250)	
- S to P (80% of Tshs26,208)	(20,966)	
- GT to P	(17,595)	
- P to GT	(8,415)	(68,226)
		6,353,774

W5 Deferred tax liability

	Tshs'000
DTL on FV adjustment at acquisition (250,000 x 15%)	37,500
Less: DTA on URP adjustments ((25,000 + 30,833 + 20,700 + 9,900) W6 x 15%)	(12,965)
Net deferred tax liability	**24,535**

W6 URP in inventory

	URP in Inventory	After Deferred tax
URP in Pudong to Shanghai	Tshs300,000 x ½ x 1/6 = Tshs25,000	Tshs21,250
URP in Shangahi to Pudong	Tshs370,000 x ½ x 1/6 = Tshs30,833	Tshs26,208
URP in Grand Theatre to Pudong	Tshs230,000 x 30% x 30% = Tshs20,700	Tshs17,595
URP in Pudong to Grand Theatre	Tshs110,000 x 30% x 30% = Tshs9,900	Tshs8,415

SECTION D

FINANCIAL STATEMENTS OF GROUP OF ENTITIES

D3

STUDY GUIDE D3: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Get Through Intro

In today's economy, transactions spanning the world involving foreign currencies have become the rule rather than the exception. Hence a modern accountant needs to understand how foreign exchange transactions are recorded and presented in the financial statements.

Imagine that Corex Co, based in the UK bought a machine made in India by Index Co on 23 January 20X6. The machine was priced at Rs.200,000 where the exchange rate of £ to Rs is 1:100.Corex Co would show the machine as having been purchased for 200,000/100 = £2,000.

However, Corex has 3 months credit from Index Co, so will not pay until 23 April 20X6. Now imagine that on 23 April 20X6, when Corex is to pay, the rate has changed to 1:120.Corex will actually have to pay 200,000/120 = £1,666, instead of £2,000. The question is, how is this all recorded in the financial statements?

This Study Guide which is based on IAS 21'The effects of changes in foreign exchange rates' takes you through all the concepts and principles which you need to master to ensure compliance with IAS 21 while recording foreign exchange transactions.

Learning Outcomes

a) Determine the functional currency of an entity in accordance with International Financial Reporting Standards.
b) Discuss and apply the principles of relevant accounting standards to record foreign currency transactions and translate monetary/non-monetary items at the reporting date for individual entities.
c) Distinguish between reporting and functional currencies.

1. **Determine the functional currency of an entity in accordance with International Financial Reporting Standards**.

2. **Discuss and apply the principles of relevant accounting standards to record foreign currency transactions and translate monetary/non-monetary items at the reporting date for individual entities**

[Learning Outcomes a and b]

Case Study

Kyio Software Systems Ltd: functional currency and translation

Apart from this flagship company, the group also has several subsidiaries located in Brazil. The transactions entered into by the group as well as these subsidiaries are denoted and measured in Brazilian Real (B$) which is the currency of the primary economic environment within which these companies operate and, therefore, their functional currency.

The group, instead of using its own functional currency, i.e. B$, has selected the Euro (€) as its presentation currency, since it believes that most of the users of its financial statements would be more familiar with the Euro. This has resulted in translating the financial statements from the functional currency i.e. B$ to the presentation currency i.e. € in accordance with the principles set out in IAS 21.

The assets and liabilities of the Brazilian companies whose functional currency is not the Euro are translated into Euro at the closing rate as at the date of each statement of financial position. Issued capital, share premium and all other reserves are translated into Euro using the exchange rate as on the date of the transaction, while income and expenses have been translated at the average monthly exchange rates.

Translation differences arising as a result of the translation of the financial statements are recognised as a separate component of equity under “Foreign currency translation reserve”.

The above extract shows how the financial statements of a reporting entity may not be in the currency of the primary economic environment in which the entity operates. This knowledge is required while accounting for foreign exchange transactions and you will need to use it frequently because of the increase in foreign exchange transactions in today’s organisations.

IAS 21 requires each entity to determine its functional currency.

Definition

Functional currency is the currency of the primary economic environment in which the entity operates.

IAS 21 Para 8

1.1 The **primary economic environment (PEcoE)** in which an entity operates

Diagram 1: The primary economic environment in which an entity operates

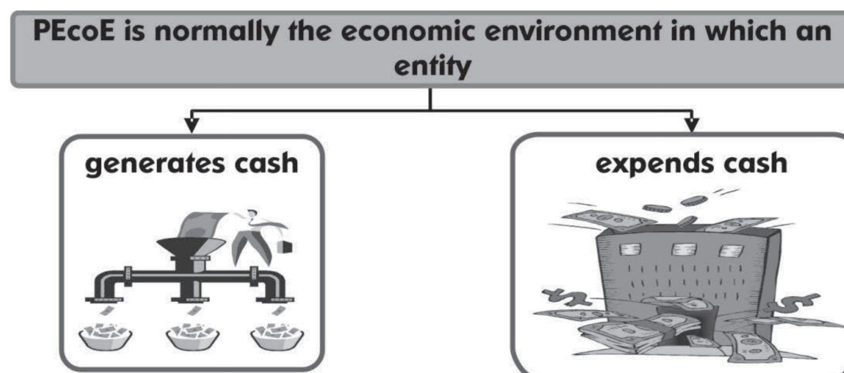
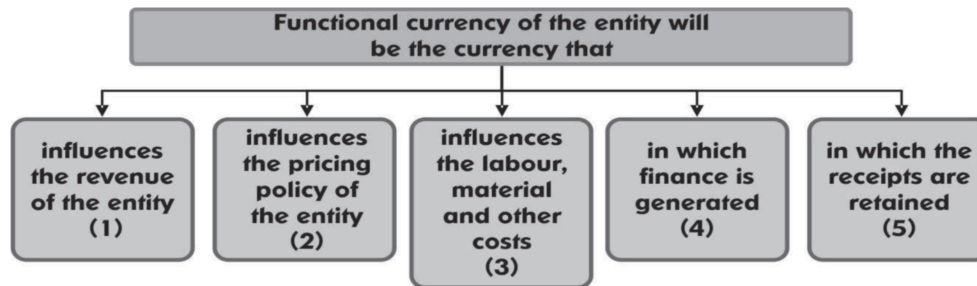


Diagram 2: Factors which determine the functional currency of the entity



These factors are explained below

1. **The currency that mainly influences the prices at which the entity sells its goods and services.**

Candide Internationale is located in Dar es Salaam, Tanzania. The currency that mainly influences the prices at which it sells its goods and services is Tanzanian Shillings (Tshs). In this case the functional currency of Candide Internationale is the Tshs (assuming that the other factors also indicate that the Tshs is the functional currency of Candide Internationale).

The currency of the country, whose competitive forces and regulations mainly influence the pricing policy of the entity.

In the above example the competitive forces and laws of Tanzania mainly influence the pricing policy of Candide Internationale. Hence, the functional currency of Candide Internationale is the Tshs (assuming that the other factors also indicate that the Tshs is the functional currency of Candide Internationale).

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2. **The currency that mainly influences labour, material and other costs of providing these goods and services.**

In the above example Candide Internationale mainly settles its costs in Tshs. It pays for the raw material it imports from England in £ but these expenses are only 20% of its total expenses. Hence, the functional currency of Candide Internationale is the Tshs (assuming that the other factors also indicate that the Tshs is the functional currency of Candide Internationale).

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3. **The currency in which finance is generated by the entity.**

In the above example Candide Internationale has raised finance through the issue of equity shares and loan notes. The equity issue and the loan notes were subscribed for and are retained in Tshs. Hence, the functional currency of Candide Internationale is the Tshs (assuming that the other factors also indicate that the Tshs is the functional currency of Candide Internationale).

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4. **The currency in which the receipts from customers is retained by the entity.**

In the above example Candide Internationale sells goods both within and outside Tanzania. For its overseas sale, it receives payment in the currency of the county of sale. However it converts this foreign currency into the Tshs and retains it in Tshs. Hence, the functional currency of Candide Internationale is the Tshs. (Assuming that the other factors also indicate that the Tshs is the functional currency of Candide Internationale).

So overall, from the above examples, it would be concluded that the functional currency of Candide. Internationale is the Tanzanian Shillings (Tshs).

Test Yourself 1

Senorita Pastures is a Tanzanian entity located in Arusha.

1. The currency that mainly influences its selling price for its goods and services is Tshs.
2. The competitive forces and regulations of Tanzania mainly influence the pricing policy of Senorita Pastures.
3. Senorita Pastures mainly pays for the labour in Tshs but pays for the imports of raw material and other material in Tshs which are 80% of its total expenses.

Required:

State the functional currency in each of the above cases.

Test Yourself 2

Casa Camiyo operates in Germany, it has raised its capital in €, incurs all expenses in € and is governed by the laws of Germany.80 % of its sales revenue comes from France.

Required:

State the functional currency of Casa Camiyo.

1.2 Foreign operations of an entity

Foreign operations of an entity include any subsidiary, associate, joint venture or branch which conducts business in a country or in a currency which is different from those of the reporting entity.

Test Yourself 3

In the above example Candid Internationale (which is located in Tanzania) has a subsidiary Candid Inc which is situated in UK.

Required:

Determine whether Candid Internationale has foreign operations?

If the entity has any foreign operations then it has to consider a few additional factors while determining its functional currency. The additional factors are

1. Whether the activities of the foreign operation are carried out as

2. An extension of the reporting entity: in this case the functional currency of the reporting entity **will be** the functional currency of the foreign operation.

Test Yourself 4

Yaber Gmbh is a Tanzanian entity which makes machine tools. It has a subsidiary in Singapore called Shape Inc to which it sells some of its finished goods. Shape Inc is the authorised dealer of Yaber Gmbh for the whole of South-East Asia and engages in no other activity of its own.

Required:

Determine the functional currency of Shape Inc.

---

3. With a significant degree of autonomy: in this case the functional currency of the reporting entity **may not be** the functional currency of the foreign operation.

4. Whether the proportion of transactions which the foreign operations have with the reporting entity is high or low. If the volume is high then the functional currency of the reporting entity **will be** the functional currency of the foreign operation. If the volume is low then the functional currency of the reporting entity **may not be** the functional currency of the foreign operation.

Example

Gambtor & Procle (a Tanzanian entity) has a functional currency Tshs. It has a subsidiary in France. This subsidiary sells all its products to Gambtor & Procle. In this case the proportion of transactions which the foreign operations (the subsidiary) have with Gambtor & Procle (the reporting entity) is high. Hence the functional currency of the subsidiary will be the Tshs which is the functional currency of the reporting entity Gambtor & Procle (assuming it satisfies the other conditions).

---

5. Whether the cash flows from the activities of the foreign operation

(a) directly affect the cash flows of the reporting entity and
(b) are readily available for remittance to it.

If the answer is yes then the functional currency of the subsidiary will be the same as the functional currency of the reporting entity.

Test Yourself 5

Pleasant Ltd, an entity incorporated in Tanzania sells 80% of its products through its branch office which is situated in China. The head office at Tanzania depends upon the remittances made by its branch office in China to finance its normal operating activities. The Chinese branch is able to readily remit cash to its head office.

Required:

Determine the functional currency of the Chinese branch of Pleasant Ltd.

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6. Whether cash flows from the activities of the foreign operation are

(a) enough to repay its existing and normally expected debt obligations in this case the functional currency of the reporting entity **may not be** the functional currency of the foreign operation;
(b) or whether it has to depend upon funds from the reporting entity to repay its dues in this case the functional currency of the reporting entity **will become** the functional currency of the foreign operation.

Test Yourself 6

Surefire Inc a Tanzanian entity whose functional currency is Tshs, has a subsidiary Fireaway Co in UK. The following information is available of Fireaway Co

Ordinary share capital	£20,000
Loan from bank	£40,000

As it has not commenced its operations, it depends upon Surefire Inc for repayment of the bank loan.

Required:

Determine the functional currency of Fireaway Co.

When the above indicators are mixed and the functional currency is not obvious the **management** of the reporting company **determines the functional currency** which faithfully represents the financial transactions.

An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Hence, once determined, the functional currency is changed only when there is a change in the underlying transactions, events and conditions.

Test Yourself 7

Nice Corp is located in Tanzania and its functional currency is the Tshs. It manufactures electronic goods and sells some of its finished products to Flash Inc in France.

Flash Inc is an associate of Nice Corp and its total revenue can be split as follows

	% of revenue
Sale of goods purchased from Nice Corp	35%
Sale of other goods	65%

Required:

Determine the functional currency of Flash Inc.

1.3 Initial recognition (IR)

Definition

Foreign currency is a currency other than the functional currency of the entity.

IAS 21 Para 8

A foreign currency transaction is a transaction that is denominated or requires settlement in a foreign currency, including transactions arising when an entity

buys or sells goods or services whose price is denominated in a foreign currency;
borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or
acquires or disposes of assets, or incurs or settles liabilities denominated in a foreign currency.

Example

Convenience Inc, a company located in Tanzania, buys raw material from Bravo Co which is situated in Germany. Bravo Co raises its invoices in € and Convenience Inc has to pay for the invoice in €. The functional currency of Convenience Inc is the Tshs.

In this case, the payment made by Convenience Inc to Bravo Co is in €. Therefore this is a foreign currency transaction.

At the time of initial recognition, an entity has to first determine the value at which the transaction is to be recognised in terms of foreign currency by applying the relevant accounting standard. For example, the carrying amount of a machine acquired in foreign currency should be measured under the cost model or revaluation model in accordance with IAS 16 Property, Plant and Equipment.

This initial amount is then translated into the functional currency at the **spot exchange rate at the date of the transaction.**

Recognised in FS = Foreign currency amount x Spot exchange rate between the functional currency and the foreign currency as on the date of the transaction

The date of a transaction is the **date on which the transaction first qualifies for recognition** in accordance with International Financial Reporting Standards. For practical reasons a rate that is approximately the same as the actual rate at the date of the transaction is taken.

Example

An average rate for a week or a month is used for all foreign currency transactions that occur during that period.

However, if exchange rates fluctuate significantly, then each transaction has to be recorded at the rate on the date of the transaction and an average rate cannot be used.

Example

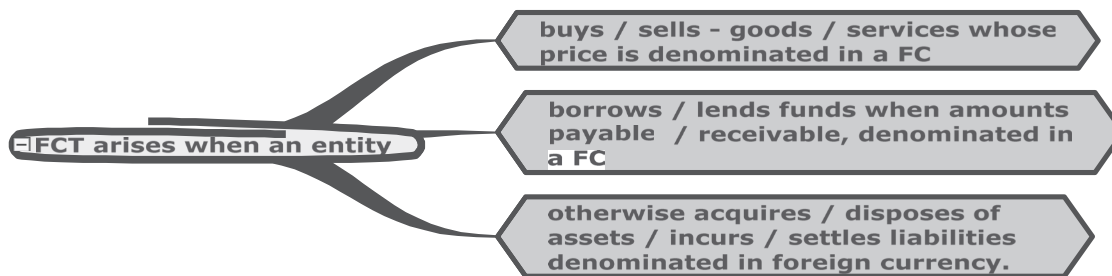
Beetles Plc, London bought music cassettes and music MP3 CDs from Elvis Co, Los Angeles on 3 September 20X4 for $270,000 when the exchange rate was £1 = $2. Beetles Plc closed its books on 31 December 20X4 when the rate of exchange was £1 = $1.75. Beetles Plc paid Elvis Co on 24 February 20X5 when the exchange rate was £1 = $2.05. The average rate of exchange between the two currencies was £1 = $1.90.

Beetles would initially record the purchase by translating $ at the spot rate of £1 = $2.Therefore it would record the transaction at £135,000.

Alternatively, if there were many transactions in $ and £, and the exchange rates between the two currencies did not significantly fluctuate, Beetles would record the transaction at the average rate of £1 = $1.90. i.e.at £142,105

SUMMARY

A foreign currency transaction (FCT) is one which needs settlement in foreign currency (FC).



Recognised in FS = Foreign currency amount x spot exchange rate between the functional currency and the foreign currency as on the date of the transaction

1.4 Subsequent translation (ST)

For subsequent translation the foreign currency transactions are split into monetary and non-monetary items.

Definition

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

IAS 21 Para 8

The standard states that the essential feature of a monetary item is the right to receive or an obligation to deliver a **fixed or determinable number of units of currency.**

Example

1. Cash and bank balance
2. Trade receivables and payables
3. Loan receivables and payables
4. Pensions and other employee benefits to be paid in cash
5. Provisions (e.g. dividend payable) that have to be settled in cash

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Non-Monetary items

The essential feature of a non-monetary item is the **absence of a right to receive or an obligation** to deliver a **fixed or determinable number of units of currency.**

Example

Goodwill and other intangible assets
Non-current assets
Inventories
Provisions that are settled by delivering a non-monetary asset
Prepaid expenses

The monetary and non-monetary items are recognised in the statement of financial position in the following manner

Item	Rate used for subsequent translation
Monetary items	Spot exchange rate as on the date of the statement of financial position or date of settlement, if earlier

Test Yourself 8

Succinct Inc whose functional currency is the Tshs has purchased goods worth £250,000 (payable after 3 months) from Bliterzeg Co on 15 November 20X6 when the rate of exchange was £1 = Tshs2,500 The rate of exchange at the end of reporting period 31 December 20X6 was £1 = Tshs2,700.

Required:

How will the trade payables be recorded by Succinct Inc?

Item	Rate used for subsequent translation
Non-monetary items recognised at cost	Rate of exchange as on the date of the original transaction i.e. on the date of purchase / acquisition of the non-monetary item

Test Yourself 9

Fairplay Publishers whose functional currency is the Tshs publishes books in Tanzania. On 4 September 20X6 it has paid $30,000 to its publishers when the rate of exchange was $1 = Tshs1,600. However no work has been done by the publishers up to 31 December 20X6 (end of reporting period) when the rate of exchange was $1 = Tshs1,700.

Required:

How will the prepaid expenses be recorded by Fairplay Publishers?

Item	Rate used for subsequent translation
Non-monetary item recognised at fair value	Rate of exchange as on the date on which the fair value was determined

If the carrying amount of the non-monetary asset is determined through a formula (e.g. higher of cost and NRV for inventories), then the two different elements (i.e. cost and NRV) are translated separately.

IAS 2 Inventories requires the inventories to be valued at the lower of the cost or net realisable value. In this case the cost amount is translated at the rate of exchange of original transaction and the net realisable value at the rate as at the end of reporting period.

Test Yourself 10

Perfect International is situated in Germany and raises bills and makes expenses primarily using the €. On 12 October 20X6 it has purchased goods worth £40,000 from Deliberate Inc of England. 50% of these goods are included in the inventory of Perfect International. The net realisable of these goods is £21,500. The rates of exchange as on 12 October 20X6 is €1 = £0.73 and on 31 December 20X6 is €1 = £0.65.

Required:

At what value will the inventory appear in the statement of financial position?

Test Yourself 11

Daimmler Corp whose functional currency is the £ has purchased land worth €125,000 on 1 July 20X5. The fair value of the land was determined at €140,000 on 15 October 20X5 and €190,000 on 1 November 20X6. The relevant rates of exchange are

On 01/07/20X5 €1 = £0.80
On 15/10/20X5 €1 = £0.73
On 31/12/20X5 €1 = £0.82
On 01/11/20X6 €1 = £0.60
On 31/12/20X6 €1 = £0.65

Required:

Determine how land will be recognised initially and at the subsequent end of reporting periods.

1.5 Treatment of exchange differences

1. Monetary items

The exchange difference is recognised in the statement of profit or loss **in the period in which the exchange difference arises.** However IAS 21 does not specify where this exchange difference should be presented in the statement of profit or loss.

Example

Quebec Bottling Co, Dar es Salaam, ordered glass bottles from Yamoto Glassworks, USA for $720,000 on 12 May 20X7. The bottles were delivered to Quebec Bottling, Dar es Salaam on 27 May 20X7. On this date, the rate of exchange was USD $1 = Tshs1,600.

Quebec would make the following entry in its books of accounts

		Tshs'000	Tshs'000
Dr	Inventory ($720,000 x Tshs1,600)	1,152,000	
Cr	Yamoto Glassworks		1,152,000

Being inventory purchased on credit

Quebec made its payment to Yamoto on 30 June 20X7. On this date the rate of exchange was $1 = Tshs1,500.

The journal entry to record this payment would be as follows

		Tshs'000	Tshs'000
Dr	Yamoto Glassworks	1,152,000	
Cr	Cash ($720,000 x Tshs1,500)		1,080,000
Cr	Exchange gain (Tshs1,152,000 – Tshs1,080,000)		72,000

Being payment made on glass bottles purchased

Note that there is a difference in exchange rates on 27 May 20X7, i.e. the date of delivery, and 30 June 20X7 i.e. the date the payment was made. In order to account for this change in exchange rates, Quebec could alter its inventory values by making a counter entry to the one to record the delivery. Alternatively, and more appropriately, Quebec could record a gain on the transaction or a profit on conversion of Tshs72,000,000.

If, on the other hand the exchange rate had fallen to $1 = Tshs1,800, there would have been an exchange loss of Tshs144,000,000 (Tshs1,296,000,000 – Tshs1,152,000,000) recorded in Quebec's books. The journal entry to record the transaction would have been as follows

		Tshs'000	Tshs'000
Dr	Yamoto Glassworks	1,152,000	
Dr	Exchange loss	144,000	
Cr	Cash ($720,000 x Tshs1,800)		1,296,000

Being payment made on glass bottles purchased

Example

Let us continue with the example of Succinct Inc given in Test Yourself 8 above. The rate of exchange when Succinct paid Blitzerg for the goods on 15 February 20X7, i.e., the payment date, was £1 = Tshs2,800.

Required:

Determine the profit or loss on this transaction and state how it will be recognised in the books.

The only exception being exchange differences arising on monetary items which form part of the reporting entity's net investment in a foreign operation. These exchange differences are recognised in other comprehensive income part of the statement of profit or loss and other comprehensive income in the consolidated financial statements that include the foreign operation; however these differences will be recognised in profit or loss on disposal of the net investment.

Important

When borrowing costs are capitalised according to the requirements of IAS 23 then any exchange differences are also capitalised and not recognised in the statement of profit or loss and other comprehensive income.

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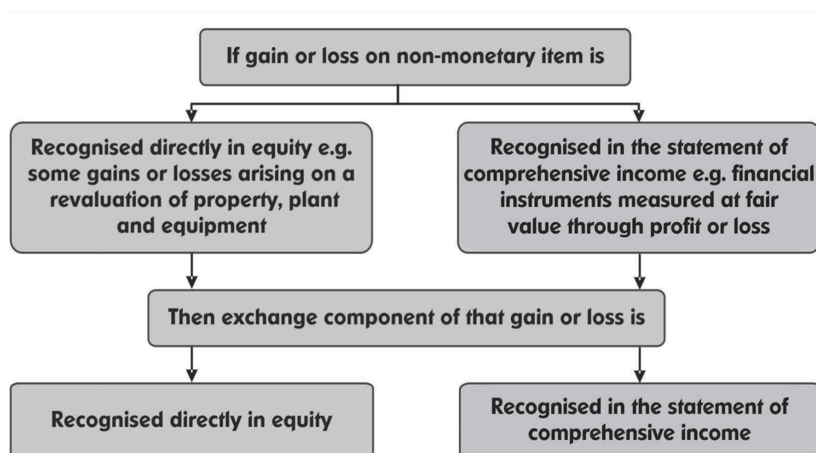
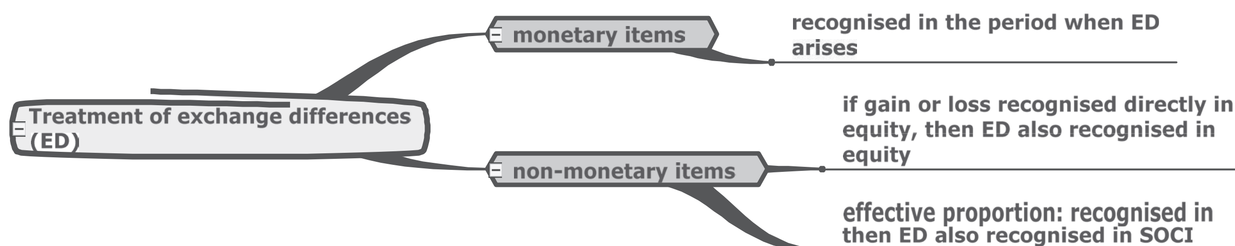
2. Non-monetary items

Diagram 3: Loss or gain on non-monetary items



SUMMARY



Test Yourself 13

On 1 April 20X6 Fortune International, whose functional currency is Tshs, had purchased a non-current asset for £40,000 when the rate of exchange was £1 = Tshs2,500 It was revalued on 1 July 20X6 for £41,000 when the rate of exchange was £1 = Tshs2,400 It was sold on 1 October 20X6 for £45,000 when the rate of exchange was £1 = Tshs2,200.

Required:

Determine the profit or loss on this transaction and state how it will be recognised in the books (ignore depreciation).

Important

If we analyse the requirements of IAS 21, we can draw following conclusions

- IAS 21 split up foreign exchange transactions as monetary and non-monetary
- The split up is essential as the measurement of financial items depends on their classification.
- The financial items means, (Though not directly stated in the standard) SOFP items
- In case of accounts related to income or expenses the measurement is done using the foreign exchange rate existing on the date of transaction or average rate, so the impact of foreign exchange rate is already considered, therefore no need to consider the impact again.

3. Distinguish between reporting and functional currencies.

[Learning Outcome c]

The term **'reporting currency'** was defined in the previous IAS 21 (1993) as 'the currency used in presenting the financial statements'.

Reporting currency was split into two parts

- The **measurement currency**: the currency in which the entity measures the items in the financial statements; and
- The **presentation currency**: the currency in which the entity presents its financial statements.

The Standard did not specify the currency in which an entity should present its financial statements though it noted that an entity would normally use the currency of the country in which it was located.

The revised IAS 21 (2005) has separated these two parts and given them each its own identity. The revised IAS 21 uses the terms

- The **functional currency**: this term replaces the term measurement currency and was adopted as it is more common. It is the currency of the primary economic environment in which the entity operates.
- The **presentation currency**: the currency in which the entity presents its financial statements.

Thus the main difference between reporting and functional currencies is that

(a) Reporting currency includes both measurement currency and presentation currency while
(b) Functional currency means measurement currency only.

Test Yourself 14

Grand International is established in Tanzania but has extensive dealings in the UK. The following details are available

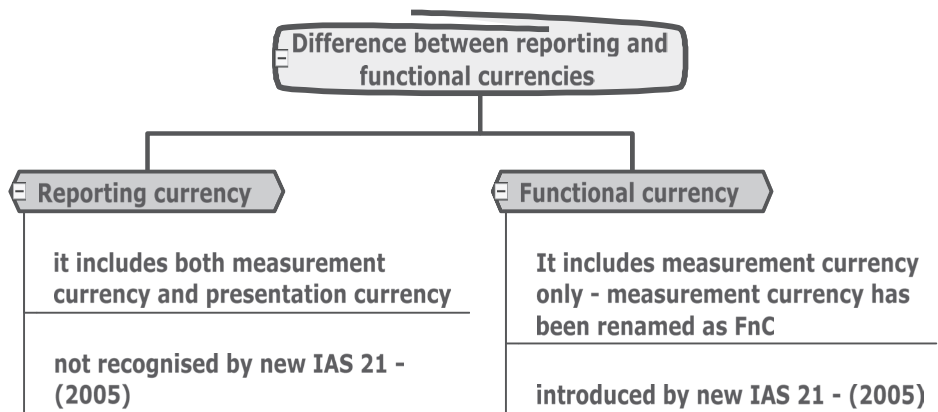
The currency of the primary economic environment in which the entity operates is Tshs and it presents its financial statements in £.

Required:

What is the reporting currency (according to IAS 21 – 1993) and functional currency (according to IAS 21 – 2005) of Grand International?

It should be noted that the **notion of reporting currency is not recognised by the new IAS 21 – (2005).**

SUMMARY



Answers to Test Yourself

Answer to TY 1

The following factors indicate that the functional currency of Senorita Pastures is the Tshs.

1. The currency that mainly influences its selling price for its goods and services is Tshs.
2. The competitive forces and regulations of Tanzania mainly influence the pricing policy of Senorita Pastures. (The Tshs is the currency of Tanzania).

However 80% of its total expenses are incurred in Tshs which indicate that the Tshs can be considered to be the functional currency of Senorita Pastures. In this case, because there are conflicting indicators, the management has to decide which currencies best reflects the underlying transactions, events and conditions that are relevant to it. Once determined, the functional currency can be changed only when there is a change in the underlying transactions, events and conditions.

Answer to TY 2

Casa Camiyo operates in Germany and earns 80% of its sales revenue from France. Hence the functional currency could be the currency of either France or Germany. However, as the currency of both these countries is the € the management does not need to consider the factors which determine the functional currency because in either case the functional currency will be the €.

Answer to TY 3

In this case Candid Inc conducts its business in UK where the national currency is the £ whereas Candid Internationale conducts its business in Tanzania where the national currency is the Tshs.

Hence it can be inferred that Candid Internationale has foreign operations.

Answer to TY 4

In this case Shape Inc only resells the goods manufactured by Yaber Gmbh throughout South-East Asia. It does not do any value addition nor does it engage in any other independent activity of its own. Hence Shape Inc (the foreign operation of Yaber Gmbh) is just an extension of Yaber Gmbh. So the functional currency of Shape Inc is

1. the Tshs(the functional currency of Yaber Gmbh assuming that the other factors also indicate that the Tshs is the functional currency of Yaber Gmbh) and;
2. not the Singapore $ (the national currency of the country in which Shape Inc operates).

Answer to TY 5

In this case the functional currency of the Chinese branch of Pleasant Ltd is the Tshs (the national currency of Tanzania) because

The cash flow of the foreign operation directly affects the cash flow of Pleasant Ltd in Tanzania, and
There is no obstacle to the remittance of cash by the branch to the head office.

Answer to TY 6

Under these circumstances, even if Fireaway Co has an equity capital of £20,000 its functional currency is Tshs (the functional currency of Surefire Inc) because it depends upon Surefire Inc to repay its dues.

Answer to TY 7

In this case Flash Inc operates with a significant degree of autonomy because the share of goods from Nice Corp in its total revenue is only 35%.

Hence the functional currency of Flash Inc can be

1. the national currency of France(assuming that the other factors also indicate that the € is its functional currency) and
2. not the Tshs (which is the functional currency of Nice Corp).

However, before taking a decision management has to consider other factors also. Its decision depends upon answers to the following

Which currency influences the revenue of the entity?
Which currency influences the pricing policy of the entity?
Which currency influences the overhead costs?
In which currency is finance generated?
In which currency are the receipts retained by the entity?

If answers to most of these questions indicate the €, then it will be the functional currency of Flash Inc. However if there are conflicting indications then the management has to decide which currency best reflects the underlying transactions, events and conditions that are relevant to it.

Note – the local currency of France is €,.

Answer to TY 8

In this case the trade payables are recognised by Succinct Inc in the following manner:

Date	Rate used	Rate	Amount
			Tshs'000
15/11/20X6 (IR)	Rate on date of transaction	£1 = Tshs2,500	625,000
31/12/20X6 (SR)	Rate at the end of reporting period	£1 = Tshs2,700	675,000

As trade payables are monetary assets they will be recognised at the end of reporting period at the spot exchange rate at the end of reporting period.

Answer to TY 9

In this case the prepaid expenses are recognised by Fairplay Publishers in the following manner

Date	Rate used	Rate	Amount
			Tshs'000
04/09/20X6 (IR)	As on date of transaction	$1 = Tshs1,600	48,000
31/12/20X6 (SR)	As on date of original transaction	$1 = Tshs1,600	48,000

As prepaid expenses are non-monetary assets they are recognised in the subsequent statement of financial positions at the rate of exchange as on the date of original transaction.

Answer to TY 10

In this case the inventory (50% of purchases) is recognised by Perfect International in the statement of financial position as at 31 December 20X6 at €27,397(see working below).

Carrying amount	£20,000	Rate of original transaction	€1 = £0.73	€27,397
Net realisable value	£21,500	Rate at end of reporting period	€1 = £0.65	€33,076

Inventory = lower of carrying amount or net realisable value = €27,397

Answer to TY 11

Land will be recognised by Daimler Corp in the following manner

Date	Rate used	Rate	Amount
On 01/07/20X5 (IR)	Rate on date of purchase	€1 = £0.80	£100,000
On 31/12/20X5(SR)	End of reporting period	€1 = £0.80	£100,000
On31/12/20X6(SR)	End of reporting period	€1 = £0.80	£100,000

As land is a non-monetary asset it is recognised in the subsequent statements of financial position at the rate of exchange as on the date of original transaction i.e. on the date of purchase of land where the cost model is used. If the revaluation model was used, then the rate prevailing on the revaluation date will be used.

Answer to TY 12

For this transaction the exchange loss recognised in the statement of profit or loss for the year to 31 December 20X6 is £12,500 (£162,500 - £150,000). This is determined in the following manner

Date	Rate used	Rate	Amount
			Tshs'000
15/11/20X6 (IR)	As on date of transaction	£1 = Tshs2,500	625,000
31/12/20X6 (SR)	Rate at the end of reporting period	£1 = Tshs2,700	675,000
Exchange loss recognised in the year to 31 December 20X6			50,000

The exchange loss recognised in the statement of profit or loss for the year to 31 December 20X7 is Tshs25,000,000 (Tshs700,000,000 – Tshs675,000,000). This is determined in the following manner

Date	Rate used	Rate	Amount (Tshs'000)
01/01/20X7	Carrying value	£1 = Tshs2,800	675,000
15/02/20X7	Amount paid		700,000
Exchange loss recognised in the year to 31 December 20X7			25,000

In this way the total exchange loss of Tshs75,000,000 is split between the two periods in order to recognise the exchange difference in the period in which this exchange difference arises.

Answer to TY 13

On revaluation of asset

Date	Foreign currency	Recorded at	Rate	Functional currency
01/04/20X6	£40,000	Rate on date of purchase	£1 = Tshs2,500	Tshs100,000,000
01/07/20X6	£41,000	Rate on date of revaluation	£1 = Tshs2,400	Tshs98,400,000

Profit transferred to revaluation reserve (Tshs100,000,000 – Tshs98,400,000) is Tshs1,600,000.

On sale of asset

Date	Detail	Foreign currency	Rate	Functional currency
01/10/20X6	Carrying amount	41,000		Tshs98,400,000
01/10/20X6	Sale	45,000	£1 = Tshs2,200	Tshs99,000,000

The profit of Tshs600,000 (Tshs99,000,000 – tshs98,400,000) will be recognized in the profit or loss. The revaluation reserve will be transferred directly to retained earnings.

Answer to TY 14

In this case

The reporting currency (per IAS 21 – 1993) is as follows
Measurement currency - Tshs
Presentation currency - £

The functional currency (per IAS 21- 2005) is Tshs.

Quick Quiz

1. Define functional currency.

2. State an exception to the rule related to recognition of exchange difference on monetary items in Profit or loss in the period in which this exchange difference arises'.

3. It is not compulsory for a reporting entity to present its financial statements using the functional currency. True or False?

4. What is the main difference between reporting and functional currency?

Answers to Quick Quiz

1. Functional currency is the currency of the primary economic environment in which the entity operates.

2. When borrowing costs are capitalised according to the requirements of IAS 23 'Borrowing Costs' then any exchange differences are also capitalised and not recognised in the statement of profit or loss and other comprehensive income.

3. True because IAS 21 states that an entity can present its financial statements in any currency this currency is called the presentation currency.

4. The main difference between reporting and functional currencies is that

   (a) Reporting currency includes both measurement currency and presentation currency while
   (b) Functional currency means measurement currency only

Self Examination Questions

Question 1

In 20X4 Cheeseland started its venture in Arusha, using Tshs as its functional currency. After a few years it opened a new branch in Cheshire and started recording its expenses and income in CHF. In due course 85% of the operations of Cheeseland were conducted from Cheshire.

Required:

Can management change the functional currency from Tshs to CHF?

Question 2

Super Growth Fund is a Tanzanian based fund, embedded in a strong regulatory environment. Its investment strategy is to invest in Indian companies, and in return to offer a high return in alignment with the performance of these companies in the Bombay Stock Market. As a result, all the transactions are denominated in Indian Rupees (INR). While the fund's asset manager and major investors are based in Tanzania (other investors in Europe) and the funds management and service providers are remunerated in Tanzanian Shillings (Tshs), the reporting on the fund and the fund's financial statements are prepared using INR as the presentation currency.

Required:

Determine the functional currency of Super Growth Fund.

Answers to Self Examination Questions

Answer to SEQ 1

An entity's functional currency reflects the underlying transactions, events and conditions that are relevant to it. Hence once determined, the functional currency is changed only when there is a change in the underlying transactions, events and conditions.

In the case of Cheeseland there has been a change in the underlying transactions, events and conditions as the majority of the operations have shifted from Arusha to Cheshire. Hence the management can change the functional currency from Tshs to CHF.

Answer to SEQ 2

When determining the functional currency of an entity, the management of the entity will have to consider that the securities are invested in Mumbai, while the fund's investors are located in Tanzania and Europe. Since the fund is a Tanzanian based fund, it will be subject to Tanzanian laws. The fees are paid in Tshs while all the buy sell transactions are denominated in INR.

The above situation gives a very complicated picture, which does not make it easy for management to determine the functional currency of the fund. As a result, they will have to select the currency which most realistically represents the economic effect of the underlying transactions and events.

The fund operates in an Indian economic environment, gives returns in INR and competes with other Indian funds. In addition, the management has also been reporting the financial statements in INR. As a result, the functional currency of the fund should be the Indian Rupee (INR).

SECTION E

REPORTING FOR SPECIALISED ENTITIES

E1

STUDY GUIDE E1: REPORTING FOR SPECIALISED ENTITIES

Get Through Intro

In this Study Guide we discuss the relevance of IFRSs to other kinds of entities. Other kinds of entities are:

- those who have not been established for making profits for example libraries, museums etc. and
- public sector entities owned, managed or controlled by the government for example, public roads, public transport etc.

The Framework states that it applies to the financial statements of all commercial, industrial and business reporting entities, whether in the public or in the private sectors.

The International Accounting Standards Board (IASB) and the US Accounting Standards Board (FASB) are currently working to bring out a framework for reporting by not-for-profit entities in the public and private sector. Also, the International Public Sector Accounting Standards Board (IPSAB) has so far issued 31 International Public Sector Accounting Standards (IPSAS), loosely based on IFRSs.

Although IFRSs have been designed with profit-oriented entities in mind, other kinds of entities may find them appropriate. They can refer to IFRSs until such time that they get their own standards.

Learning Outcomes

a) Discuss and apply the knowledge with regards to specialised, not-for-profit, and public sector entities.
b) Discuss and apply the requirements of IAS 41 Agriculture.

1. Discuss and apply the knowledge with regards to specialised, not-for-profit, and public sector entities.

[Learning Outcome a]

When preparing general purpose financial statements on an international level, the standards and framework applicable are the IASs / IFRSs, in the case of private sector entities, and the International Public Sector Accounting Standards (IPSAS), in the case of public sector entities.

While the IPSAS are IASs / IFRSs changed to meet the requirements of public sector entities, the IPSAS state that where there is no currently applicable IPSAS, the IASs / IFRSs should be looked to for guidance on disclosure on accounting events.

The above extract shows how the standards for public sector entities are based on IFRSs / IASs and that they are relevant for the accounting of such organisations.

1.1 Specialised entities and their objectives

Apart from large, listed companies, there are other types of entities which also prepare and publish financial statements. These types of entities include

1. **Public sector entities:** these are broadly classified into two categories

(a) those enterprises owned, managed and controlled by the government
(b) those where services performed by management are with the intention of providing services to the society

The examples of public sector entities include public roads, public transport, primary education, healthcare for the poor and electricity, etc.

2. **Not-for-profit entities (NFPs):** these entities do not operate for the financial gain of any of their members.

In addition, they plough the profits generated from their activities back into their activities. They are also called specialised entities and entities for public benefit. The examples of NFPs are schools, churches, cultural societies, environmental protection societies, public museums, libraries, scientific societies and sports clubs.

1.2 Difference between commercial entities and not-for-profit entities

While large corporations and many commercial private enterprises focus on maximising their shareholders' wealth, public sector entities and NFPs exist to carry out the activities for which they have been formed.

Although public sector entities and NFPs receive the funds required to carry out their activities smoothly through voluntary contributions from members, the government or from outside agencies, they may or may not carry out trading activities to supplement their income. Even if trading is carried out, the trading activity will be secondary to their main activity.

As a result, these entities measure their performance by evaluating whether they provide value for money to the recipients of their services. The term value for money refers to how well the NFPs make use of the available resources by utilising the three Es: **Economy, Efficiency** and **Effectiveness**. The meanings of these terms are explained below

1. **Economy:** buying goods and services at the best possible price so as to reduce costs.
2. **Efficiency:** utilising the inputs in the most resourceful manner so as to obtain the maximum output.
3. **Effectiveness:** meeting the right goals at the right time.

Public sector entities are not supposed to show a profit or under spend their budget. If they do under spend their budget, the allocation for the next year would be considerably reduced. As a result, instead of financial performance measures, the performance of public sector entities is measured by what they have achieved. They will have key performance measures illustrating the level of service achieved by spending public money.

Charities, on the other hand, have to provide the public with a detailed analysis of the funds they have collected and how they have made use of those funds in terms of their stated objectives. Some charities very specifically state what they set out to achieve, what they have achieved so far and what remains for them to be achieved. Mismanagement of funds by a charity is taken very seriously by the authorities and the public.

1.3 Framework and accounting standards for public sector entities and not for profit entities

Typically, the IASs and IFRSs usually followed by profit-making entities are not suitable for public sector entities and NFPs. This is because NFPs and public sector entities are required to report different financial information from that reported by profit-making entities. The users of this information are also different and look at this information from a different perspective.

Although some countries have set specific standards for NFPs and public sector entities to follow (e.g. Statements of Recommended Practice in the UK), or the guidelines to be followed by these entities are prescribed by the legal framework, most entities use their own accounting techniques and methods or even the cash basis of accounting. However, in recent times, many public sector enterprises follow IASs and IFRSs, where possible, so as to bring about a sense of uniformity in their accounts.

The **IASB** and the **FASB** are currently developing a framework for reporting by not-for-profit entities in the public and private sector. The project is titled as The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information. The project is a part of the joint project between the IASB and the FASB to develop a common conceptual framework and will be addressed under Phase G. Currently, Phase G is inactive.

In addition, **the International Public Sector Accounting Standards Board (IPSAB),** a body of the IFAC, regulates public not-for-profit entities and public sector enterprises. This Board has so far issued 30 **International Public Sector Accounting Standards (IPSAS),** loosely based on IFRSs. Each IPSAS is based on a particular related IASs / IFRSs and follows the accrual method of accounting, a move designed to encourage NFPs to switch over from the cash basis they have so far been following.

As more and more NFPs and public sector enterprises are encouraged to switch over to IFRSs so as to ensure comparability among financial statements, there are two issues which remain. These are discussed below

1. Transition costs

Currently, NFPs and public sector enterprises follow the cash basis of accounting. On transition to the accrual basis, the financial statements of these specialised entities will be easily comparable with private sector entities. As a result, the cost of producing a product in the public sector versus the cost of producing the same product in the private sector can be compared. From this, it will be possible to identify the most economical way of sourcing inputs.

However, while the above argument seems favourable, no cost / benefit analysis has been made. The term cost refers to the number of qualified accountants needed to make this change. What's more, the move to accrual accounting has not yet received universal acceptance, with countries such as China, Japan, Malaysia and Singapore not accepting the change.

2. Liabilities

Technically, a liability is a present obligation of an entity which will result in an outflow of cash or resources of the entity. Specialised entities are committed to providing public benefits so as to achieve their goal. Yet there is a conflict of opinion as to whether this commitment constitutes a liability. Although the existence of the commitment can be regarded as an obligation, there has been no exchange of goods and services to give rise to the liability. This issue is still being looked into by the IPSAB.

IPSAS standards

The IPSASB is developing standards based on the IFRSs / IASs issued by the IASB. IPSAS are modelled around the International Financial Reporting Standards (IFRS.) The use of IPSAS also ensures that nancial statements are comparable for organisations that adopt them. The application of the IPSAS gives bodies incorporated under public law greater significance through comparability with general and internationally recognised regulations for submitting accounts. This facilitates dealing financiers and simplifies communication with the general public

The following is a list of IPSAS issued till date. These are given for reference purposes and need not be memorised.

IPSAS	Standard	Based on
IPSAS 1	Presentation of Financial Statements	IAS 1
IPSAS 2	Cash Flow Statements	IAS 7
IPSAS 3	Accounting Policies, Changes in Accounting Estimates and Errors	IAS 8
IPSAS 4	The Effects of changes in Foreign Exchange Rates	IAS 21
IPSAS 5	Borrowing Costs	IAS 23
IPSAS 6	Consolidated Financial Statements – Accounting for Controlled Entities	IAS 27
IPSAS 7	Accounting for Investments in Associates	IFRS 10
IPSAS 8	Financial Reporting of Interests in Joint Ventures	IFRS 11
IPSAS 9	Revenue from Exchange Transactions	IAS 18
IPSAS 10	Financial Reporting in Hyperinflationary Economies	IAS 29
IPSAS 11	Construction Contracts	IAS 11
IPSAS 12	Inventories	IAS 2
IPSAS 13	Leases	IAS 17
IPSAS 14	Events after the Reporting Date	IAS 10
IPSAS 15	Financial Instruments: Disclosure and Presentation - superseded by IPSAS 28 and IPSAS 30	
IPSAS 16	Investment Property	IAS 40
IPSAS 17	Property, Plant and Equipment	IAS 16
IPSAS 18	Segment Reporting	IFRS 8
IPSAS 19	Provisions, Contingent Liabilities, Contingent Assets	IAS 37
IPSAS 20	Related Party Disclosures	IAS 24
IPSAS 21	Impairment of Non-cash-generating Assets	IAS 36
IPSAS 22	Disclosure of Financial Information About the General Government Sector	NA
IPSAS 23	Revenue from Non-Exchange Transactions (Taxes and Transfers)	NA
IPSAS 24	Presentation of Budget Information in Financial Statements	NA
IPSAS 25	Employee Benefits	IAS 19
IPSAS 26	Impairment of Cash-Generating Assets	IAS 36
IPSAS 27	Agriculture	IAS 41
IPSAS 28	Financial Instruments: Presentation	IAS 32
IPSAS 29	Financial Instruments: Recognition and Measurement	IFRS 9
IPSAS 30	Financial Instruments: Disclosures	IFRS 7
IPSAS 31	Intangible Assets	IAS 38
IPSAS 32	Service Concession Arrangements: Grantor	IFRIC 12

Test Yourself 1

What are the key objectives of specialised, not-for-profit and public sector entities?

1.4 Small and medium sized entities

IFRSs for small and medium sized entities are discussed in detail in Study Guide C7.

1.5 Entities engaged in agricultural activities

Discussed in detail in Learning Outcome 2 of this Study Guide.

2. Discuss and apply the requirements of IAS 41 Agriculture.
[Learning Outcome b]

2.1 Entities engaged in agricultural activities

In this Study Guide we will specifically deal with entities engaged in agricultural activities.

Traditionally, all agricultural activities were accounted for at historical cost. As a result, gains were accounted for only on the sale of agricultural produce to a customer. There was a lot of diversity in accounting for agricultural activities, as assets related to agricultural activities and changes in those assets were excluded from the scope of international accounting standards.

In 1994, the IASC Board decided to develop an international accounting standard on agriculture, with the aim of reducing this diversity. There was a greater need of financial statements based on **sound and generally acceptable principles**. Since the use of a historic cost model was not seen as wholly appropriate for accounting for agricultural activity, the Board issued IAS 41 based on a fair value model.

Moreover, most business organisations involved in agricultural activity are generally small, cash-oriented and family-oriented. These small agricultural entities also seek outside capital and subsidies, mainly from banks or government agencies and are required to produce financial statements. These financial statements are required to be based on generally acceptable and sound accounting principles.

1. Scope

IAS 41 applies to accounting of the following agricultural activities

Biological assets
Agricultural produce at the point of harvest
Government grants

The standard does not apply to agricultural land or intangibles related to agricultural activity.

Example

A sheep is reared to give us wool. The wool is further processed to make yarn and carpet. Here

The sheep is a biological asset
The wool is the agricultural produce
The yarn and carpet would not be considered agricultural produce, as they are the result of processing after harvest

The table given below will explain the differences between biological assets, agricultural produce and products that are the result of processing after harvest.

These will not be considered as agricultural produce.

Biological assets	Agricultural produce	Products as a result of processing
Sheep	Wool	Pullovers, shawls
Cotton plant	Cotton	Cloth
Dairy cattle	Milk	Butter, Cheese
Plants	Sugarcane	Sugar
Orchards	Grapes	Wines
Fruit trees	Fruits	Jam

2. Definitions

Definition

A **biological asset** is a living animal or plant.

Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for sale, or for conversion into agricultural produce, or into additional biological assets.

Biological transformation comprises the processes of growth, degeneration, production and procreation that cause qualitative or quantitative changes in a biological asset.

IAS 41 Para 5

The following points should be noted in particular

Agricultural activity is any activity that results in a change in assets through increase or decrease in quantity or quality of an animal or plant. It can also be due to the in-house addition of living animals or plants.

All living plants and animals are considered biological assets (e.g. cattle, trees, vines, sheep and other plants).

Biological assets that are not used in agricultural activity will remain outside the scope of the standard.

Test Yourself 2

DEF Ltd owns a sheep farm in Scotland, where it rears 300 sheep. In the year 20X6, 40 lambs were born and 20 more were purchased. Also, 30 sheep died due to an outbreak of disease.

Required:

Are these agricultural activities, and if so, why?

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3. Recognition

An asset can be recognised as a biological asset or agricultural produce when and only when **ALL** of the following three conditions are fulfilled

The **asset is controlled due to some past events**. These events can be legal ownership of livestock, the branding (marking) of an animal or its birth.

Probable future benefits related to the asset flow to the entity.

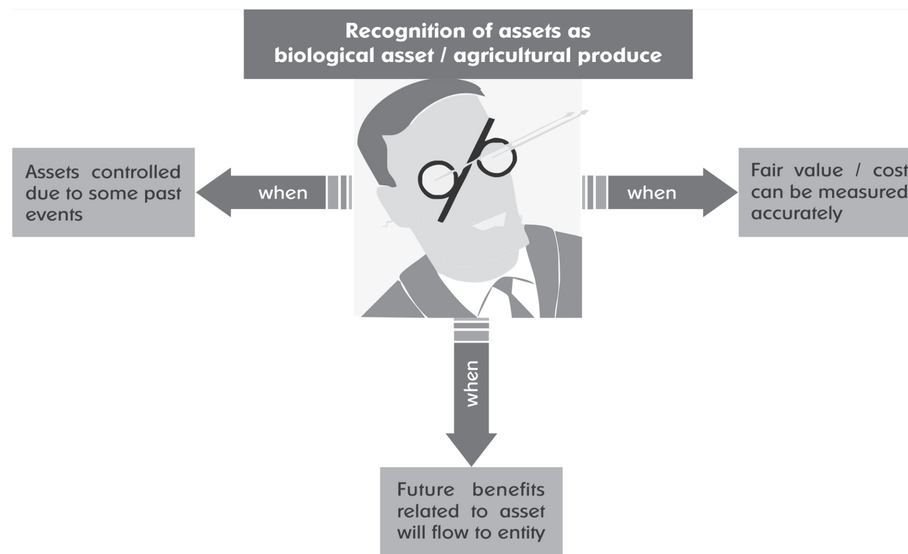
The fair value or the cost of the asset can be measured with accuracy.

Example

XYZ Ranch Ltd owns a sheep farm and has a flock of 200 sheep. The sheep will be recognised as biological assets as soon as the sheep are purchased by the company or the company obtains legal ownership of the livestock.

Furthermore, when the entity is in a position to gain monetary benefits from the sale of wool, then wool will be recognised as agricultural produce.

Diagram 1: Recognition of biological asset and agricultural produce



Test Yourself 3

A pregnant ewe (a female sheep) gives birth to a lamb. Is the ewe a biological asset? When will the offspring be recognised as a biological asset? When will the agricultural produce (with respect to the lamb) be recognised?

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4. Measurement

(a) A biological asset shall be measured on initial recognition and on each reporting period (end of reporting period) at its fair value less costs to sell, except where the fair value cannot be measured reliably.
(b) Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less costs to sell at the point of harvest.

The standard requires an entity to use a fair value approach, when measuring its biological assets and agricultural produce. To understand this, we need to know how to **determine the fair value.**

Definition

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

IAS 41 Para 8

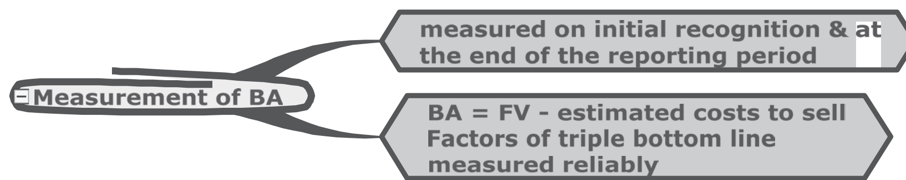
Fair value is the amount at which an asset can be exchanged or a liability settled in the market. It should be noted that fair value depends upon the asset's present location and condition. As a result, the fair value considered should take into account related cost to sell, if any. For example, the fair value of cattle at a farm is the price for the cattle in the relevant market less the transport and other costs of getting the cattle to that market.

The standard states that the determination of fair value for a biological asset or agricultural produce can be done by grouping biological assets or agricultural produce according to significant attributes; for example, by age or by quality. An entity selects the attributes corresponding to the attributes used in the market, as a basis for pricing.

Example

JKL dairy farms own cattle and calves. The calves are of different age groups. So, to determine their fair value, the first step would be to group the calves according to their age groups i.e. 2 years, 3 years and so on.

SUMMARY



5. Active market

If there is an active market for a biological asset or agricultural produce in its present location and condition, **the price quoted in the market will be the fair value of the asset or the produce**.
If an entity has access to different active markets**, the entity uses the most relevant market.**

Definition

An active market is a market where all the following conditions exist

The items traded within the market are homogeneous.
Willing buyers and sellers can normally be found at any time.
Prices are known to the public.

IAS 41 Para 8

An **active market** is a market which is uniform and where there are willing buyers and sellers for the produce.

Example

DEF Grapes Ltd sells agricultural produce, i.e. grapes, in three different markets: Delhi, Pune and Mumbai.

The price quoted in these three markets is different. As the maximum quantity of grapes is sold in Delhi, the price quoted in Delhi will be considered the fair value of the agricultural produce.

If an active market does not exist, the entity can use one of the following for the determination of fair value:

The most current market transaction price.
Market prices for similar assets with adjustment to show differences.
Sector benchmark such as the value of cattle expressed per kilogram of meat.

Example

Sharman Traders in Nashik are wholesalers of black grapes. If no active market exists for the black grapes, the fair value to be taken in this case will be the most current market transaction price. If no such price exists, then the fair value can be determined on the basis of market prices for similar assets.

If market prices are currently not available for a biological asset, the entity should use the present value of the expected net cash flows to determine the fair value of a biological asset. The present value of the expected net cash flows will be the net cash flows from the asset, discounted at a current market based rate. The objective behind this is to determine the fair value of a biological asset in its present location and condition.

In determining the discounted cash flows, any cash flows for financing the assets, taxation or re-establishing the biological assets should be ignored. For example, the cost of replanting trees in a plantation forest after harvest should not be included in the calculation of discounted cash flows.

Entities often enter into **contracts** to sell their biological assets or agricultural produce at a future date. Contract prices are not considered in determining fair value because fair value is the current market price and cannot be adjusted due to the existence of a contract.

In determining the present value of expected net cash flows, an entity includes the net cash flows that market participants would expect the asset to generate in its most relevant market.

Example

The Manas Group in Africa owns timber plantations which it operates in order to supply to Escort Mills.

The company enters into a forward contract for the supply of logs. The fair value of standing timber of eight years or more, being the age at which it is marketable, will be based on the market price of the estimated volumes less costs to sell. The fair value will not be adjusted for the future sales contract.

Test Yourself 4

Ann Ltd owns farms in which it grows sugarcane. The company enters into a future contract for the supply of the sugarcane to Farms Co.

Required:

How will the fair value of the agricultural produce be measured?

Tip

Remember that biological assets and agricultural produce will be measured at their fair value less costs to sell.

6. Treatment of gains and losses

A **gain or loss arising on initial recognition of a biological asset** that is measured at fair value less costs to sell, should be included in the profit or loss for the period in which it arises. Also, a change in fair value less costs to sell should be included in the profit or loss for the period in which it arises. A gain arising from the birth of offspring should be shown as a gain in the profit or loss.

Example

Moo Co purchased 200 cattle at an auction for Tshs100 million on 30 June 20X2. An amount of Tshs1 million was incurred in transporting the cattle. The auctioneer's fees amounted to 1% of sales price.

The fair value of the cattle on the date of purchase would be Tshs99 million (Tshs100 million - Tshs1 million auctioneer's fees) and an immediate expense of Tshs2 million (Tshs1 million + Tshs1 million) would be recognised in the statement of profit or loss. The cattle's fair value increased from Tshs100 million to Tshs110 million on 31 December 20X2.

At this stage the cattle would be measured at Tshs108.90 million (Tshs110 million – Tshs1.1 million) and a gain of Tshs9.9 million (Tshs108.9 million - Tshs99 million) would be recognised in the statement of profit or loss.

Tip

Remember that a gain or loss arising on initial recognition of a biological asset and measured at fair value less costs to sell and also the changes in fair value should be included in the profit and loss.

7. Inability to measure fair value reliably

It is always presumed that the fair value can be measured reliably for a biological asset. However, this assumption does not always hold true. There is a chance that the market prices of a few biological assets are not available and, if alternative estimates are available, they may not be clearly reliable.

(a) In these cases, the biological asset shall be measured at its cost less any accumulated depreciation and any accumulated impairment losses. For this purpose, cost, accumulated depreciation and impairment losses shall be determined in accordance with IAS 2, IAS 16 and IAS 36.

(b) Once the fair market value becomes reliably measurable (if an active market opens), an entity shall measure the biological asset at its fair value less costs to sell.

An impairment loss is the amount by which the carried forward amount of asset exceeds its recoverable amount. In determining the cost, the entity needs to consider the requirements of IAS 2, IAS16 and IAS 36 Impairment of assets.

However, in a reverse scenario, an entity that has measured biological assets at fair value less costs to sell may not revert to a cost model, if a reliable measure of fair value ceases to be available. Few people found this prohibition harsh and impracticable. It was argued by IASC that entities might use a reliability exception as an excuse to discontinue fair value measurement in a falling market. So, measurement at cost is permissible, only when a reliable measure of fair value is unavailable at the point of recognition.

Tip

Remember that if the fair value of a biological asset cannot be measured reliably, then the biological asset shall be measured at its cost less accumulated depreciation and any accumulated impairment losses.

8. Treatment of government grants

Definition

Government grants are assistance by government in the forms of transfer of resources to any entity in return for past or future compliances with certain conditions relating to the operating activities of the entity.

IAS 20 Para 3

Agricultural activity often attracts government support. Government grants are given on the condition that an entity carries out a particular activity.

Although there is an international standard on government grants (IAS 20), IAS 41 contains specific guidance in respect of grants receivable in relation to biological assets measured at fair value less costs to sell.

An unconditional government grant is recognised as income when it is receivable.
If a conditional government grant is taken, it shall be recognised as income only when the conditions relating to the grant are satisfied.

Example

Bhatt Company is in the business of cultivating and selling rice. The company has offered grants to growers as an incentive to remain in the industry. The grants will be given at the end of each of the next three years.

This grant will be recognised at the end of each of the three years, when the grant is receivable.

Example

A government grant may require an entity to farm in a particular location for four years and require the entity to return the entire government grant if it farms for less than four years.

In this case, the government grant is not recognised as income until four years have passed.

The provisions described above only relate to grants awarded in respect of biological assets measured at fair value less costs to sell. If the biological assets are carried at cost less accumulated depreciation and impairment losses, any government grants related to those assets will be dealt with under IAS 20.

Test Yourself 5

Bush Co grows fruit trees using inorganic methods. Now, it wants to grow the trees using organic methods. In order to assist with the costs of converting to organic farming, government grants are available for the next five years; provided the land is registered with an organic inspection body throughout the next five years and the company does not revert to traditional methods during these years.

Required:

When will the grant be recognised as income?

---

9. Presentation

Presentation of financial statements requires that biological assets should be presented separately on the face of the statement of financial position.

The presentation of biological assets as current assets and non-current assets will depend on their nature.

Consumable assets are those assets that are harvested as agricultural produce or sold as biological assets such as wheat, maize and trees being grown for lumber. Bearer biological assets are assets other than consumable biological assets such as dairy cattle, grape vines, and fruit trees.

However, where the period of maturity of a consumable asset is long, it may be presented as a non-current asset. Short lived consumable assets such as wheat and sugar will be presented as current assets, whereas bearer assets such as dairy cattle will be presented as non-current assets.

The following example will show how biological assets are presented on the face of the statement of financial position.

Presentation of agricultural assets in the Statement of financial position

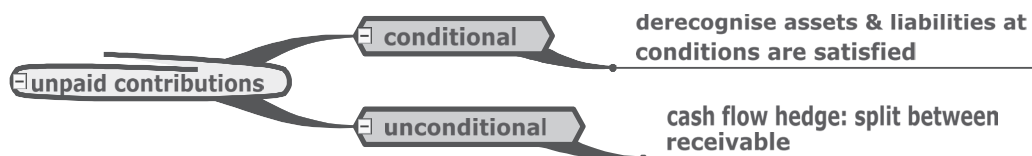
XYZ Groups - Statement of financial position as at 31 December 20X5

	20X5	**20X4**
	Tshs	**Tshs**
Non-current assets		
Dairy livestock - immature	60,000	52,000
Dairy livestock - mature	200,000	250,000
Subtotal - biological assets	260,000	302,000
Property, plant and equipment	1,230,460	1,100,300
Total non-current assets	**1,490,460**	**1,402,300**
Current assets		
Inventories	60,950	50,650
Trade and other receivables	88,000	55,000
Cash and cash equivalents	15,000	10,000
Total current assets	**163,950**	**115,650**
Total assets	**1,654,410**	**1,517,950**
EQUITY AND LIABILITIES		
Equity		
Issued capital	1,000,000	1,000,000
Accumulated profits	504,120	377,570
Total equity	**1,504,120**	**1,377,570**
Current liabilities		
Trade and other payables	150,290	140,380
Total current liabilities	**150,290**	**140,380**
Total equity and liabilities	**1,654,410**	**1,517,950**

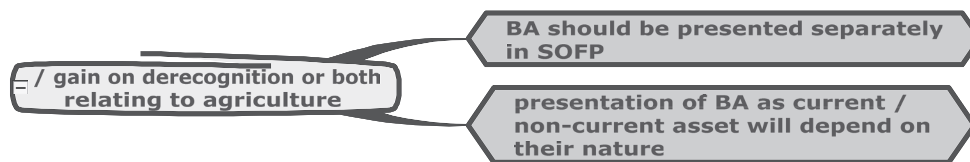
XYZ Groups - Statement of profit or loss for the year to 31 December 20X5

	Tshs
Fair value of milk produced	667,230
Gains from changes in fair value	25,340
Total income	**692,570**
Inventories used	(250,200)
Staff costs Depreciation	(123,980)
expense Other operating	(15,240)
expenses **Total**	(50,050)
expenses	**(439,470)**
Profit before operations	**253,100**
Income tax expenses	126,550
Profit for the period	**126,550**

SUMMARY



SUMMARY



10. Disclosure

(a) General

(i) Aggregate gain or loss

The entity is required to disclose the aggregate gain or loss arising during the current period on initial recognition of biological assets and agricultural produce and also from the change in fair value less costs to sell**.** This disclosure can be made on the face of the statement of profit or loss or in the notes to the financial statements.

(ii) Group of biological assets

(iii) An entity should provide a description of each group of its biological assets.

(iv) Separate disclosure of physical and price change

Changes in the fair value can take place due to both physical changes and price changes in the market. The standard sets out that it is better for the entity to make a separate disclosure of physical and price changes, especially when the production cycle is for more than one year. This disclosure is not of much use when the production cycle is less than a year. Refer example below to understand this disclosure requirement.

(b) Other disclosures

IAS 41 requires other detailed disclosure requirement pertaining to the nature of activities, significant assumptions applied in determination of fair values, reconciliation between carrying amounts in comparison to previous years, etc. Another point to note is that the agricultural activity is often exposed to risks related to nature, climate and disease. If an event occurs that gives rise to a material item of income or expense, the nature and amount of that item are to be disclosed in accordance with IAS 1 Presentation of Financial Statements. The examples of such events can be an outbreak of a disease, a flood, a severe drought or frost or a plague of insects.

Test Yourself 5

A herd of 20, 4 - year old animals was held in Marigold Source farms as at 1 January 20X6, valued at Tshs200,000.

The following transactions took place during the year:

On 1 July 20X6:
One animal aged 4.5 years was purchased for Tshs210,000
One animal was born

No animal was sold or disposed of.
The per-unit fair values less costs to sell were as follows:

	Tshs'000
4 - year old animal on 01/01/20X6	200
Newborn animal on 01/07/20X6	150
4.5 - year old animal on 01/07/20X6	210
Newborn animal on 31/12/ 20X6	155
0.5 - year old animal on 31/12/20X6	170
4 - year old animal on 31/12/ 20X6	205
4.5 - year old animal on 31/12/ 20X6	220
5 - year old animal on 31/12/20X6	230

Required:

1. The change in fair value less costs to sell showing:

   The portion attributable to the price change
   The portion attributable to physical changes

2. The carrying cost of the herd as at 31 December 20X6.

3. An extract of the livestock account for the year to 31 December 20X6.

Answer

1. The change in fair value less costs to sell due to price changes is:

	Calculation (Tshs'000)	Tshs'000
20 animals	20 x (205 – 200)	100
Animal purchased	1 x (220 – 210)	10
Newborn mid-year	1 x (155 - 150)	5
	Total	**115**

Here, we are trying to see the effect of the change in the fair value due to the change in price, by comparing their values on 31 December 20X6 with 1 January 20X6. Change in age (physical change) will not be taken into consideration compared to 1 January 20X6 there is now an extra Tshs115,000 due to the new addition.

The change in fair value less costs to sell due to physical changes

	Calculation (Tshs'000)	Tshs'000
20 animals	20 x (230 – 205)	500
Animal purchased	1 x (230 – 220)	10
Increase in value of newborn	1 x (170 – 155)	15
Newborn	1 x 150	150
Total		**675**

Here, we are trying to see the effect of the change in the fair value due to physical change, by comparing the increase in age values as at 31 December 20X6. Change in price will not

Continued on the next page

2. The carrying cost of the herd as at 31 December 20X6 (means the amount that we are going to carry for next year).

	Tshs'000
21 x 230 (total 5 year old animals)	4,830
1 x 170 (one 0.5 year old animal)	170
	5,000

3. An extract of the livestock account for the year to 31 December 20X6

	Tshs'000	Tshs'000
Carrying cost of herd at 1/01/20X6 (20 x 200)		4,000
Add: Purchase on 1/07/20X6 (1 x 210)	210	
Increase in fair value less costs to sell (price changes)	115	
Increase in fair value less costs to sell (physical changes)	675	
Total additions		1,000
Carrying Cost of herd on 31/12/20X6		**5,000**

Remember that the carrying cost of the livestock as at 31 December 20X6 taken out by both ways as in 2 and 3 must tally.

Answer to Test Yourself

Answer to TY 1

The key objectives of specialised, not-for-profit and public sector entities include the following:

1. To provide the general public with services.

2. To break even (in order to stay in business) rather than generate a surplus.

3. To provide value for money which can be broken down into providing the following three Es:

(a) Economy
(b) Efficiency
(c) Effectiveness

4. To provide the services and fulfil the objectives they were created to fulfil

Answer to TY 2

Yes, they are agricultural activities.

The birth of 40 lambs in the farm and the purchase of 20 more result in agricultural activities according to IAS 41 because biological transformation has taken place.

The death of 30 sheep also results in an agricultural activity, as change in an asset (degeneration) has taken place, which has led to the decrease in the quantity of sheep.

Answer to TY 3

The pregnant ewe is a biological asset according to IAS 41.
The offspring will be recognised as a biological asset as soon as it is born.
Agricultural produce with respect to the lamb will be recognised when the economic benefits associated with the lamb flow to the owner.

Answer to TY 4

Sugarcane is the agricultural produce according to IAS 41.

The fair value of sugarcane will be based on the market price of the estimated sugarcane volumes less costs to sell. The fair value will in no way be adjusted for the future contract.

Answer to TY 5

The government grant should be recognised as income when the land gets registered and the grant becomes non-refundable.

The reason behind this is that the company has taken a conditional grant and, according to IAS 41, the government grant can be recognised as income only when the condition is satisfied.

Quick Quiz

1. How are not-for-profit entities different from commercial enterprises?

2. How do public sector enterprises differ from NFPs?

3. Which of the following will be considered agricultural produce?

   (a) Wool
   (b) Cloth
   (c) Milk
   (d) Sugarcane
   (e) Wine

4. How are biological assets and agricultural produce measured at the point of harvest?

5. If an entity has measured biological assets at fair value less costs to sell, can it revert to a cost mode?

6. Does IAS 41 require the separate disclosure of physical changes and price changes?

7. When should government grants related to agricultural activity be recognised?

Answers to Quick Quiz

1. Not-for-profit entities focus on value for money and providing a service to society by integrating economy, efficiency and effectiveness into their daily operations. Commercial enterprises, on the other hand, exist to maximise the wealth of their shareholders.

2. While both exist to serve society, public sector enterprises are owned, managed and controlled by the government while NFPs are run by non-governmental organisations.

3. (a), (c), (d).

4. A biological asset shall be measured on initial recognition and on each reporting period at its fair value less costs to sell, except where the fair value cannot be measured reliably. Agricultural produce harvested from an entity's biological assets shall be measured at its fair value less costs to sell at the point of harvest.

5. No.

6. Yes.

7. An unconditional government grant is recognised as income when it is receivable.

   If a conditional government grant is taken, the same shall be recognised as income only when the conditions are satisfied.

Self Examination Questions

Question 1

Explain with the help of an example how accounting for a not-for-profit entity is different from that of a profit-making entity.

Question 2

Supreme Ltd purchased 100 sheep at an auction for Tshs60 million on 31December 20X5. The auctioneer's fees amounted to be 1% of sales price. At what value would the sheep be measured in the statement of financial position and what gain / loss would be shown in the statement of profit or loss?

Suppose the fair value of the sheep rises to Tshs70 million on 30 June 20X6. At what value would the sheep be measured in the statement of financial position and what gain / loss would be recognised in the statement of profit or loss?

Question 3

A herd of 15, 4-year old animals valued at Tshs250,000 was held in Marigold Source farms as at 1 January 20X6.

The following transactions took place during the year:

On 1 July 20X6:
One animal aged 4.5 years was purchased for Tshs260,000
One animal was born

No animal was sold or disposed of.

The per-unit fair values less costs to sell were as follows:

	Tshs'000
4-year old animal on 1/01/20X6	250
Newborn animal on 1/07/ 20X6	200
4.5-year old animal on 1/07/20X6	260
Newborn animal on 31/12/20X6	205
0.5-year old animal on 31/12/20X6	220
4-year old animal on 31/12/ 20X6	258
4.5-year old animal on 31/12/ 20X6	270
5-year old animal on 31/12/ 20X6	280

Required:

1. The change in fair value less costs to sell showing:

   The portion attributable to physical changes
   The portion attributable to price change

2. The carrying cost of the herd as at 31 December 20X6

3. An extract of the livestock account for the year to 31 December 20X6

Answers to Self-Examination Questions

Answer to SEQ 1

An NFP's purpose and set-up is different from those of commercial entities and therefore different information is required by its stakeholders. Hence, its financial statements would also differ from that of a profit-making entity.

A public sector enterprise does not report on its profit for the period, but instead reports the income it has earned during the period and the manner in which it has spent that income. An NFP's financial statements include a statement of financial position and a statement of financial activities or an income and expenditure account. An example of an NFP's financial statements (with imaginary figures) is given below:

Statement of financial position as on 31 December 20X1

	Tshs'000
Non-current assets	
Property, plant and equipment	56,350
Investment in securities	8,728
Current assets	
Inventory	1,518
Receivables	7,359
Cash	2,771
Total assets	**76,726**
Non-current liabilities	
Pensions	6,794
Current liabilities	
Payables	4,376
Reserves	
Restricted funding	14,140
Unrestricted funding	51,416
Total liabilities	**76,726**

Statement of financial activities for the year ended 31 December 20X1

	Tshs'000
Resources from funds generated	
Grants	7,378,700
Legacies	3,615,662
Donations	1,119,090
Activities for generating funds	
Charity shop sales Income	7,036,885
from investments **Total**	2,763,958
incoming resources Cost	**21,914,295**
of generating funds	
Fundraising	790,890
Publicity	573,880
Operating costs	4,318,246
Community support	12,784,598
Childcare activities	3,072,385
Other miscellaneous activities	323,511
Total outflow of resources	**21,863,510**
Net inflow of resources during the year	50,785
Last year's funds brought forward	14,771
Funds carried forward to next year	65,555

Answer to SEQ 2

The company purchased 100 sheep at an auction for Tshs60 million, and the auctioneer's fees were Tshs0.6 million (1% of Tshs60 million).
The fair value of the sheep on 31 December would be Tshs59.4 million (Tshs60 million – Tshs0.6 million) and it will be shown in the statement of financial position.

A loss of Tshs0.6 million would be shown in the statement of profit or loss.

When the fair value of the sheep rises to Tshs70 million on 30 June 20X6,

The sheep would be measured at Tshs69.30 million (Tshs70 million – Tshs0.7 million).
A gain of Tshs9.9 million (Tshs69.3 million - Tshs59.4 million) would be reflected in the statement of profit or loss.

Answer to SEQ 3

1. The change in fair value less costs to sell due to price changes is:

		Tshs'000
15 animals	15 x (258 – 250)	120
Animal purchased	1 x (270 – 260)	10
Newborn mid-year	1 x (205 - 200)	5
	Total	**135**

In this, we are trying to see the effect of the change in the fair value due to the change in price, by comparing their values as at 31 December 20X6 with 1 January 20X6. Here, change in age (physical change) will not be taken into consideration.

The change in fair value less costs to sell due to physical changes is:

		Tshs'000
15 animals	15 x (280 – 258)	330
Animal purchased	1 x (280 – 270)	10
Increase in value of newborn	1 x (220 – 205)	15
Newborn	1 x 200	200
	Total	**555**

Here, we are trying to see the effect of the change in the fair value due to physical change, by comparing the increase in age values as at 31 December 20X6. Change in price will not be considered

2. The carrying cost of the herd as at 31 December 20X6 (means the amount that we are going to carry for next year).

	Tshs'000
16 x 280 (Total 5-year old animals	4,480
1 x 220 (one 0.5-year old animal)	220
	4,700

3. An extract of the livestock account for the year to 31 December 20X6

	Tshs'000	Tshs'000
Carrying cost of herd at 01/01/ 20X6 (15 x 250)		3,750
Add: Purchase on 01/07/ 20X6 (1 x 260)	260	
Increase in fair value less costs to sell (price changes)	135	
Increase in fair value less costs to sell (physical changes)	555	
Total additions		950
Carrying Cost of herd on 31/12/ 20X6		**4,700**

Remember that the carrying cost of the livestock as at 31 December 20X6 calculated by both the methods in note 2 and note 3 must balance.

SECTION F

FINANCIAL AND BUSINESS ANALYSIS

F1

STUDY GUIDE F1: FINANCIAL AND BUSINESS ANALYSIS

Get Through Intro

Accounting standards are prepared so that financial statements reflect a true and fair picture of a company's financial position. However all numbers are not equal – some reveal the truth while others conceal it. Hence, the need for other performance indicators!

Traditionally, financial performance indicators like profitability ratios such as ROI and EPS have been considered as important measures of corporate performance. Ratios add life to numbers which then squeal facts which they earlier do not reveal.

Not every aspect of corporate activity can be expressed in terms of financial measures. There are certain aspects such as product quality, delivery, reliability, after sales service and customer satisfaction which affect the fortunes of a company. Non-financial performance indicators are used to measure performance which cannot be expressed in monetary terms.

This Study Guide discusses indicators of financial and non-financial performance. This will help you assess a company's performance in your professional life – it will also help you make well informed personal investment decisions.

Learning Outcomes

a) Identify and calculate suitable performance, position and prospect measures using key indicators, financial statement ratios, stock market ratios, comparisons, trend analyses and other representations of relationships that support a meaningful financial and business analysis of a private or public sector entity.
b) Draw conclusions and report on the analysis undertaken from a business perspective.
c) Identify and assess the choice of accounting treatments that may be adopted based on a given scenario explaining how they may affect a users' understanding of a business.
d) Explain and justify changes in accounting policies and the treatment of the same as per the IFRSs, distinguishing them from changes in estimate and correction of prior period errors.
e) Identify and assess chosen policies and treatments for a given entity or entities comparing the fairness of presentation and compliance with international and local practice for a private or public sector entity.
f) Identify and comment upon limitations of analysis.

1. Identify and calculate suitable performance, position and prospect measures using key indicators, financial statement ratios, stock market ratios, comparisons, trend analyses and other representations of relationships that support a meaningful financial and business analysis of a private or public sector entity.

2. Draw conclusions and report on the analysis undertaken from a business perspective.
[Learning Outcomes a and b]

The performance, position and prospect of any public or private sector entity can be measured through a numbers of indicators which include ratio analysis, trend analysis and other comparisons. These indicators are the basis of a meaningful financial and business analysis, and are discussed in detail below in this Learning Outcome:

1.1 Performance

The word performance is interpreted by different people in different manners. Selection and calculation of performance indicators has to address the needs of various users. Various user groups and their information needs and performance measures can be summarised in the following manner:

	User group	Information needs and performance assessment relates to
1	Management	Performing efficiency (Information needs are detailed)
2	Employees	Long-term job prospects Profit-sharing bonus
3	Investors	Profitability Financial health of the company Soundness of investments
4	Government	Tax compliance Compliance with other laws
5	Lenders and creditors	Creditworthiness

1.2 Profitability

Traditionally, the amount of profits earned was treated as a prime performance indicator. However other measures such as earnings per share (EPS) now have more prominence. EPS, the paramount performance indicator, is discussed in Study Guide C1.

1.3 Operating cash flows

Since profits are dependent upon accounting policies and accrual adjustments, analysts give more importance to cash flows from operations when judging the performance of a company. You already have studied cash flows in Paper A3 and Paper B2 earlier. Furthermore statement of cash flows from the group perspective has also been discussed under Section E of this Paper in detail.

1.4 Ratio analysis

Performance is better analysed when it is possible to compare the situation between two dates of two entities or industries. Ratios help us to do this. Ratios indicate a meaningful relationship between certain variables. Various user groups apply a series of accounting ratios to interpret and appraise financial performance. This analysis involves comparisons such as:

- the current year's results with the previous year, to compare current performance with prior performance
- the current year's results with those of comparable companies in the same line of business, to establish whether the company is performing better or worse than its competitors
- one segment or division of a business with others to establish which parts of the business are achieving their objectives
- current performance against a standard or benchmark of performance

The calculation of ratios has already been studied at an earlier stage of the course (in Paper B2); in this paper not many calculations will be needed. More emphasis will be on the interpretation and analysis of ratios. However, for this purpose, **a quick recap** of the important ratios, their functions and formulae is required.

Summary of Financial ratios

The following table summarises the above discussion:

	Key accounting Ratios	Formula	Interpretation	Favourable situation	
A	**Profitability ratios**			**H**	**L**
1	Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$	Reflects gross margin made on sales		-
2	Operating profit margin	$\frac{\text{Operating profit margin}}{\text{Sales revenue}} \times 100$	Reflects operating margin made on sales		-
3	Net profit margin	$\frac{\text{Net profit (PBT)}}{\text{Sales revenue}} \times 100$	Reflects net margin made on sales		-
4	Return on capital employed	$\frac{\text{Operating profit}}{\text{Capital employed}} \text{ x } 100$	Reflects relationship between profits earned and size of company (measures overall performance of company)		-
5	Return on assets	$\frac{\text{Operating profit}}{\text{Total assets}} \text{ x } 100$	Reflects relationship between profits earned and total assets		-
B	**Liquidity ratios**				
1	Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Measures ability to pay current liabilities from the current assets		-
2	Quick ratio	$\frac{\text{Quick assets}}{\text{Current liabilities}}$	Indicates the ability to pay all current liabilities if they become due for payment immediately		-
C	**Working capital efficiency ratios**				
1	Asset turnover	$\frac{\text{Sales revenue}}{\text{Total assets}}$ (times p.a.)	Shows how much revenue generated by a Tshs1 worth of assets		-
2	Inventory turnover	$\frac{\text{Cost of sales}}{\text{Inventory}}$ (times p.a.)	Indicates how many times the inventory is being turned over in a year		-
3	Receivable days	$\frac{\text{Receivable}}{\text{Credit sales}} \times 365 \text{ days}$	Reflects the number of days it takes for a customer to pay	-	
4	Payable days	$\frac{\text{Payables}}{\text{Credit purchases}} \text{ x } 365 \text{ days}$	Reflects the number of days it takes for a company to settle its bills		-
5	Working capital cycle	Inventory turnover days + Receivable days - Payable days	Approximate number of days it takes to purchase the inventory, sell the inventory and receive cash.	-	

Continued on the next page

D	Financial risk ratios				
1	Capital gearing ratio	$\frac{\text{Total long-term debt}}{\text{Shareholders funds}} \times 100$	It expresses the relationship between a company's borrowings and its own funds	-	-
2	Debt ratio	$\frac{\text{Total liabilities}}{\text{Total assets}}$	Indicates the percentage of assets financed with debt	-	-
3	Interest cover	$\frac{\text{Profit before interest and tax}}{\text{Interest expenses}}$	Indicates the number of times, the profit covers the interest charge		-
4	Cash flow ratios				
(i)	Ratio of long-term borrowings to cash generated from operations	$\frac{\text{Long-term borrowings}}{\text{Cash generated from operatio}}$	Measures the ability of the company to meet its long-term obligations from its operating activities	-	-
(ii)	Ratio of net cash from operating activities to capital expenditure	Net cash flow from $\frac{\text{Operating activity}}{\text{Capital expenditure}} \times 100$	Helps decide the extent to which the operating activities of a company can finance its capital expenditure		-

H stands for High
L stands for low

1.5 Stock Market ratios

Stock market ratios measure investor response to owning a company's stock and also the cost of issuing stock. These are concerned with the return on investment for shareholders, and with the relationship between return and the value of an investment in company's shares. The various stock market ratios are discussed below:

	Investor performance ratios				
1	Earnings per share (EPS)	Profits available for distribution to ordinary shareholders/Weighted average number of ordinary shares outstanding	Amount which an entity has earned per share for the given period.		-
2	Price earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings Per Share}}$	Helps to assess the relative risk of an investment		-
3	Profit retention ratio	$\frac{\text{Profit after dividend}}{\text{Profit before dividend}}$ x 100	Measures the proportion of retained profits to the profits earned by the entity	-	
4	Dividend yield	$\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$	Measures the return on capital investment as a percentage of market prices		-
5	Dividend cover	$\frac{\text{Profit after tax}}{\text{Dividend}}$	Measures the ability of the company to maintain its existing levels of dividends		-

Note – Ratio analysis has been covered in Section E of the Paper B2 in detail.

1.6 Trend Analysis

Information from the following sources can be used to identify trends:

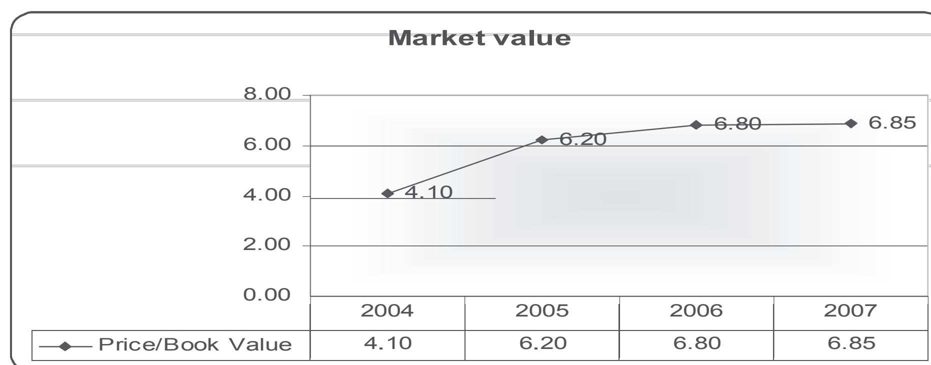
- comparative amounts given in the financial statements
- summaries for several years (e.g. turnover, profitability and net worth summaries for 10 years, the so-called historical summary)

An example of trend analysis follows:

Performance area	20X4	20X5	20X6	20X7	Trend
Leverage					
Debt % Total assets	29.00	30.00	34.00	26.00	Drop in leverage during 20X6
Interest coverage	200.00	320.00	400.00	280.00	Lower coverage during 20X7
Liquidity					
Current Ratio	2.30	2.80	2.50	2.40	Lower liquidity since 20X5
Quick Ratio	1.05	1.35	1.40	1.30	Lower liquidity since 20X5
Interval measure (days)	88.00	120.00	95.00	65.00	Lower liquidity since 20X5
Profitability					
Return on assets (%)	20.00	22.00	24.00	21.00	Lower ROA during 20X7
Profit margin (%)	23.00	24.00	28.00	25.00	Lower profitability during 20X7
Return on equity (%)	30.00	31.00	37.00	26.00	Lower ROE during 20X7
Efficiency					
Asset turnover	2.78	2.63	2.60	2.51	Lower efficiency since 20X5
Receivables turnover	7.00	6.00	7.00	6.80	Increased efficiency since 20X5
Inventory turnover	5.10	5.50	6.10	5.60	Increased efficiency since 20X5
Market Value					
Price / Book value	4.10	6.20	6.80	6.85	Good market perceptions, but stagnated after 20X6

The above table indicates that a generally healthy trend has been arrested in 20X7. Many ratios show unfavourable developments. Management has to attend to possible problems in these areas. Some statistical techniques are used by analysts to discover trends.

These variables can be plotted on a graph. The example of market value is given below:



The predictive value of trend analysis may be restricted due to the general limitations of ratios and financial analysis. These are discussed in the next section. Therefore, the trend figure should be used with caution.

Cross-sectional comparison

Like the comparison of the figures for an entity over a period, the figures of two entities may be compared, or the figures of an entity may be compared with industry averages and conclusions may be drawn. Assuming that the figures are comparable, this helps in assessing the efficiency or otherwise of an entity.

Common size financial statements

Since different entities have different sizes, comparison of line items may not be easy. Analysts try to overcome this difficulty by preparing common size statements. In the case of the statement of profit or loss, the revenue is treated as 100 and other items are changed to a proportionate fraction of 100. In the case of statement of financial position, the total of assets and liabilities are taken as 100 and the other line items are converted to a proportionate fraction of 100. This process in illustrated in the following table.

Common size statement of profit or loss

	Statement of profit or loss (Tshs '000)	Common Size Statement of profit or loss %
Revenue	85,000	100%
Cost of Goods Sold	(61,200)	(72%)
Gross Profit	**23,800**	**28%**
Selling and Administrative Expenses	(10,200)	(12%)
Operating Income	**13,600**	**16%**
Interest Expense	(5,950)	(7%)
Provision for Taxes	(4,250)	(5%)
Net Income	**3,400**	**4%**

Common Size Statement of financial position

	Statement of financial position Tshs '000	Common Size Statement of financial position %
Assets		
Cash and Marketable Securities	7,875	17.50
Accounts Receivable	15,075	33.50
Inventory	15,750	35.00
Total Current Assets	**38,700**	**85.70**
Property, Plant and Equipment	6,300	14.00
Total Assets	**45,000**	**100.00**
Equity and liabilities		
Current Liability	12,600	28.00
Long Term Debt	15,750	35.00
Shareholders' Equity	16,650	37.00
Total equity and liabilities	**45,000**	**100.00**

An example would help to revise the topic.

Example

Two companies, May Flower Co Ltd and June Bud Co Ltd, have approached Reapwell Finance Co for loans. Their statements of profit or loss are as follows:

	May Flower Co Ltd		June Bud Co Ltd	
	Year ended 01/04/20X7	Year ended 01/04/20X6	Year ended 01/04/20X7	Year ended 01/04/20X6
	Tshs million	Tshs million	Tshs million	Tshs million
Revenue	1,650	1,800	1,680	1,860
Cost of sales	(840)	(900)	(951)	(978)
Gross profit	**810**	**900**	**729**	**882**
Admin / selling expenses	(315)	(360)	(256)	(270)
Profit before interest and tax	**495**	**540**	**473**	**612**
Interest	(54)	(60)	(66)	(66)
Income tax expense	(149)	(162)	(142)	(184)
Net profit	292	318	265	362

Other information

	May Flower Co Ltd		June Bud Co Ltd	
	Year ended 01/04/20X7	Year ended 01/04/20X6	Year ended 01/04/20X7	Year ended 01/04/20X6
	Tshs million	Tshs million	Tshs million	Tshs million
Dividends	(90)	(90)	(90)	(90)

The following are the Statements of financial position of May Flower Co Ltd and June Bud Co Ltd

	May Flower Co Ltd		June Bud Co Ltd	
	Year ended 01/04/20X7	Year ended 01/04/20X7	Year ended 01/04/20X7	Year ended 01/04/20X7
	Tshs million	Tshs million	Tshs million	Tshs million
Non-current assets	1,845	1,800	1,428	1,364
Inventories	203	180	150	165
Trade receivables	223	240	240	270
Cash	18	30	45	45
	2,289	**2,250**	**1,863**	**1,844**
Issued share capital	450	450	330	330
Reserves	1,146	1,080	633	555
	1,596	1,530	963	885
Long-term borrowings	450	540	720	720
Current liabilities	243	180	180	239
	2,289	**2,250**	**1,863**	**1,844**

Required:

(a) Reapwell Finance Co has asked you to go through the two sets of financial statements and advise as to which company is more creditworthy.

(b) ‘Different categories of users consider and analyse only those ratios relevant to them.’ Comment.

Answer

(a) Report on the relative creditworthiness of May Flower Co Ltd and June Bud Co Ltd

An analysis of the financial statements leads to the following conclusions:

Continued on the next page

May Flower Co Ltd

There has been a marginal increase in the profitability ratios. The capital and assets are not being used at their optimal level due to the decline in return on capital employed and return on assets along with the fall in the assets turnover ratio. A positive feature observed is that there is a low capital gearing ratio which has fallen further in 20X6.

June Bud Co Ltd

The profitability ratio has fallen considerably because of the increase in direct costs. Capital gearing is less than 50%. Interest cover is adequate. However all the other relevant ratios have declined as compared the previous year.

Comparison between the two companies

Although there has been fall in the profitability of June Bud Co Ltd, with effects on the company's accounts, return on capital employed and return on assets are still higher than May Flower Co Ltd. Both companies have low capital gearing and high interest cover.

Conclusion

June Bud Co Ltd's profitability may decline further in future if the 'cause' of the decline in profitability is not identified and controlled. The profitability of May Flower Co Ltd has remained stable and so, in the situation mentioned above, May Flower Co Ltd would be more creditworthy than June Bud Co Ltd.

Appendix 1: Calculation of ratios (amounts in Tshs million)

	May Flower Co Ltd		June Bud Co Ltd	
	20X7	**20X6**	**20X7**	**20X6**
Return on capital employed ratios				
Return on capital employed	$= \frac{495}{2,046} \times 100$ = 24.20%	$= \frac{540}{2,070} \times 100$ = 26.09%	$= \frac{473}{1,683} \times 100$ = 28.10%	$= \frac{612}{1,605} \times 100$ = 38.13%
Return on assets	$= \frac{495}{2,289} \times 100$ = 21.63%	$= \frac{540}{2,250} \times 100$ = 24.00%	$= \frac{473}{1,863} \times 100$ = 25.39%	$= \frac{612}{1,844} \times 100$ = 33.19%
Profitability ratios				
Gross profit margin	$= \frac{810}{1,650} \times 100$ = 49.10%	$= \frac{900}{1,800} \times 100$ = 50.00%	$= \frac{729}{1,680} \times 100$ = 43.39%	$= \frac{882}{1,860} \times 100$ = 47.41%
Operating profit margin	$= \frac{495}{1,650} \times 100$ = 30.01%	$= \frac{540}{1,800} \times 100$ = 30.00%	$= \frac{473}{1,680} \times 100$ = 28.15	$= \frac{612}{1,860} \times 100$ = 32.9%
Net profit margin	$= \frac{292}{1,650} \times 100$ = 17.70%	$= \frac{318}{1,800} \times 100$ =17.66%	$= \frac{265}{1,650} \times 100$ = 16.06%	$= \frac{362}{1,860} \times 100$ = 19.46%
Activity ratios				
Asset turnover	$= \frac{1650}{2,289}$ = 0.72 times	$= \frac{1,800}{2,250}$ = 0.80 times	$= \frac{1,680}{1,863}$ = 0.90 times	$= \frac{1,860}{1,844}$ = 1.00 times
Gearing ratios				
Capital gearing	$= \frac{450}{2,046} \times 100$ = 22.00%	$= \frac{540}{2,070} \times 100$ = 26.09%	$= \frac{720}{1,683} \times 100$ = 42.78%	$= \frac{720}{1,605} \times 100$ = 44.85%
Interest cover	$= \frac{495}{54} \times 100$ = 9.17 times	$= \frac{540}{60} \times 100$ = 9.00 times	$= \frac{473}{66} \times 100$ = 7.20 times	$= \frac{612}{66} \times 100$ = 9.27 times

Continued on the next page

'Different categories of users consider and analyse only those ratios relevant to them'.

Financial statements are used by various users for making their economic decisions. Accounting ratio analysis helps the users of financial statements to better understand the financial position of the company.

The usefulness of financial information differs from user to user. For example, a prospective lender will check the creditworthiness of a company whereas the company's liquidity position will be a concern for a prospective supplier. On the other hand, the working capital cycle of the company is not a concern for the lender of funds and the company's interest cover is not a concern for a supplier.

The ratios relevant to the user's needs are considered and analysed.

1.7 Trend analysis

Trend analysis has also been covered in Paper B2. Students are advised to refer to the relevant discussion on trend analysis in Section E of Paper B2.

Test Yourself 1

The following information is given:

Hoffman Co

	20X5	20X6	20X7
Sales (Tshs'000)	6,660.0	5,328.0	4,262.4
Quick ratio	0.80	0.75	0.70
Gearing %	55	57	60

Orrick Co

	20X5	20X6	20X7
Sales (Tshs'000)	6,680	6,700	6,800
Quick ratio	1.25	1.30	1.40
Gearing %	25	23	20

Required:

Which company is preferable from an investor's point of view?

1.8 DuPont system

The DuPont system tries to refine the ratio analysis further.

It focuses on:

- expense control
- asset utilisation
- debt utilisation

Return on equity is the result of three components:

ROE = (Net income/Revenue) x (Revenue/Assets) x (Assets/Equity)

Example

The following information related to Pepper Co is given for analysis:

	20X7	20X6	20X5	20X4
	Tshs million	Tshs million	Tshs million	Tshs million
Net income (from SOPL)	4,854	5,556	4,126	2,853
Revenue (from SOPL)	21,018	20,056	16,678	12,962
Assets (from SOFP)	25,177	23,104	18,988	14,003
Equity (from SOFP)	18,702	15,436	13,498	9,712

Required

Comment on the performance of the company.

Answer

The following is the statement of ratios for analysing Pepper Co's performance.

	20X7	20X6	20X5	20X4	Evaluation
Profit margin % (W1)	23.10	27.70	24.74	22.01	Profits have fallen during 20X7
Asset turnover (W2)	0.83	0.87	0.88	0.93	Efficiency has been low since 20X4
Return on Assets % (W3)	19.28	24.05	21.73	20.37	Return on assets is lowest in 20X7
Equity multiplier (W4)	1.35	1.50	1.41	1.44	In 20X7, leverage has decreased
Return on equity % (W5)	25.96	35.99	30.57	29.37	In 20X7, return on equity has dropped the most

Workings

For the year 20X7

W1	Profit margin %	$= \frac{\text{Net income}}{\text{Revenue}} \times 100$	$= \frac{4,854}{21,018} \times 100$	= 23.10 %
W2	Asset turnover	$= \frac{\text{Revenue}}{\text{Asset}}$	$= \frac{21,018}{25,177}$	= 0.83 times
W3	Return on assets %	= Profit margin x Asset turnover	= 23.10 x 0.83	= 19.28%
W4	Equity multiplier	$= \frac{\text{Asset}}{\text{Equity}}$	$= \frac{25,177}{18,702}$	=1.35 times
W5 OR	Return on equity%	= Return on assets x Equity multiplier	= 19.28 x 1.35	= 25.96%
W5 (a)		$= \frac{\text{Net income}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$		= 25.96

Test Yourself 2

Two companies Pineapple Co and Pear Co have approached Blue Chip Finance Co for loans.

Statement of profit or loss

	Pineapple Co		Pear Co	
	Y.E. 31/12/20X8	**Y.E. 31/12/20X7**	**Y.E. 31/12/20X8**	**Y.E. 31/12/20X7**
	Tshs million	**Tshs million**	**Tshs million**	**Tshs million**
Revenue	1,833	2,000	1,867	2,067
Cost of sales	(933)	(1,000)	(1,057)	(1,087)
Gross profit	900	1,000	810	980
Administration / selling expenses	(350)	(400)	(284)	(300)
PBIT	550	600	526	680
Finance cost – interest paid	(60)	(67)	(73)	(73)
Income tax expense	(165)	(180)	(158)	(204)
Net profit	325	353	295	403

Other information

	Pineapple Co		Pear Co	
	Y.E. 31/12/20X8	**Y.E. 31/12/20X7**	**Y.E. 31/12/20X8**	**Y.E. 31/12/20X7**
	Tshs million	**Tshs million**	**Tshs million**	**Tshs million**
Net profit	325	353	295	403
Less: Dividends	(100)	(100)	(100)	(100)
Net profit	**225**	**253**	**195**	**303**

Statement of financial position

	Pineapple Co		Pear Co	
	As at 31/12/20X8	**As at 31/12/20X7**	**As at 31/12/20X8**	**As at 31/12/20X7**
	Tshs million	**Tshs million**	**Tshs million**	**Tshs million**
Non-current assets	2,050	2,000	1,586	1,517
Inventories	225	200	167	183
Trade receivables	248	267	267	300
Cash	20	33	50	50
	2,543	**2,500**	**2,070**	**2,050**
Issued share capital	500	500	367	367
Reserves	1,273	1,200	703	617
	1,773	1,700	1,070	984
Long-term borrowings	500	600	800	800
Current liabilities	270	200	200	266
	2,543	**2,500**	**2,070**	**2,050**

Required:

(a) Blue Chip Co has asked you to go through the two sets of financial statements and offer advice relating to the creditworthiness of the two entities.

(b) 'Different categories of users consider and analyse only those ratios which are relevant to them.' Comment

1.9 Relationship between elements of financial statements

Certain figures in the financial statements are expected to reflect certain features. They are expected to behave in a specific manner. Similarly there is expected to be a stable relationship between certain variables. The following table reflects some such features

Statement of financial position items

	Item	Features and areas of interest
1	Non-current assets	These are long-term assets. Disclosures of valuation methods enable users to judge the present values of these assets. For the assets valued at cost, fair value disclosures help. If the assets are pledged for any borrowings those disclosures are made. This indicates whether the assets are free for any further borrowing. Change in these assets cause changes in finance. Significant additions may indicate expansion of business. Details of useful lives help in assessing the need for replacement.
2	Current assets and current liabilities	They form working capital which is the lifeblood of any organisation. For a healthy organisation, current assets are expected to exceed the current liabilities. The current ratio in that case would be above 1. Increase or decrease in the current assets and liabilities are expected to be in line with revenue. The accounting policy for financial instruments needs to be noted by the readers of the financial statements
3	Non-current liabilities	These being long-term funds, they are used for long-term purposes. If any new loans are obtained, the end use and the security offered should be checked. The loans could be for purchase of non-current assets or for the fixed part of working capital. Unless there is any specific purpose, the funds could have been diverted for non-intended use.
4	Equity	The statement of changes in equity reflects the movements during the period. The composition of equity should be given. For example, if a large part of equity consists of revaluation surpluses that cannot be realised and distributed as dividends, this will be of concern to an investor who wants healthy dividends, rather than capital appreciation. If there is an issue of shares during the year, the uses of the proceeds should be given.

Statement of profit or loss items

1	Revenue	Composition of revenue should be available segment-wise. The relative importance and the future prospects of each segment should be reviewed separately on the background of the general economic situation and the specific trends.
2	Cost of sales and gross profit	The cost of sales and gross profit are expected to have a stable relationship with revenue. For example, the cost of sales and gross profits for an entity are 80% and 20% of revenue respectively. Any inconsistent movements should be investigated.
3	Operating profit	The information in the statement of cash flows will enable users to reconcile operating profit and the cash flows generated from operations. If profits are increasingly locked up in current assets, this will be discovered. This would be supported by increasing collection periods and lower inventory turnover. The effects of changes in accounting policies should be evaluated.

Continued on the next page

4	Finance cost	Finance cost is expected to have some correlation with the borrowings disclosed in the SOFP. If the relationship is not logical, the possible causes should be investigated. For example, overall finance cost as a percentage of borrowings increases from 8% in the previous year to 10% in the current year. This could be due to an increase in the interest rates or a reduction in the borrowings towards the year-end.
5	Tax	The effective tax rate of an entity and the underlying reasons for this tax rate should be given. Tax incentives available for an entity may reduce its tax burden and increase profitability. This item may frequently include amounts related to the previous year. These figures would indicate the general accuracy of tax provisions made by the entity. For the tax authorities, the figures of tax, revenues and other relevant items would form a starting point for the assessment of taxes.
6	Dividends	Trends in dividends and movements in retained earnings over the years would give an indication of the suitability of the investment
7	Accounting policies	Accounting policies should be understood before analysing financial statements. For example, if an entity's depreciation rates are lower than a competitor's rates, it will show higher profits just because of a book entry rather than performance.

Example

Ribbons Ltd. is a retail chain of confectionery shops having outlets in the major cities of Tanzania. They have appointed Smith and Jones, a firm of Chartered Accountants as their financial consultants. The company has produced its draft accounts for the year ended 31st December, 2012 which include a trading account as follows:

Trading account for the year ended 31 December, 2012:

	Tshs'000
Sales	1,44,000
Cost of sales	90,270
Gross Profit	**53,280**

The financial controller has informed that the average gross profit for the confectioner's industry is 40% on the sales. Furthermore, the gross profit has also declined from November to December this year. Therefore, the company has requested an investigation to be carried out to explain why their gross profit appears to be lower than the average and also apparently worsening. They outsourced this work to Smith and Jones. Smith & Jones carried out an analysis of the sales of the various items being sold at the confectionery shops for the last two months. This analysis is shown below:

Items	**November**	**December**
	Units	**Units**
Chocolate Pastry	3,000	3,900
Pineapple Pastry	2,800	3,300
Tiramisu	1,200	900
Coffee – Cappuccino	1,700	1,500
Coffee – Latte	1,100	900
Cold Coffee	2,000	1,800
	11,800	**12,300**

The firm calculated the gross profit percentage based on the total monthly costs and the total monthly sales for the items during December 2012. The gross profit percentage for all the items are given below:

Items	**Gross Profit %**
Chocolate Pastry	25%
Pineapple Pastry	33%
Tiramisu	46%
Coffee – Cappuccino	40%
Coffee – Latte	42%
Cold Coffee	48%

Required:

Assume you have carried out the assignment on behalf of Smith and Jones. Draft a letter to the Board of Directors of Ribbons Ltd, to explain why the gross profit percentage appears to have worsened from November 2012 to December 2012.

Answer

A letter to Ribbons Ltd. explaining why the gross profit percentage is on the decline is given below.

Smith and Jones, Chartered Accountants
Dar es Salam, Tanzania

Date: 25 January, 2013

To,
The Board of Directors
Ribbons Ltd.
Tanzania

Subject: Business Analysis

In accordance with your instructions, an investigation has been conducted into your books of accounts with a view to know the reasons behind lower gross profit percentage in comparison to average gross profit percentage in the industry. Furthermore, we have also tried to determine the factors responsible for the worsening of the gross profit percentages from November to December 2012.

We have analyzed the sales records of the company together with their associated gross profit percentages and have found that the overall gross profit percentage of the company in November was 36.7% which has declined to 35.1% in December, which is in line with your suspicion (refer to attached appendix).

The reasons for the low profit percentage as well as the decline in the gross profit are discussed below:

No.	Reasons	Recommendations
1.	**Inappropriate fixing of selling prices** During December 2012 the units sold for the Chocolate Pastry and the Pineapple pastry are quite significant as compared to other items. However, Chocolate Pastry and Pineapple Pastry have the lowest profit margins.	It is recommended that the company review its cost of production and the selling price policies for these two items.
2	**Unreasonable sales mix** The lowest profit making items of the company are Chocolate Pastry and the Pineapple pastry. However, these are the most popular items as well. Though the sales in terms of units increased from November to December, the company could not earn a higher profit margin as the profit was contributed by low margin items.	We recommend that the company review its sales and marketing plans for the items other than Chocolate and Pineapple pastry. The company needs to boost the sales for items which have a higher profit margin.
3	**High cost of production** It is likely that the raw material price is high in comparison to the competitors. Due to this the gross profit has eroded and is lower than the industry average.	We recommend that the company should conduct a market survey and invite quotations from other suppliers as well as review the purchase policies.
4	**Stock valuation errors** It is likely that an error occurred during stock verification and valuation during December 2012	We recommend that the company needs to carry out a physical verification of inventory and recheck the inventory valuation for the month of December 2012.

We trust that this discussion has satisfied your curiosity and would wish to investigate more on your sales mix.

We would be glad to offer further clarifications should the need arise.

Yours Sincerely,

Smith and Jones
(Chartered Accountants)

3. Identify and assess the choice of accounting treatments that may be adopted based on a given scenario explaining how they may affect a users' understanding of a business.

4. Explain and justify changes in accounting policies and the treatment of the same as per the IFRSs, distinguishing them from changes in estimate and correction of prior period errors.

5. Identify and assess chosen policies and treatments for a given entity or entities comparing the fairness of presentation and compliance with international and local practice for a private or public sector entity.

[Learning Outcomes c, d and e]

2.1 Choice of accounting treatment

Companies are required to provide four basic financial statements: the statement of financial position, the statement of cash flows, the statement of profit or loss and the statement of changes in equity. The entity has to report financial statements which are acceptable under the standards or, if the standards are silent on any particular transaction, then according to acceptable practices.

By reading through the financial statements, it is possible to identify the accounting treatments adopted from the way the figures are presented, titles or footnotes to different schedules, or from the notes to the financial statements.

A professional accountant needs to identify these accounting policies and assess whether they are suitable for the entity or acceptable according to IFRS. Students need to understand and remember the important provisions of different IFRSs. This will enable them to test the acceptability of given accounting policies. We have already discussed the acceptable accounting treatment of various elements of financial statements in accordance with International Financial Reporting Standards.

Example

IAS 16 Property, plant and equipment allows choice of accounting treatment to entities i.e. cost model or the revaluation model

However if the entity as classified the property as an investment property under IAS 40 Investment Property, even though the entity may follow the revaluation model, all gains and losses must be transferred to the statement of profit or loss. This is in contrast to the IAS 16 treatment of revaluation gains and losses which requires revaluation gains to be excluded from profit. In addition, under the fair value model for accounting investment properties, no deprecation is charged on investment properties.

An entity should select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS requires or permits such categorisation, an appropriate accounting policy should be selected and applied consistently to each category.

2.2 Selection of accounting policies

The general principles of accounting that guide the selection of accounting policies are as follows:

1. Fair presentations and compliance with the accounting standards

Financial statements should present a true and fair view of the financial position and performance of a company. Presentations must provide a true and fair view of the transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses.

2. Going concern

When financial statements are in the process of preparation, it is assumed that the entity would be able to continue as a going concern.

3. Accrual basis of accounting

The financial statements should be prepared using the accrual basis of accounting, except for statements of cash flows.

4. Consistency

The objective of accounting is to ensure the comparability of financial statements with those of previous periods as well as those of other entities. Each standard addresses the principle of consistency.

The selection and application of accounting policies

Accounting policies affect the view presented by financial statements, and the calculations of ratios with reference to them, without affecting a business's actual potential to generate profits and cash.

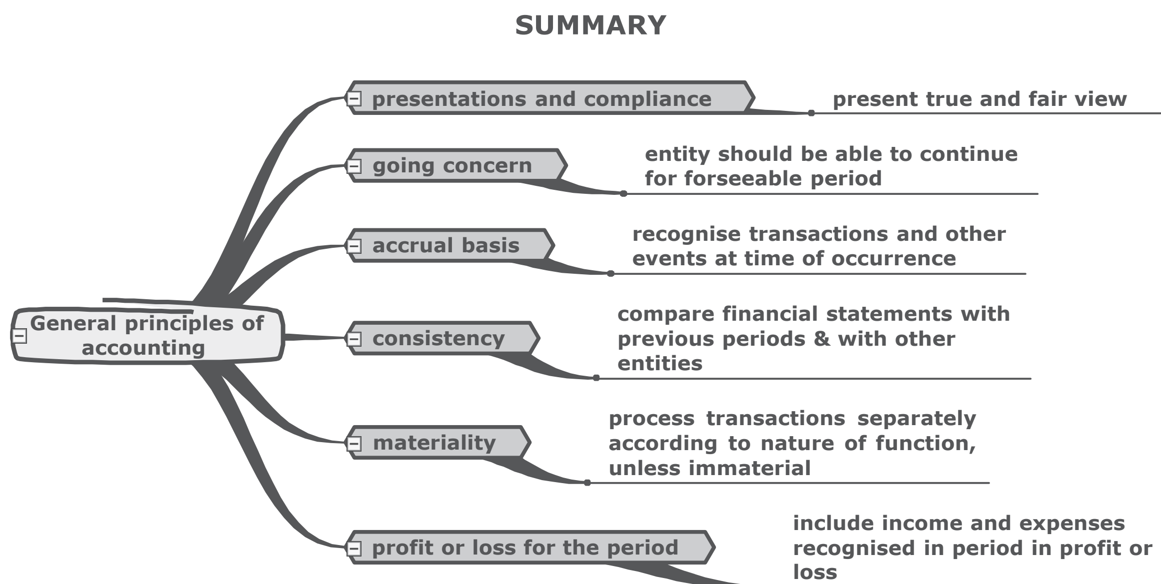
The impact of accounting policies is especially important in the following cases:

Where **accounting standards allow alternative treatments,** e.g. cost or fair value, capitalisation of borrowings or interest expense.

In **accounting estimates** where management judgement is needed e.g. in reserve for bad debts, provisions, valuation of inventory and depreciation methods.

Where **accounting standards are not clear in some areas** as, for example, in some forms of revenue recognition.

SUMMARY



2.3 Change in accounting policy

An entity shall change an accounting policy only if the change:

is required or permitted by a standard or an interpretation; or

results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

When a change in accounting policy is applied retrospectively, the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

Limitations on retrospective application

When retrospective application is required, a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

2.4 Errors

Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements. Financial statements do not comply with IFRS if they contain either material errors or immaterial errors are made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are authorised for issue.

However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

Example

In 20X5, Lamba reported:

	Tshs million
Sales	147,000
Less: Cost of goods sold	(107,000)
Profit before income taxes	40,000
Less: Income taxes	(12,000)
Profit	**28,000**

An error of Tshs13,000 million in respect of 20X5 purchases was found during 20X6, after the financial statements for 20X5 had been authorised for issue. The results for 20X5 would be restated. The extract from the statements of profit or loss would appear as follows:

	20X6	**20X5**
	Tshs million	**Tshs million**
Sales	208,000	147,000
Less: Cost of goods sold	(160,000)	(120,000)
Profit before income taxes	48,000	27,000
Less: Income taxes	(16,800)	(9,450)
Profit	**31,200**	**17,550**

Limitations on retrospective restatement

A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.

Example

A company has two investment properties, X and Y, at carrying values of Tshs200 million and Tshs500 million respectively. Y's fair value has increased by a material amount and is expected to be around Tshs200 million. The directors ask your opinion as to whether there is any acceptable accounting policy where they can record this value.

Answer

While deciding the accounting policy, one needs to check the provisions of IAS 40, Investment Properties. If the company chooses the fair value model, it shall measure all of its investment property at fair value. This means that property X will also have to be measured at fair value. There is a presumption that the fair values of all the properties can be determined.

The best way to determine the fair value is to use the current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts. Any differences in the nature, location or condition of the property, or in the contractual terms of the leases and other contracts relating to the property, should be considered. In the absence of current market prices, other factors such as prices of similar properties on less active markets, or discounted cash flows should be used.

Once the fair value method is adopted, it applies to all investment properties and shifting back to the cost method is not possible. Hence the decision should be made after careful consideration.

Test Yourself 3

On 1 February 20X8, Brown Co bought a new energy conserving machine for Tshs100 million which qualifies for a government grant of Tshs10 million. The useful life of the asset is 10 years. This is the first government grant that Brown Co has received and therefore the company is unsure as to the correct accounting treatment of the grant.

Required:

Guide Brown Co in the selection of an accounting policy regarding presentation of grants related to assets in accordance with IAS 20.

2.5 Changes in accounting estimates

Changes in accounting estimates are usually the result of new information or new developments. This indicates that the earlier estimates were correct, based on the information available then. This is the reason why a change in the method of depreciation is termed as a change in accounting estimate. The significant change in the expected pattern of consumption of the future economic benefits embodied in the asset is reflected in the change in the method of depreciation.

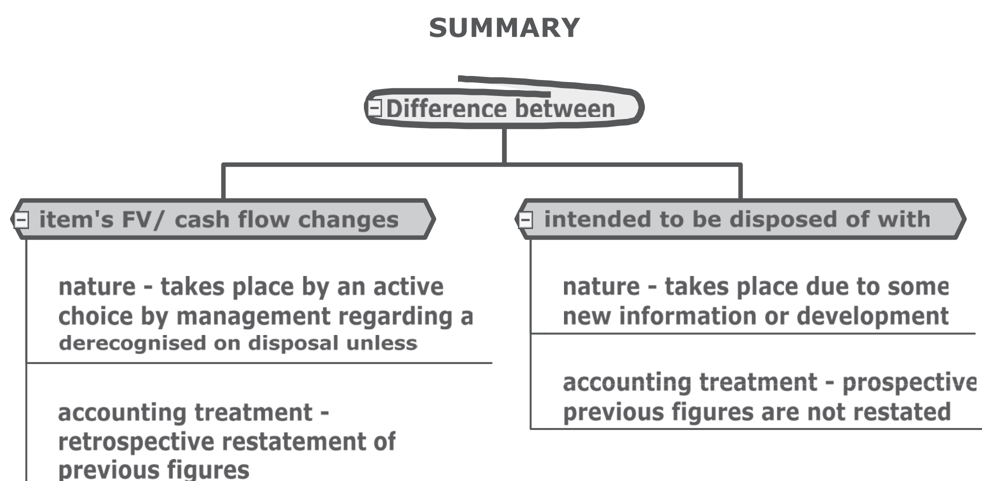
Example

Pacific Co checks inventory for obsolescence, and estimates that items originally worth Tshs25 million are obsolete at 31 December 20X5 and thus need to be written off. At December 31 20X6, management estimates that, owing to technological changes, other items originally worth Tshs55 million are also now obsolete. This is a change in an accounting estimate and accordingly a further Tshs55 million will be written off the value of inventory.

Changes in accounting estimates are recognised prospectively in the profit or loss of the current period and / or future periods. If changes in estimates lead to changes in the values of assets, liabilities or equity, the carrying values are changed in the period of change. Prior period figures are not restated.

It is necessary to understand the distinction between changes in accounting policy and changes in accounting estimate. Refer the summary below to understand the differences:

SUMMARY



2.6 Effect of accounting policy on the users of financial statements

A professional accountant has to carefully apply suitable accounting policies so as not to give a misleading picture to the stakeholders. The following example will help you understand the impact of accounting policy selection on the understanding of stakeholders.

Example

Snoopy Co leased a machine costing Tshs12 million on a three-year lease from Garfield Co. The rate of depreciation on this machine was 15%.

Snoopy Co was to pay Tshs4 million immediately and then two annual lease rental payments of Tshs5 million, the interest portion of which was Tshs1 million. The terms of the lease led to the risks and rewards of ownership being transferred to Snoopy Co.

This is a finance lease according to the terms of the lease agreement.

If recorded correctly, these transactions would be reflected in the financial statements, in the following manner:

Year 1 Statement of financial position:

	Tshs'000
Non-current asset	
Cost	12,000
Less: Depreciation	(1,800)
Net book value	10,200
Current liability	
Lease obligations	4,000
(capital portion due next year)	
Non-current liability	
Lease obligations	4,000
(capital portion due in second year)	

Statement of profit or loss:

	Tshs'000
Depreciation	1,800
Lease interest	1,000

However, if the lease were classified as an operating lease, then the transactions would be reflected in the financial statements in the following manner:

Statement of profit or loss

	Tshs'000
Lease payments	4,000

No assets or liabilities will be recognised except for accrued and unpaid lease rental.

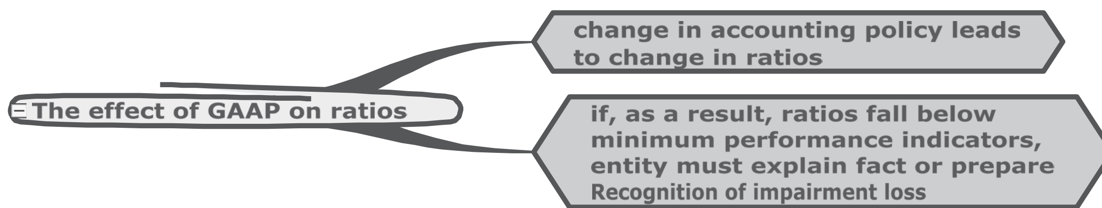
The above example shows that when a finance lease is incorrectly recorded as an operating lease, it will give a misleading picture of the financial position of an entity to the users. This is likely to affect their understanding of the financial statements.

2.7 Effect of GAAP on ratios

The financial ratios show a relationship between any two financial variables. Since many financial variables are affected by the accounting policies followed, if these policies are changed, the ratios will also change. When policies are changed mandatorily, for example, on transition to IFRS, the users will be concerned about the impact of such a change on the ratios.

For some users, the cause of concern may be that they have committed certain ratios as performance indicators to lenders or investors. If the ratios are pushed below the minimum performance indicators only as a result of a change in accounting policies, the entity has to explain the fact or prepare additional financial statements based on the earlier GAAP. This begs the question whether accounting policies matter and, to many analysts, they do not.

SUMMARY



The following simple example will illustrate this impact.

Example

Two companies, M and N, have similar profits (Tshs1 million each) and equity (Tshs8 million each). M uses the cost model to value the assets, whereas N uses the revaluation model to values its assets. N revalues its property, plant and equipment upwards by Tshs2 million and credits the increase to revaluation surplus, forming a part of equity. ROCE is calculated as follows:

$$\text{Return on capital employed} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100$$

M 1/8 x 100 = 12.5%
N 1/10 x 100= 10%

Even though the basic facts are the same, different accounting policies have caused a difference in ratios.

Accounting policies are discussed throughout the Section C and Section E in this Paper. The policies on the recognition and valuation of assets and liabilities may affect the ratios in a different manner.

Test Yourself 4

The following accounting treatment is required under IFRS:

IAS 40 Investment Property gives a choice between the fair value model and the cost model for measuring investment properties.

Required:

Briefly explain how these choices affect financial statements and performance measures in the context of:

(a) Earnings per share and
(b) Return on Capital Employed

2.8 Assessing compliance with IFRS and fair presentation

An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs. In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs. A fair presentation also requires an entity:

(a) to select and apply accounting policies in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. IAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an IFRS that specifically applies to an item.

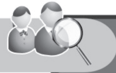
(b) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.

(c) to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

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

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

Let us look at an example to understand compliance with IFRS and how it will impact fair presentation.



Example

The directors of Swift Ltd are considering the acquisition of Fast Ltd, a company which designs and manufactures weighing machines. The acquisition price is likely to be based on either the carrying amount of the net assets in the statement of financial position nor on profits.

The finance director of Swift Ltd has received a copy of the draft financial statements of Fast Ltd for the year to 31 December 2007. The non-current assets and profit of Fast Ltd in the draft financial statements for the year ended 31 December 2007 were Tshs12.0 million and Tshs3.0 million respectively.

You are an accountant at Swift Ltd and the finance director has given you the working papers which relate to the non-current assets in the draft statement of financial position at 31 December 2007.

1. At a directors' board meeting of Fast Ltd on 1 January 2007, the directors committed themselves to building a new factory building and the work began on 1 February 2007. The work was suspended in June and July because of the unavailability of raw materials. On 1 November 2007, the new factory building was completed and on 1 December 2007 production began in the new factory building.

   The cost of the new office building was Tshs2.5 million, which was financed from existing borrowings. The borrowings and interest rates for the year ended 31 December 2007 were as follows:

Bank loan	Tshs1.5 million	6% p.a
Debenture	Tshs2.5 million	8% p.a

   It is the accounting policy of Fast Ltd to capitalise borrowing costs and the accountant at Fast Ltd has capitalised borrowing costs of Tshs0.2 million, being Tshs2.5 million at 8%.

2. On 1 January 2007, work began on the development of a new weighing machine at Fast Ltd. On 1 April 2007, all the recognition criteria for development costs were met and on 1 June 2007 the development of the weighing machine was complete. The total development costs were Tshs0.9 million and these costs were incurred evenly over the period from 1 January 2007 to 30 June 2007.

   The accountant at Fast Ltd has not capitalised any of these development costs; he has, however, capitalised advertising costs amounting to Tshs120,000 directly relating to the new weighing machine. The weighing machine was made available for sale on 1 July 2007. The estimated product life cycle of the weighing machine is three years. The accountant has charged Tshs20,000 (120,000/3 x 6/12 months) for amortisation of advertising to the statement of profit or loss.

Required:

Draft a reply to your finance director which by presenting the revised calculations in accordance with International Financial Reporting Standards.

Answer

Reply to finance director

To,
The Finance Director
Swift Ltd

I have reviewed the working papers which relate to non-current assets in the draft statement of financial position of Fast Ltd. I set out below the revised calculations, together with explanations.

1. Complex asset

IAS 16 Property, plant and equipment states that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.

The building and lift are separate components of a larger asset and should be recognised as distinct assets. The useful lives of these components differ and so each asset needs to be depreciated over its own life.

	Incorrect treatment	**Correct treatment (revised calculations)**		
New factory unit	Building + Lift	Building	Lift	Total
Estimated life	40 years	40 years	10 years	
Cost on 1 January 2004	2,000,000	1,500,000	500,000	2,000,000
Accumulated depreciation until 31 December 2007 2m/40 x 4, 1.5m/40 x 4, .5m/10 x 4	(200,000)	(150,000)	(200,000)	(350,000)
Carrying amount 31 December 2007	1,800,000	1,350,000	300,000	1,650,000

2. Capitalisation of borrowing costs on construction of factory

The working papers do not mention that the debentures were issued to finance the cost of the new factory building. This leads us to believe that Fast Ltd has used part of its general loans to finance the construction. In this case, the capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period.

The capitalisation rate in this case is:

	Tshs		**Tshs**
Bank loan	1,500,000	6%	90,000
Debenture	2,500,000	8%	200,000
Total	4,000,000		290,000

Capitalisation rate = 290,000/4,000,000 x 100 = 7.25%

The capitalisation of borrowing costs begins when the expenditure for the asset is being incurred. Hence, in this case, capitalisation will begin from 1 February 2007 and not 1 January 2007.

Capitalisation of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Hence, in this case, capitalisation will end on 1 November 2007 when the construction of the building was complete and not on 1 December 2007 when the new building was put to use.

Capitalisation of borrowing costs shall be suspended during extended periods in which active development is interrupted. In this case, as the construction activity was suspended in June and July, interest costs for these two months cannot be capitalised.

Hence borrowing costs can be capitalised for February, March, April, May, August, September and October (7 months).
The borrowing costs which should be capitalised are Tshs2.5m x 7.25% x 7/12 = Tshs105,730.

The revised calculations are:

Cost of factory building	Tshs2,500,000
Borrowing costs capitalised	Tshs 105,730
Total	**Tshs2,605,730**

The difference in the amount capitalised will also affect the depreciation charge. However, as the working papers do not mention the rate of depreciation, I cannot quantify this error.

3. Identify and comment upon limitations of analysis.

[Learning Outcome f]

3.1 Limitations of information

Different entities may **classify and aggregate figures differently**. This affects comparisons.

Financial statements contain **historical information**. This information may not be relevant for decisions related to the future. Moreover, historical cost accounting ignores the effects of inflation.

By the **time the information has been analysed** for decisions to be taken, the relevant variables might have changed, rendering the decisions wrong.

Information may be **arbitrary** e.g. the life of an asset may be estimated differently by different persons, affecting the depreciation calculations.

Except for the mandatory disclosures required by accounting standards, **access to information** depends upon the decisions of management. It may disclose the facts only to the extent it chooses.

Sometimes **financial statements are manipulated** to present particular results or ratios. Such cosmetic financial statements cheat the investors and other users.

It is **not always possible to quantify the information relevant for analysis purposes**. For example, in the event of a fire or earthquake, it may be possible to quantify the amount of actual loss to property etc. However, how does one quantify the loss due to lost opportunities?

Test Yourself 5

Superb Inc, a manufacturing company, has a capital base of Tshs485 million and EBIT is Tshs110 million. Out of the total capital, Tshs85 million was issued in the last week of the financial year.

Required:

Does this fact have any relevance while assessing the company's performance?

3.2 Limitations of analytical methods and financial ratios

Transactions during the year / towards the year-end: when there are substantial transactions during the year or towards the year end, they affect the ratios. This effect is more prominent if one of the two variables relates to the statement of profit or loss and the other relates to the statement of financial position e.g. if substantial non-current assets are obtained towards the end of the year, they would not contribute to the earnings. This would distort the return on assets, unless the weighted average of assets is used to calculate the ratio.

Differences between different units: different units may function under different circumstances and use different accounting policies. This reduces comparability.

Government incentives: entities that receive government incentives will show better performances. E.g. in some jurisdictions, entities in undeveloped areas are allowed exemption from VAT for a certain period. This would boost their profitability in comparison with other units which don't receive the same benefits.

Interpretation techniques depend on assessments and estimates. Minor mistakes in identifying and quantifying relevant information can have a major adverse effect on the results of analysis and interpretation.

The size of a company affects its operations. Larger companies enjoy economies of scale and attract professional manpower. This may enhance their profitability.

Comparison with industry averages is difficult if the firm operates many different divisions.

Seasonal factors can distort ratios.

Often different ratios give different signals, so it is difficult to tell, on balance, whether a company is in a strong or weak financial condition.

Not all ratios are relevant for all industries. We must understand what the ratio is telling us in order to determine its usefulness.

Extraordinary movement in any financial item may change a ratio drastically.

Example

Price/Earnings ratio is arrived at by using the formula:

$$\text{Price/Earning ratio} = \frac{\text{Price per share}}{\text{Earnings per share}} \times 100$$

If market price per share as at 30 December 20X7 is Tshs2,500 and the earnings per share at that date is Tshs2,000, then the ratio is (Tshs2,500/Tshs2,000) x 100 = 125%

Suddenly, market price per share increases to Tshs4,000, then ratio is (Tshs4,000/Tshs2,000) = 200%

3.3 Business environment

Business environment includes

- industry in which entity operates
- market condition
- entity's asset base
- government policy

The business environment in which an entity operates has a substantial impact on its financial statements. Therefore, general economic norms may not apply to all.

Manufacturing units will have higher average investments in non-current assets. Similarly, inventories would be higher. Among manufacturing industries, capital intensive industries will have more investment whereas labour intensive industries will show lower investments in non-current assets.

Service entities such as insurance companies will have lower investments in non-current assets and inventories but higher receivables.

Retail businesses do not usually sell on credit; their receivables will be low and cash balances high.

The construction industry will have higher work in progress. If they are taking advances from customers, the net receivables may be negligible.

Sometimes the existence of a group of companies makes a difference to the business environment. Group companies may receive favourable treatment from other groups. Furthermore, just being a member of a reputed group may enable a member company to obtain resources at favourable rates e.g. banks may charge lower interest rates if the credit rating of the group is higher.

Example

Right Inc. is engaged in the production of cars. These cars have wide demand in the market. Right Inc. is making consistent profits and has an adequate asset base totalling Tshs5,000,000. Its capital gearing ratio is 45%.

Rong Inc. is a consultancy, with an insufficient asset base, totalling Tshs200,000 in value to be offered for security. Its capital gearing ratio (borrowed funds to total funds) is 40%.

Axis Bank (lender) decides quickly that Rong Inc. is more creditworthy than Right Inc. as it has a lower capital gearing ratio than Right Inc.

Continued on the next page

In this example,

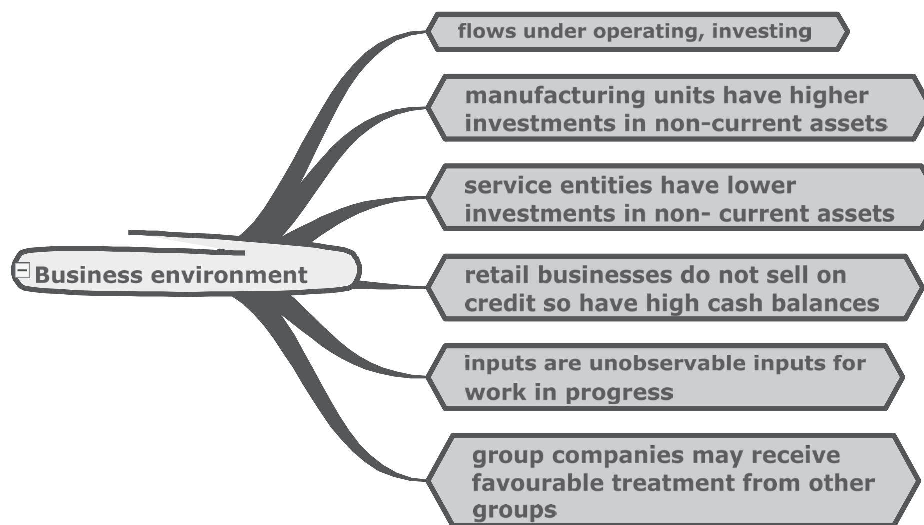
The capital gearing ratio of Rong Inc. is lower than that of Right Inc, but it is very high for the nature of its business, while Right Inc's ratio is low, considering the nature of its business.

Before deciding the companies' creditworthiness, Axis Bank should have examined the industry averages, the nature of business, the companies' asset bases and the business environment. The capital gearing ratio is not the only indicator of creditworthiness.

On the basis of its capital gearing ratio, Rong Inc. is more creditworthy than Right Inc. However, considering the other factors mentioned above, it can be concluded that Right Inc. is more eligible for credit than Rong Inc.

It is very essential to obtain all possible information, both financial and non-financial in nature, which is relevant to the assessment of entity's performance.

SUMMARY



Test Yourself 6

Waffles Ltd is a waffle manufacturing company. Trendy Solutions is a software development company.

The ratios of Waffles Ltd and Trendy Solutions Co are as follows.

	Waffles Co	Trendy Solutions Ltd
Profitability ratios		
Return on capital employed	25%	60%
Operating profit margin	22%	40%
Gearing ratio		
Debt-equity ratio	70%	35%
Liquidity ratios		
Current ratio = times	2.50	4.00
Quick ratio = times	0.70	3.80
Activity ratios		
Asset turnover = times	2.50	3.80

Required:

Compare and analyse the ratios of the two companies. Does it make a difference whether the company is a manufacturing company or a service company?

Answers to Test Yourself

Answer to TY 1

The above mentioned companies had approximately the same sales for the year 20X5. However, in the case of Hoffman Co, there is a sharp drop in sales. Hoffman Co's gearing ratio is increasing which indicates high risk. The higher a company's degree of leverage, the riskier the company is considered to be.

The quick ratio of Hoffman, which was already below 1 in 20X5, is deteriorating further. These facts indicate that the company is increasingly living on borrowed funds (as shown by high gearing) and, at the same time, showing decreasing ability to pay the liabilities when they fall due (as shown by decreasing quick ratio) Hoffman Co will find itself in severe difficulties if this trend continues over the next year or so.

Orrick Co has managed to achieve growth by gradually increasing sales and reducing the gearing ratio. Its quick ratio is also improving. Orrick Co's working capital and borrowings are managed progressively which is a very positive feature.

Answer to TY 2

1. Report on the relative creditworthiness of Pineapple Co and Pear Co

An analysis of the financial statements leads to the following conclusions:

Pineapple Co:

In spite of a marginal increase in the profitability ratios, there is a decline in Return on Capital Employed and Return on Assets. This, together with the decrease in Asset Turnover, suggests that the capital and assets are not being used at their optimal level.

It has a low Capital Gearing ratio which has fallen further in 20X8. This low level of borrowings has led to a high Interest Cover – a positive feature.

Pear Co

The reason for the increase in direct costs which has led to a considerable fall in the profitability ratios needs to be investigated. This fall in profitability has led to a fall in all the relevant ratios.

Capital gearing is less than 50%. Interest cover is adequate.

Comparison between the two companies

Inspite of the fall in the profitability and its cascading effects on the accounts of Pear Co, the return on capital employed and return on assets are better than in Pineapple Co.

Both companies have low capital gearing and high interest cover.

Conclusion

Pear Co can be more creditworthy than Pineapple Co if:

- the reason for the fall in the profitability of Pear Co can be identified
- the fall in profitability can be controlled and
- it can be ensured that there are no further losses in the coming years

On the other hand, the profitability of Pineapple Co has remained constant therefore Pineapple Co appears to be more creditworthy than Pear Co.

Appendix 1: Calculation of ratios (ratios calculated in Tshs million)

	Pineapple Co		Pear Co	
	20X8	**20X7**	**20X8**	**20X7**
Return on Capital Employed ratios:				
Return on Capital Employed	$\frac{550}{2,273}$ x 100	$\frac{600}{2,300}$ x 100	$\frac{526}{1,870}$ x 100	$\frac{680}{1,784}$ x 100
	24.20%	**26.09%**	**28.13%**	**38.12%**
Return on Assets	$\frac{550}{2,543}$ x 100	$\frac{600}{2,500}$ x 100	$\frac{526}{2,070}$ x 100	$\frac{680}{2,050}$ x 100
	21.63%	**24.00%**	**25.41%**	**33.17%**
Profitability ratios:				
Gross Profit Margin	$\frac{900}{1,833}$ x 100	$\frac{1,000}{2,000}$ x 100	$\frac{810}{1,867}$ x 100	$\frac{980}{2,067}$ x 100
	49.10%	**50.00%**	**43.39%**	**47.41%**
Operating Profit Margin	$\frac{550}{1,833}$ x 100	$\frac{600}{2,000}$ x 100	$\frac{526}{1,867}$ x 100	$\frac{680}{2,067}$ x 100
	30.01%	**30.00%**	**28.17%**	**32.90%**
Net Profit Margin	$\frac{325}{1,833}$ x 100	$\frac{353}{2,000}$ x 100	$\frac{295}{1,867}$ x 100	$\frac{403}{2,067}$ x 100
	17.73%	**17.65%**	**15.80%**	**19.50%**
Activity ratios:				
Asset Turnover	$\frac{1,833}{2,543}$	$\frac{2,000}{2,500}$	$\frac{1,867}{2,070}$	$\frac{2,067}{2,050}$
	0.72 times	**0.80 times**	**0.91 times**	**1.01 times**
Gearing ratios:				
Capital Gearing	$\frac{550}{2,273}$ x 100	$\frac{6000}{2,300}$ x 100	$\frac{800}{1,870}$ x 100	$\frac{800}{1,784}$ x 100
	22.00%	**26.09%**	**42.78%**	**44.84%**
Interest Cover	$\frac{500}{60}$	$\frac{600}{67}$	$\frac{526}{73}$	$\frac{680}{73}$
	9.17 times	**8.96 times**	**7.2 times**	**9.32 times**

2. **'Different categories of users consider and analyse only those which are ratios relevant to them.'**

A wide range of users depend upon the information contained in financial statements to make economic decisions. As the financial statements by themselves only present data, they have to be analysed. The tools used for these analyses are accounting ratios.
The following table displays some categories of users and the different purposes for which they require financial information.

User	Concerned with	Ratios analysed
Prospective lender	Creditworthiness of the company	Interest coverage ratio, debt equity ratio, net profit margin etc.
Investor	Performance of the company	ROCE, EPS, Price earnings ratio, etc.

It can be seen from the above table that an investor would not be bothered about the interest cover which the company has to offer, whereas this information is important to a prospective lender of the company.
This is the reason why different categories of users consider and analyse only those ratios which are relevant to them.

Answer to TY 3

This is a grant related to a capital asset. IAS 20 stipulates the following:

Brown Co should present government grant of Tshs10 million in the statement of financial position by adopting either of the two methods given below:

(a) By setting up the grant as deferred income over the 10 years of the asset's useful life. This comes to Tshs1 million per year for 10 years. Depreciation in this case will be charged on the full cost of Tshs100 million i.e. Tshs100 million/10 years = Tshs10 million.

(b) By deducting the grant from the cost of the asset to arrive at the carrying amount of the asset. (Cost of asset Tshs100 million - Government grant Tshs10 million). This grant is recognised as income by a reduced depreciation charge over the life of the depreciable asset. The depreciation charge would be Tshs9 million (Tshs90 million/10 years).

The net charge to the statement of profit or loss would be the same in both the cases.

The gross investment in the asset and the government grant received should disclosed by Brown Co as separate items in the statement of cash flows regardless of whether or not the grant is deducted from the related asset for the purpose of statement of financial position presentation.

Answer to TY 4

IAS 40 Investment Property

Under the fair value model, investment property is re-measured at fair value each year and no depreciation is charged whereas the cost model carries an investment property at its cost less any accumulated depreciation and any accumulated impairment losses.

If the fair value model is applied, the assets will be carried at higher values (during the period of rising prices) and hence the profit will be increased during the period of upward revaluation. This is because the revaluation changes are recognised in profit or loss.

$$\text{(a) Earnings per share} = \frac{\text{Net profit}}{\text{Total number of shares issued}}$$

The fair value model (when compared to cost model) will have the effect of an increase in profit which will lead to an increase in earnings per share.

$$\text{(b) Return on capital employed} = \frac{\text{Profits before interest}}{\text{Capital employed}}$$

Under the fair value model, the increase in fair value will increase the profit as well as the capital employed. The effect on the ratio will be minimal.

Answer to TY 5

From the information given, we can assess the performance of Superb Inc as follows:

$$\text{Return on capital employed} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100$$

$$= \frac{\text{Tshs110 million}}{\text{Tshs485 million}} \times 100$$

$$= 22.68\%$$

However, this is not a "correct" ratio, because Tshs85 million of the total capital was issued in the last week of the financial year and the company does not get any returns from this capital. Hence, this amount should not be included in capital employed when assessing the performance of the company.

The adjusted ratio will be:

$$\text{Return on capital employed} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100$$

$$= \frac{\text{Tshs110 million}}{\text{Tshs400 million}} \times 100$$

Tshs485 million – Tshs85 million

= 27.5%

Answer to TY 6

The business segment in which a company operates does make a difference to the ratio. This is because the variables that determine different ratios are different in the case of different businesses.

Return on capital employed

Trendy Solutions Ltd, being a software technology company, utilises intellectual property and expertise. It does not need capital investments as high as those of a manufacturing company. Hence, Trendy Solutions Ltd has a higher return on capital employed than Waffles Ltd.

Operating profit margin

The operating profit margin of Trendy Solutions Ltd is higher than that of Waffles Ltd, a manufacturing company. This is because Trendy Solutions Ltd has no expenses relating to inventory, factory overheads and raw material storage, which are a necessity for a manufacturing company.

Debt-equity ratio

Trendy Solutions owns its office premises and did not borrow the funds from the market. Waffles Ltd, on the other hand, has made borrowings to finance its expansion. Hence Trendy Solutions Ltd's debt-equity ratio is lower than that of Waffles Co.

Current ratio

In the case of Trendy Solutions Ltd, current liabilities are low as it does not need to purchase raw materials; hence no trade payables exist. Since current assets are higher than current liabilities, Trendy Solutions Ltd has a high current ratio.

Quick ratio

This ratio will remain almost the same as the current ratio for Trendy Solutions Ltd as there is no substantial inventory involved in this business, unlike Waffles Ltd.

Asset turnover

Waffles Ltd requires high capital investments yielding lower asset turnover. In the case of Trendy Solutions Ltd, capital investment is lower in comparison with turnover, resulting in a higher asset turnover ratio.

Quick Quiz

1. What is meant by cross-sectional comparison?

2. Give any three limitations of information.

3. What is the current ratio? What does it indicate?

4. Rain Inc is engaged in production of parts for machines. Its cost of sales is Tshs250 million and inventory is Tshs30 million. Calculate the inventory turnover ratio.

5. State three investors' ratios, giving their formulae.

6. The financial statements of Jack Inc show receivables of Tshs85 million and credit sales during the year of Tshs275 million. Calculate the total receivable days.

Answers Quick Quiz

1. Cross-sectional comparison means comparison between the figures of two different entities, or the figures of an entity compared with industry averages to assess the efficiency of an entity.

2. Limitations of information

   a) Financial statements contain historical information which may not be relevant for decisions related to the future.
   b) By the time the information has been analysed so as to take decisions, the relevant variables might have changed, rendering the decisions incorrect.
   c) Sometimes financial statements are manipulated to show particular results or ratios in order to cheat users.

3. Current ratio is the proportion of current assets to current liabilities. It indicates whether the current assets will be able to generate sufficient cash to pay off the current liabilities.

4. Inventory turnover ratio

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventory}} \text{ (times p.a.)}$$

$$= \frac{\text{Tshs250 million}}{\text{Tshs30 million}}$$

$$= 8.33 \text{ times}$$

5. Investors' ratios

   (a) $\text{Earnings per share} = \frac{\text{Profit available for distribution to ordinary shareholders}}{\text{WANOS}}$

   (b) $\text{Price/Earnings ratio} = \frac{\text{Current market price per share}}{\text{Earnings per share}}$

   (c) $\text{Profit retention ratio} = \frac{\text{Profits after dividend}}{\text{Profits before dividend}} \times 100$

6. $\text{Receivable days} = \frac{\text{Receivables}}{\text{Credit sales}} \times 365$

$$= \frac{\text{Tshs85 million}}{\text{Tshs275 million}} \times 365$$

$$= 112.82 \text{ days}$$

Self Examination Questions

Question 1

The financial statements of Wine Inc for the years ended 31 December 20X7 and 20X6 are shown below. They show that profits have increased dramatically because of an increase in sales.

Wine Inc - Income and expenditure account

	20X6	20X5
	Tshs'000	Tshs'000
Sales	255,000	48,000
Cost of sales	(151,200)	(17,280)
Gross profit	**103,800**	**30,720**
Selling expenses	(24,300)	(7,200)
Administrative expenses	(12,600)	(864)
Depreciation	(18,720)	(2,784)
Interest	(17,280)	(576)
Net profit	**30,900**	**19,296**
Balance brought forward	34,992	15,696
	65,892	**34,992**

Wine Inc - Statements of financial position

	20X7		20X6	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Premises	39,690		21,600	
Plant	142,572	182,262	28,320	49,920
Current assets				
Inventory	21,420		1,440	
Receivables	52,470		3,984	
Bank	-	73,890	576	6,000
Total assets		**256,152**		**55,920**
Equity and liabilities				
Share capital	24,720		12,000	
Reserves	65,892		34,992	
Redeemable preference shares	4,800	95,412	2,400	49,392
Non-current liabilities				
Loans from banks	144,000	144,000	4,800	4,800
Current liabilities				
Payables	15,750		1,728	
Bank overdraft	990	16,740	-	1,728
Total equity and liabilities		**256,152**		**55,920**

In 20X6, the directors of Wine Inc invested heavily in non-current assets. They claim that this has helped the company to increase its production, which in turn increased its sales turnover.

Required:

With the help of accounting ratios, report on whether the performance of Wine Inc has improved in the year 20X7.

Question 2

Fredric Co acquired certain patents with effect from 1 January 20X7 by issuing share capital.

The financial statements of Fredric for the year ended 31 March 20X6 and 20X7 are shown below:

Fredric Co - Statement of profit or loss

	20X7		**20X6**	
	Tshs000		**Tshs000**	
Revenue Cost of	1,620		2,520	
sales **Gross**	(648)		(1,512)	
profit Selling		**972**		**1,008**
expenses Bad	(270)		(243)	
debts	(32)		(126)	
Depreciation	(104)		(187)	
Interest	(22)	(428)	(173)	(729)
Net profit		**544**		**279**
Balance brought forward		589		566
		1,132		**845**

Fredric Co - Statements of financial position

	20X7		**20X6**	
	Tshs'000		**Tshs'000**	
Non-current asset				
Tangible				
Factory	380		396	
Machinery	1,312		1,612	
Intangible assets: patents	245	1,937	-	2,008
Current assets				
Inventory	54		214	
Receivables	149		525	
Bank	22	225	-	739
		2,162		**2,747**
Equity and liabilities				
Share capital	540		295	
Profit / loss	1,377	1,917	845	1,140
Current liabilities				
Payables	65		157	
Bank	-	65	10	167
Borrowings		180		1,440
		2,162		**2,747**

Required:

(a) State whether the performance of Fredric Co has improved in 20X7 in comparison with 20X6 after acquisition of the patents. The answer should be supported by appropriate ratios.

(b) If the credit period offered to customers is fixed at 45 days, what will be the immediate financial impact?

Answers to Self Examination Questions

Answer to SEQ 1

A report on the performance of Wine Inc in the year 20X7

An improvement is shown in the sales turnover and net profit of Wine Inc in absolute terms in 20X7 due to the heavy investment Wine Inc has made in non-current assets.

An improvement in the performance of the company shall be assessed with the help of accounting ratios. The calculations of the ratios have been included in Appendix 1 of the report.

Profitability ratios

	Difference (% points)
The gross profit margin has fallen from 64% to 41%	23%
The operating profit margin has fallen from 41% to 19%	22%
The net profit margin has fallen from 40% to 12%	28%

(The unit % point is used when referring to differences in percentages).

Some explanations of these movements are as follows:

The sales might have increased as an effect of a decrease in selling prices.

The direct and operating costs should be controlled costs as the reduction in gross profit margin and operating profit margin are almost the same (23% & 22%)

Selling expenses have fallen substantially reflecting effective control over these expenses.

The administrative expenses have gone up and therefore need to be controlled.

Increased borrowings to finance the purchase of non-current assets have resulted in a reduction in profit margin.

Return on capital employed (ROCE) and asset turnover

	Difference (% points)
ROCE has fallen from 36% to 20%	16
Return on assets (ROA) has fallen from 36% to 19%	17
Asset turnover ratio has shown a marginal increase.	

This indicates that the investment in non-current assets has not yet started to give the required results.

The asset turnover ratio should be compared with industry averages or with the ratio of another entity with a similar business to assess whether or not the investment has been as productive as expected.

If the above is not the reason for the decrease, then the reason could be that:

1. the assets have not been used to their full potential; or
2. they have a long development period.

Therefore, the analyses of ratios show that the performance of the company has not improved in 20X7. A further analysis needs to be undertaken (along the lines suggested above) in order to identify the causes of the underperformance and to take corrective measures.

Appendix 1: Calculations of ratios used in the report

(Amounts in Tshs'000)

Profitability ratios	**20X7**	**20X6**
Gross profit margin	$= \frac{103,800}{255,000} \times 100$ = 41.00%	$= \frac{30,720}{48,000} \times 100$ = 64.00%
Operating profit margin (W1)	$= \frac{48,180}{255,000} \times 100$ = 19.00%	$= \frac{34,272}{48,000} \times 100$ = 71.40%
Net profit margin	$= \frac{\$30,900}{\$255,000} \times 100$ = 12.11%	$= \frac{19,296}{48,000} \times 100$ = 40.00%
Selling expenses: sales	$= \frac{40,500}{255,000} \times 100$ = 15.88%	$= \frac{7,200}{48,000} \times 100$ = 15.00%
Administrative expenses: sales	$= \frac{24,300}{255,000} \times 100$ = 9.53%	$= \frac{864}{48,000} \times 100$ = 1.80%
Activity ratios:		
Asset turnover	$= \frac{255,000}{256,152}$ = 0.99 times	$= \frac{48,000}{55,920}$ = 0.86 times
Return on capital employed ratios:		
ROCE (W1)	$= \frac{48,180}{239,412} \times 100$ = 20.00%	$= \frac{34,272}{54,192} \times 100$ = 63.24%
Return on assets (W1)	$= \frac{48,180}{256,152} \times 100$ = 19.00%	$= \frac{19,872}{55,920} \times 100$ = 36.00%

Workings

W1 Operating profit (used for operating profit margin, ROCE, ROA)

	Tshs'000	**Tshs'000**
Gross profit	103,800	30,720
Less:		
Selling expenses	(24,300)	(7,200)
Administrative expenses	(12,600)	(864)
Depreciation	(18,720)	(2,784)
Operating profit	**48,180**	**19,872**

Answer to SEQ 2

The ratios provide positive results. The profitability of Fredric Co in percentage terms has improved in 20X7 as compared to 20X6.

The new management's policies of extensive advertising and new products for which Fredric Co acquired patents are yielding good returns. The gross and net profit margins have both improved. However, it is a worrying fact that sales have fallen. The company will have to increase the sales in the future, hopefully after the products manufactured with the help of the new patents penetrate the markets sufficiently.

The return on capital employed has significantly increased from 18% to 27%. The business transacted with the help of the new patents is yielding better margins.

The company has considerably reduced its long-term debt. This is reflected in a large reduction in capital gearing ratio. Perhaps a small part has been repaid from the proceeds of sale of machines and the remaining part from operating profits. Probably the sale of machinery may be related to the fact that the company has sold off machinery related to the business line that was giving lower profits and hence lower revenue.

In spite of the reduction in the current and acid test ratios, the solvency position appears healthy.

(Amounts in Tshs'000)

Profitability	**20X7**	**20X6**
Gross profit: sales	$= \frac{972}{1620} \times 100$ = 60%	$= \frac{1008}{2520} \times 100$ = 40%
Net profit: sales	$= \frac{544}{1620} \times 100$ = 34%	$= \frac{279}{2520} \times 100$ = 11%
ROCE	$= \frac{544 + 22}{1917 + 180} \times 100$ = 27%	$= \frac{279 + 173}{1140 + 1440} \times 100$ = 18%
Solvency		
Current ratio	$= \frac{225}{65}$ = 3.49:1	$= \frac{739}{168}$ = 4.41:1
Acid test ratio	$= \frac{225 - 54}{65}$ = 2.65:1	$= \frac{(739 - 214)}{168}$ = 3.13:1
Capital structure		
Capital gearing	$= \frac{180}{(180 + 1917)} \times 100$ = 9%	$= \frac{1440}{(1140 + 1440)} \times 100$ = 56%

Current receivables collection periods (i.e receivables days) $= \frac{\text{Receivables}}{\text{Sales}} \times 365$

$$= \frac{149{,}000}{1{,}620{,}000} \times 365$$

= 34 days

The new trade receivables' amount would be $= \frac{45{,}000}{34{,}000} \times 149{,}000$

= Tshs197,206

The amount released if the collection period is extended to 45 days would be Tshs197,206. An additional working capital of Tshs48,206 (Tshs197,206 - Tshs149,000) would be tied up in the form of receivables.