Content

Introduction

There are different study materials and modes for you to prepare for ACCA professional exams.

You can prepare the exam through self-study mode by reading textbooks and practicing revision tests from Approved Content Providers

Or you can go directly to the classes offered by ACCA Approved Learning Partners and stick into their notes.

However, no matter you are choosing which modes of study or which textbook, you need to know the technical articles published by ACCA for each paper is one of the best materials to prepare for your exams that you cannot miss.

In general, the articles are published by ACCA exam team and the contents are updated on a regular basis.

They highlight the core concepts or important areas that a lot of students cannot do well in the past exams.

The most important part is technical articles are generally the guidance to which question to be seen in upcoming exam.

Here are June 2018 examiners comments on ACCA Paper P7 (Advanced Audit & Assurance):

Question Five

This was a reporting question and was in two sections. It was noted that this question was favoured by candidates who had obviously read the recently updated relevant article on the student website.

The second requirement was to critically appraise an extract from an auditor's report, which had been incorrectly prepared and needed amendment. As noted above it was clear that the candidates who selected this question had evidently read the relevant article and were able to identify that the sections were in the wrong order, contained inappropriate wording and that the key audit matters and emphasis of matters paragraphs had been incorrectly used. Good candidates were able to explain when an issue should be included as a key audit matter or if the issue would result in a qualification and hence needed to be part of the basis of opinion paragraph. Other candidates correctly commented that it would be inappropriate to include an emphasis of matter paragraph but that the report should include a section headed material uncertainty related to going concern.

Since it help thousands of students to prepare exam, I organized the articles published by ACCA and summarized them according to their topics and syllabus with relevant questions as Supplementary Notes for those who are interested to focus on the key or challenging areas.

Remember these articles are helping you to enhance your knowledge on particular subjects, and not a substitute of approved textbook.

Chapter 1 Extreme makeover – IASB edition

Executive Summary

The International Accounting Standards Board has now published a new version of the Conceptual Framework, and this article considers some of the more significant changes to the Conceptual Framework that the Board has made.

- Chapter 1 – The objective of general purpose financial reporting
- Chapter 2 – Qualitative characteristics of useful financial information
- Chapter 3 – Financial statements and the reporting entity
- Chapter 4 – The elements of financial statements
- Chapter 5 – Recognition and derecognition
- Chapter 6 – Measurement
- Chapter 7 – Presentation and disclosure

For ACCA candidates, some of these changes such as recognition and measurement are key and can be examined in both the *Financial Reporting* and *Strategic Business Reporting* exams.

A building renovation can be tricky and it can be overwhelming: at the beginning, you definitely know that some parts of the building need to be upgraded, but you can often find more and more that needs to be fixed after the renovation begins. Often, the project can take longer than you ever anticipated, and you change much more of the building than you originally planned.

In March 2018, the International Accounting Standards Board (the Board) finished its renovation of The Conceptual Framework for Financial Reporting (the Conceptual Framework). Much like a renovation and its implications for the existing building, the Board needed to consider that too many changes to the Conceptual Framework may have knock-on effects to existing International Financial Reporting Standards (IFRS®). Despite that, the Board has now published a new version of the Conceptual Framework, and this article considers some of the more significant changes to the Conceptual Framework that the Board has made.

Chapter 1 – The objective of general purpose financial reporting

A gentle introduction

As with any major renovation, all issues, both significant and minor, need to be considered. When considering the objective of general purpose financial reporting, the Board reintroduced the concept of 'stewardship'. This is a relatively minor change and, as many of the respondents to the Discussion Paper highlighted, stewardship is not a new concept. The importance of stewardship by management is inherent within the existing Conceptual Framework and within financial reporting, so this statement largely reinforces what already exists.

Chapter 2 – Qualitative characteristics of useful financial information

Originally, the Board had not planned to make any changes to this chapter, however following many comments made in responses to the Discussion Paper, there have been some.

Leaving the foundations in place

Primarily, the qualitative characteristics remain unchanged. Relevance and faithful representation remain as the two fundamental qualitative characteristics. The four enhancing qualitative characteristics continue to be timeliness, understandability, verifiability and comparability.

Restoring the original features

Whilst the qualitative characteristics remain unchanged, the Board decided to reinstate explicit references to prudence and substance over form.

Although these two concepts were removed from the 2010 Conceptual Framework, the Board concluded that substance over form was not a separate component of faithful

representation. The Board also decided that, if financial statements represented a legal form that differed from the economic substance, then they could not result in a faithful representation.

Whilst that statement is true, the Board felt that the importance of the concept needed to be reinforced and so a statement has now been included in Chapter 2 that states that faithful representation provides information about the substance of an economic phenomenon rather than its legal form.

In the 2010 Conceptual Framework, faithful representation was defined as information that was complete, neutral and free from error. Prudence was not included in the 2010 version of the Conceptual Framework because it was considered to be inconsistent with neutrality. However, the removal of the term led to confusion and many respondents to the Board's Discussion Paper urged for prudence to be reinstated.

Therefore, an explicit reference to prudence has now been included in Chapter 2, stating that 'prudence is the exercise of caution when making judgements under conditions of uncertainty'.

Is that level?
As is often the case with a building project, making one minor change may lead to others, and everyone wants a building that is level. The problem with adjusting the building blocks here, even slightly, was that by adding in the reference to prudence, the Board encountered the further issue of asymmetry.

Many standards, such as International Accounting Standard (IAS®) 37, *Provisions, Contingent Liabilities and Contingent Assets*, apply a system of asymmetric prudence. In IAS 37, a probable outflow of economic benefits would be recognised as a provision, whereas a probable inflow would only be shown as a contingent asset and merely disclosed in the financial statements. Therefore, two sides in the same court case could have differing accounting treatments despite the likelihood of the pay-out being identical for either party. Many respondents highlighted this asymmetric prudence as necessary under some accounting standards and felt that a discussion of the term was required. Whilst this is true, the Board believes that the Conceptual Framework should not identify asymmetric prudence as a necessary characteristic of useful financial reporting.

The 2018 Conceptual Framework states that the concept of prudence does not imply a need for asymmetry, such as the need for more persuasive evidence to support the recognition of assets than liabilities. It has included a statement that, in financial reporting standards, such asymmetry may sometimes arise as a consequence of requiring the most useful information.

Chapter 3 – Financial statements and the reporting entity

Building the extension
Since the inception of the Conceptual Framework, the chapter on the reporting entity has

been classified as 'to be added'. Finally, this part of the extension has been built, even though it might be described as an extension built out of practicality, rather than excitement.

This addition relates to the description and boundary of a reporting entity. The Board has proposed the description of a reporting entity as: an entity that chooses or is required to prepare general purpose financial statements.

This is a minor terminology change and not one that many examiners could have much enthusiasm for. Therefore, it is unlikely to feature in many professional accounting exams!

Chapter 4 – The elements of financial statements

Not to everyone's taste

As part of this project, the Board has changed the definitions of assets and liabilities. To casual observers, it may seem like some of these changes are the decorative equivalent of 'repainting cream walls as magnolia', but to some accountants it can feel like a seismic change.

The changes to the definitions of assets and liabilities can be seen below.

	2010 definition	**2018 definition**	**supporting concept**
Asset (of an entity)	A resource controlled by the entity as a result of past events and from which future economic benefits are **expected** to flow to the entity.	A present economic resource controlled by the entity as a result of past events.	
Economic resource		A right that has the **potential to produce** economic benefits	
Liability (of an entity)	A present obligation of the entity arising from past events, the settlement of which is **expected** to result in an outflow from the entity of resources	A present obligation of the entity to transfer an economic resource as a result of past events.	An entity's obligation to transfer and economic resource must have the **potential to require** the entity to transfer an economic resource to another party.

	embodying economic benefits.		
Obligation		A duty of responsibility that an entity has no practical ability to avoid.	

The Board has therefore changed the definitions of assets and liabilities. Whilst the concept of 'control' remains for assets and 'present obligation' for liabilities, the key change is that the term 'expected' has been replaced. For assets, 'expected economic benefits' has been replaced with 'the potential to produce economic benefits'. For liabilities, the 'expected outflow of economic benefits' has been replaced with the 'potential to require the entity to transfer economic resources'.

The reason for this change is that some people interpret the term 'expected' to mean that an item can only be an asset or liability if some minimum threshold were exceeded. As no such interpretation has been applied by the Board in setting recent IFRS Standards, this definition has been altered in an attempt to bring clarity.

The Board has acknowledged that some IFRS Standards do include a probability criterion for recognising assets and liabilities. For example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision can only be recorded if there is a probable outflow of economic benefits, while IAS 38 *Intangible Assets* highlights that for development costs to be recognised there must be a probability that economic benefits will arise from the development.

The proposed change to the definition of assets and liabilities **will leave these unaffected**. The Board has explained that these standards don't rely on an argument that items fail to meet the definition of an asset or liability. Instead, these standards include probable inflows or outflows as a criterion for **recognition**. The Board believes that **this uncertainty is best dealt with in the recognition or measurement of items**, rather than in the definition of assets or liabilities.

Chapter 5 – Recognition and derecognition

In terms of recognition, the 2010 Conceptual Framework specified three recognition criteria which applied to all assets and liabilities:

- the item needed to meet the definition of an asset or liability
- it needed to be probable that any future economic benefit associated with the asset or liability would flow to or from the entity
- the asset or liability needed to have a cost or value that could be measured reliably.

The Board has confirmed a new approach to recognition, which requires decisions to be made by reference to the qualitative characteristics of financial information. The Board has confirmed that an entity should recognise an asset or a liability (and any related income, expense or changes in equity) if such recognition provides users of financial statements with:

- relevant information about the asset or the liability and about any income, expense or changes in equity
- a faithful representation of the asset or liability and of any income, expenses or changes in equity, and
- information that results in benefits exceeding the cost of providing that information

A key change to this is the removal of a 'probability criterion'. This has been removed as different financial reporting standards apply different criterion; for example, some apply probable, some virtually certain and some reasonably possible. This also means that it will not specifically prohibit the recognition of assets or liabilities with a low probability of an inflow or outflow of economic resources.

This is potentially controversial, and the 2018 Conceptual Framework addresses this specifically in chapter 5; paragraph 15 states that 'an asset or liability can exist even if the probability of an inflow or outflow of economic benefits is low'.

The key point here relates to relevance. If the probability of the event is low, this may not be the most relevant information. The most relevant information may be about the potential magnitude of the item, the possible timing and the factors affecting the probability.

Even stating all of this, the Conceptual Framework acknowledges that the most likely location for items such as this is to be included within the notes to the financial statements.

Finally, a major change in chapter 5 relates to derecognition. This is an area not previously addressed by the Conceptual Framework but the 2018 Conceptual Framework states that derecognition should aim to represent faithfully both:

(a) the assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event); and

(b) the change in the entity's assets and liabilities as a result of that transaction or other event.

Chapter 6 – Measurement

A new en-suite?

The 2010 version of the Conceptual Framework did not contain a separate section on

measurement bases as it was previously felt that this was unnecessary. However, when presented with the opportunity of re-drafting the Conceptual Framework, some additions which are helpful and practical may be considered, even if we have previously managed without them.

In the 2010 Framework, there were a brief few paragraphs that outlined possible measurement bases, but this was limited in detail. In the 2018 version, there is an entire section devoted to the measurement of elements in the financial statements.

The first of the measurement bases discussed is historical cost. The accounting treatment of this is unchanged, but the Conceptual Framework now explains that the carrying amount of non-financial items held at historical cost should be adjusted over time to reflect the usage (in the form of depreciation or amortisation). Alternatively, the carrying amount can be adjusted to reflect that the historical cost is no longer recoverable (impairment). Financial items held at historical cost should reflect subsequent changes such as interest and payments, following the principle often referred to as amortised cost.

The 2018 Conceptual Framework also describes three measurements of current value: **fair value**, **value in use (or fulfilment value for liabilities)** and **current cost**.

Fair value continues to be defined as the price in an orderly transaction between market participants. Value in use (or fulfilment value) is defined as an entity-specific value, and remains as the present value of the cash flows that an entity expects to derive from the continuing use of an asset and its ultimate disposal.

Current cost is different from fair value and value in use, as current cost is an entry value. This looks at the value in which the entity would acquire the asset (or incur the liability) at current market prices, whereas fair value and value in use are exit values, focusing on the values which will be gained from the item.

In addition to outlining these measurement bases, the Conceptual Framework discusses these in the light of the qualitative characteristics of financial information. However, it stops short of recommending the bases under which items should be carried, but gives some guidance in the form of examples to show where certain bases may be more relevant.

Relevance is a key issue here. The 2018 Conceptual Framework discusses that historical cost may not provide relevant information about assets held for a long period of time, and are certainly unlikely to provide relevant information about derivatives. In both cases, it is likely that some variation of current value will be used to provide more predictive information to users.

Conversely, the Conceptual Framework suggests that fair value may not be relevant if items are held solely for use or to collect contractual cash flows. Alongside this, the Conceptual Framework specifically mentions items used in a combination to generate cash flows by producing goods or services to customers. As these items are unlikely to be able

to be sold separately without penalising the activities, a cost-based measure is likely to provide more relevant information, as the cost is compared to the margin made on sales.

Chapter 7 – Presentation and disclosure

On-site discussions
This is a new section, containing the principles relating to how items should be presented and disclosed.

The first of these principles is that income and expenses should be included in the statement of profit or loss unless relevance or faithful representation would be enhanced by including a change in the current value of an asset or a liability in OCI.

The second of these relates to the recycling of items in OCI into profit or loss. IAS 1 *Presentation of Financial Statements* suggests that these should be disclosed as items to be reclassified into profit or loss, or not reclassified.

The wisdom of crowds?
The recycling of OCI is contentious and some commenters argue that all OCI items should be recycled. Others argue that OCI items should never be recycled, whilst some argue that only some items should be recycled. Sometimes the best way forward on a project isn't necessarily to seek the wisdom of crowds.

The foreman's call
Luckily, the Board has managed to find a middle ground on recycling. The 2018 Conceptual Framework now contains a statement that income and expenses included in OCI are recycled when doing so would enhance the relevance or faithful representation of the information. OCI may not be recycled if there is no clear basis for identifying the period in which recycling should occur.

Summary

To the majority of preparers, these changes to the Conceptual Framework will have little or no impact on the financial statements and they are seen as minor terminology changes which simply confirm what is already in existence. However, for ACCA candidates, some of these changes such as recognition and measurement are key and can be examined in both the *Financial Reporting* and *Strategic Business Reporting* exams.

Written by a member of the *Financial Reporting* examining team

Questions

Which of the following meet(s) the recognition criteria for an asset and/or a liability?
(1) Green Co spent $100,000 providing health and safety training to its staff
(2) Green Co has been told by a brand consultancy that the value of its internally created brands is $2,000,000
(3) Green Co is suing a supplier for $450,000 for losses that it suffered due to faulty goods. Greene Co is likely, though not certain, to win the court case
(4) Green Co has sold goods subject to a five-year warranty on which it expects some claims will be made

A 1 and 2
B 3 and 4
C 2 only
D 4 only

Answer: D

4 only. This is because a legal obligation (the warranty) has been created as a result of the sales contract.

Chapter 2 Accounting for property, plant and equipment

Executive Summary

This article is designed to outline the key areas of IAS 16, Property, Plant and Equipment that you may be required to attempt in the Financial Reporting exam.

There are essentially four key areas when accounting for property, plant and equipment that you must ensure that you are familiar with:

- initial recognition
- depreciation
- revaluation
- derecognition (disposals).

The accounting for International Accounting Standard (IAS®) 16, *Property, Plant and Equipment* is a particularly important area of the Financial Reporting syllabus. You can almost guarantee that in every exam you will be required to account for property, plant and equipment at least once.

This article is designed to outline the key areas of IAS 16, *Property, Plant and Equipment* that you may be required to attempt in the *Financial Reporting* exam.

IAS 16, Property, Plant and Equipment overview

There are essentially four key areas when accounting for property, plant and equipment that you must ensure that you are familiar with:

- initial recognition
- depreciation
- revaluation
- derecognition (disposals).

Initial recognition

The basic principle of IAS 16 is that items of property, plant and equipment that qualify for recognition should initially be measured at cost.

One of the easiest ways to remember this is that you should capitalise all costs to bring an asset to its present location and condition for its intended use.

Commonly used examples of cost include:

- purchase price of an asset (less any trade discount)
- directly attributable costs such as:
  • cost of site preparation
  • initial delivery and handling costs
  • installation and testing costs
  • professional fees
- the initial estimate of dismantling and removing the asset and restoring the site on which it is located, to its original condition (ie to the extent that it is recognised as a provision per IAS 37, *Provisions, Contingent Assets and Liabilities*)
- borrowing costs in accordance with IAS 23, *Borrowing Costs*.

EXAMPLE 1

On 1 March 20X0 Yucca Co acquired a machine from Plant Co under the following terms:

	$
List price of machine	82,000
Import duty	1,500
Delivery fees	2,050
Electrical installation costs	9,500
Pre-production testing	4,900
Purchase of a five-year maintenance contract with Plant	7,000

In addition to the above information Yucca Co was granted a trade discount of 10% on the initial list price of the asset and a settlement discount of 5% if payment for the machine was received within one month of purchase. Yucca Co paid for the plant on 25 March 20X0.

How should the above information be accounted for in the financial statements? (See 'Related links' for the solution to Example 1.)

EXAMPLE 2

Construction of Ham Co's new store began on 1 April 20X1. The following costs were incurred on the construction:

	$000
Freehold land	4,500
Architect fees	620
Site preparation	1,650
Materials	7,800
Direct labour costs	11,200
Legal fees	2,400
General overheads	940

The store was completed on 1 January 20X2 and brought into use following its grand opening on the 1 April 20X2. Ham Co issued a $25m unsecured loan on 1 April 20X1 to aid

construction of the new store (which meets the definition of a qualifying asset per IAS 23). The loan carried an interest rate of 8% per annum and is repayable on 1 April 20X4.

Required

Calculate the amount to be included as property, plant and equipment in respect of the new store and state what impact the above information would have on the statement of profit or loss (if any) for the year ended 31 March X2.

(See 'Related links' for the solution to Example 2.)

Subsequent costs

Once an item of PPE has been recognised and capitalised in the financial statements, a company may incur further costs on that asset in the future. IAS 16 requires that subsequent costs should be capitalised if:

- it is probable that future economic benefits associated with the extra costs will flow to the entity
- the cost of the item can be reliably measured.

All other subsequent costs should be recognised as an expense in the income statement in the period that they are incurred.

EXAMPLE 3

On 1 March 202 Yucca Co purchased an upgrade package from Plant Co at a cost of $18,000 for the machine it originally purchased in 20X0 (Example 1). The upgrade took a total of two days where new components were added to the machine. Yucca agreed to purchase the package as the new components would lead to a reduction in production time per unit of 15%. This will enable Yucca to increase production without the need to purchase a new machine.

Should the additional expenditure be capitalised or expensed? (See 'Related links' for the solution to Example 3.)

Depreciation

Depreciation is defined in IAS 16 as being the systematic allocation of the depreciable amount of an asset over its useful life. In other words, depreciation applies the accruals concept to the capitalised cost of a non-current asset and matches this cost to the period that it relates to.

Depreciation methods
There are many methods of depreciating a non-current asset with the most common being:

- Straight line
  • % on cost, or
  • Cost – residual value divided by useful life

- Reducing balance
  • % on carrying amount

EXAMPLE 4

An item of plant was purchased on 1 April 20X0 for $200,000 and is being depreciated at 25% on a reducing balance basis.

Prepare the extracts of the financial statements for the year ended 31 March 20X2. (See 'Related links' for the solution to Example 4.)

Useful life and residual value

IAS 16 requires that these estimates be reviewed at the end of each reporting period. If either changes significantly, the change should be accounted for over the useful life remaining.

EXAMPLE 5

A machine was purchased on 1 April 20X0 for $120,000. It was estimated that the asset had a residual value of $20,000 and a useful life of 10 years at this date. On 1 April 20X2 (two years later) the residual value was reassessed as being only $15,000 and the useful life remaining was considered to be only five years.

How should the asset be accounted for in the years ending 31 March 20X1/20X2/20X3? (See 'Related links' for the solution to Example 5.)

Component depreciation

If an asset comprises two or more major components with different useful lives, then each component should be accounted for separately for depreciation purposes and depreciated over its own useful life.

EXAMPLE 6

A company purchased a property with an overall cost of $100m on 1 April 20X1. The property elements are made up as follows:

	$000	Estimated life
Land and buildings (Land element $20,000)	65,000	50 years
Fixtures and fittings	24,000	10 years
Lifts	11,000	20 years
	100,000	

Calculate the annual depreciation charge for the property for the year ended 31 March 20X2. (See 'Related links' for the solution to Example 6.)

Revaluations

This is an important topic in the exam and features regularly in Question 2, so you should ensure that you are familiar with all aspects of revaluations.

IAS 16 rules

IAS 16 permits the choice of two possible treatments in respect of property, plant and equipment:

- The cost model (carry an asset at cost less accumulated depreciation/impairments).
- The revaluation model (carry an asset at its fair value at the revaluation date less subsequent accumulated depreciation impairment).

If the revaluation policy is adopted this should be applied to all assets in the entire category, ie if you revalue a building, you must revalue all land and buildings in that class of asset. Revaluations must also be carried out with sufficient regularity so that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date.

Accounting for a revaluation

There are a series of accounting adjustments that must be undertaken when revaluing a non-current asset. These adjustments are indicated below.

The initial revaluation

You may find it useful in the exam to first determine if there is a gain or loss on the revaluation with a simple calculation to compare:

Carrying amount of non-current asset at revaluation date	X
Valuation of non-current asset	X
Difference = gain or loss revaluation	**X**

Revaluation gains

A gain on revaluation is always recognised in equity, under a revaluation reserve (unless the gain reverse's revaluation losses on the same asset that were previously recognised in the income statement – in this instance the gain is to be shown in the income statement).

The revaluation gain is known as an unrealised gain which later becomes realised when the asset is disposed of (derecognised).

Double entry:

- **Dr** Non-current asset cost (difference between valuation and original cost/valuation)
- **Dr** Accumulated depreciation (with any historical cost accumulated depreciation)

- **Cr** Revaluation reserve (gain on revaluation)

EXAMPLE 7

A company purchased a building on 1 April 20X1 for $100,000. The asset had a useful life at that date of 40 years. On 1 April 20X3 the company revalued the building to its current fair value of $120,000.

What is the double entry to record the revaluation? (See 'Related links' for the solution to Example 7.)

Revaluation losses

A revaluation loss should be charged against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation surplus in respect of the same asset. Any additional loss must be charged as an expense in the statement of profit or loss.

Double entry:

- **Dr** Revaluation reserve (to maximum of original gain)
- **Dr** Income statement (any residual loss)
- **Cr** Non-current asset (loss on revaluation)

EXAMPLE 8

The carrying amount of Zen Co's property at the end of the year amounted to $108,000. On this date the property was revalued and was deemed to have a fair value of $95,000. The balance on the revaluation surplus relating to the original gain of the property was $10,000.

What is the double entry to record the revaluation? (See 'Related links' for the solution to Example 8.)

Depreciation

The asset must continue to be depreciated following the revaluation. However, now that the asset has been revalued the depreciable amount has changed. In simple terms the revalued amount should be depreciated over the assets remaining useful life.

Reserves transfer

The depreciation charge on the revalued asset will be different to the depreciation that would have been charged based on the historical cost of the asset. As a result of this, IAS 16 permits a transfer to be made of an amount equal to the excess depreciation from the revaluation reserve to retained earnings.

Double entry:

- **Dr** Revaluation reserve
- **Cr** Retained earnings

Be careful, in the exam a reserves transfer is only required if the examiner indicates that it is company policy to make a transfer to realised profits in respect of excess depreciation on revalued assets. If this is not the case then a reserves transfer is not necessary.

This movement in reserves should also be disclosed in the statement of changes in equity.

EXAMPLE 9

A company revalued its property on 1 April 20X1 to $20m ($8m for the land). The property originally cost $10m ($2m for the land) 10 years ago. The original useful life of 40 years is unchanged. The company's policy is to make a transfer to realised profits in respect of excess depreciation.

How will the property be accounted for in the year ended 31 March 20X2? (See 'Related links' for the solution to Example 9.)

Exam focus

In the exam make sure you pay attention to the date that the revaluation takes place. If the revaluation takes place at the start of the year then the revaluation should be accounted for immediately and depreciation should be charged in accordance with the rule above.

If however the revaluation takes place at the year-end then the asset would be depreciated for a full 12 months first based on the original depreciation of that asset. This will enable the carrying amount of the asset to be known at the revaluation date, at which point the revaluation can be accounted for.

A further situation may arise if the examiner states that the revaluation takes place mid-way through the year. If this were to happen the carrying amount would need to be found at the date of revaluation, and therefore the asset would be depreciated based on the original depreciation for the period up until revaluation, then the revaluation will take place and be accounted for. Once the asset has been revalued you will need to consider the last period of depreciation. This will be found based upon the revaluation rules (depreciate the

revalued amount over remaining useful life). This will be the most complicated situation and you must ensure that your working is clearly structured for this; ie depreciate for first period based on old depreciation, revalue, then depreciate last period based on new depreciation rule for revalued assets.

EXAMPLE 10

A company purchased a building on 1 April 20X1 for $100,000 at which point it was considered to have a useful life of 40 years. At the year end 31 March 20X6 the company decided to revalue the building to its current value of $98,000.

How will the building be accounted for in the year ended 31 March 20X6? (See 'Related links' for the solution to Example 10.)

EXAMPLE 11

At 1 April 20X1 HD Co carried its office block in its financial statements at its original cost of $2 million less depreciation of $400,000 (based on its original life of 50 years). HD Co decided to revalue the office block on 1 October 20X1 to its current value of $2.2m. The useful life remaining was reassessed at the time of valuation and is considered to be 40 years at this date. It is the company's policy to charge depreciation proportionally.

How will the office block be accounted for in the year ended 31 March 20X2? (See 'Related links' for the solution to Example 11.)

Derecognition

Property, plant and equipment should be derecognised when it is no longer expected to generate future economic benefit or when it is disposed of.

When property, plant and equipment is to be derecognised, a gain or loss on disposal is to be calculated. This can be found by comparing the difference between:

Carrying amount	X
Disposal proceeds	X

Profit or loss on disposal	**X**

Tip: When the disposal proceeds are greater than the carrying amount there is a profit on disposal and when the disposal proceeds are less than the carrying amount there is a loss on disposal.

EXAMPLE 12

An asset that originally cost $16,000 and had accumulated depreciation on it of $8,000 was disposed of during the year for $5,000 cash.

How should the disposal be accounted for in the financial statements? (See 'Related links' for the solution to Example 12.)

Disposal of previously revalued assets

When an asset is disposed of that has previously been revalued, a profit or loss on disposal is to be calculated (as above). Any remaining surplus on the revaluation reserve is now considered to be a 'realised' gain and therefore should be transferred to retained earnings as:

- **Dr** Revaluation reserve
- **Cr** Retained earnings

In summary, it can be seen that accounting for property, plant and equipment is an important topic that features regularly in the *Financial Reporting* exam. With most of what is examinable feeding though from the *Financial Accounting* exam, this should be a comfortable topic that you can tackle well in the exam.

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Questions

Which of the following should be capitalised in the initial carrying amount of an item of plant?

(1) Cost of transporting the plant to the factory
(2) Cost of installing a new power supply required to operate the plant
(3) Cost of a three-year plant maintenance agreement
(4) Cost of a three-week training course for staff to operate the plant

A 1 and 3
B 1 and 2
C 2 and 4
D 3 and 4

Answer: B

Chapter 3 Property, plant and equipment and tangible fixed assets – Part 1

Executive Summary

In the first of two articles, we look at the main features of IAS 16, Property, Plant and Equipment (PPE).

- Initial measurement of PPE
- Depreciation of PPE

IAS 16 defines PPE as tangible items that are:

- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and
- expected to be used during more than one accounting period.

Part 1

This is the first of two articles which consider the main features of International Accounting Standard (IAS®) 16, *Property, Plant and Equipment (PPE)*. This standard deals with the four main aspects of financial reporting of PPE that are likely to be of major relevance in the FR exam, namely:

- initial measurement and depreciation – covered in this article
- revaluation and derecognition – covered in the second article.

IAS 16 defines PPE as tangible items that are:

- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and
- expected to be used during more than one accounting period.

The initial measurement of PPE

IAS 16 requires that PPE should initially be measured at 'cost'. The cost of an item of PPE comprises:

- the cost of purchase, net of any trade discounts plus any import duties and non-refundable sales taxes
- any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

These are costs that would have been avoided if the asset had not been purchased or constructed. General overhead costs cannot be allocated to the cost of PPE. Directly attributable costs include:

- employee benefits payable to staff installing, constructing, or initially testing the asset
- site preparation
- professional fees directly associated with the installation, construction, or initial testing of the asset
- any other overhead costs directly associated with the installation, construction, or initial testing of the asset.

Where these costs are incurred over a period of time (such as employee benefits), the period for which the costs can be included in the cost of PPE ends when the asset is ready for use, even if the asset is not brought into use until a later date. As soon as an asset is capable of operating it is ready for use. The fact that it may not operate at normal levels immediately, because demand has not yet built up, does not justify further capitalisation of

costs in this period. Any abnormal costs (for example, wasted material) cannot be included in the cost of PPE.

IAS 16 does not specifically address the issue of whether borrowing costs associated with the financing of a constructed asset can be regarded as a directly attributable cost of construction. This issue is addressed in IAS 23, *Borrowing Costs*. IAS 23 requires the inclusion of borrowing costs as part of the cost of constructing the asset. In order to be consistent with the treatment of 'other costs', only those finance costs that would have been avoided if the asset had not been constructed are eligible for inclusion. If the entity has borrowed funds specifically to finance the construction of an asset, then the amount to be capitalised is the actual finance costs incurred. Where the borrowings form part of the general borrowing of the entity, then a capitalisation rate that represents the weighted average borrowing rate of the entity should be used.

The cost of the asset will include the best available estimate of the costs of dismantling and removing the item and restoring the site on which it is located, where the entity has incurred an obligation to incur such costs by the date on which the cost is initially established. This is a component of cost to the extent that it is recognised as a provision under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. In accordance with the principles of IAS 37, the amount to be capitalised in such circumstances would be the amount of foreseeable expenditure appropriately discounted where the effect is material.

EXAMPLE 1

On 1 October 20X6, Omega began the construction of a new factory. Costs relating to the factory, incurred in the year ended 30 September 20X7, are as follows:

	$000
Purchase of the land	10,000
Costs of dismantling existing structures on the site	500
Purchase of materials to construct the factory	6,000

	$000
Employment costs (Note 1)	1,800
Production overheads directly related to the construction (Note 2)	1,200
Allocated general administrative overheads	600
Architects' and consultants' fees directly related to the construction	400
Costs of relocating staff who are to work at the new factory	300
Costs relating to the formal opening of the factory	200
Interest on loan to partly finance the construction of the factory (Note 3)	1,200

Note 1: The factory was constructed in the eight months ended 31 May 20X7. It was brought into use on 30 June 20X7. The employment costs are for the nine months to 30 June 20X7.

Note 2: The production overheads were incurred in the eight months ended 31 May 20X7. They included an abnormal cost of $200,000, caused by the need to rectify damage resulting from a gas leak.

Note 3: Omega received the loan of $12m on 1 October 20X6. The loan carries a rate of interest of 10% per annum.

Note 4: The factory has an expected useful economic life of 20 years. At that time the factory will be demolished and the site returned to its original condition. This is a legal obligation that arose on signing the contract to purchase the land. The expected costs of fulfilling this obligation are $2m. An appropriate annual discount rate is 8%.

Requirement

Compute the initial carrying value of the factory (see solution).

Depreciation of PPE

IAS 16 defines depreciation as 'the systematic allocation of the depreciable amount of an asset over its useful life'. The 'depreciable amount' is the cost of an asset, cost less residual value, or other amount (for example the revaluation of the asset). Depreciation does not provide for loss of value of an asset, but is an accruals accounting technique that allocates the depreciable amount of the asset to the periods expected to benefit from the use of the asset. Therefore assets that are increasing in value still need to be depreciated.

IAS 16 requires that depreciation should be recognised as an expense in the statement of profit or loss, unless it is permitted to be included in the carrying amount of another asset. An example of this practice would be the possible inclusion of depreciation in the costs incurred on a construction contract that are carried forward and matched against future income from the contract, under the provisions of International Financial Reporting Standard (IFRS®) 18, *Revenue from Contracts with Customers*.

A number of methods can be used to allocate depreciation to specific accounting periods. Two of the more common methods, specifically mentioned in IAS 16, are the straight line method, and the reducing (or diminishing) balance method.

The assessments of the useful life (UL) and residual value (RV) of an asset are extremely subjective. They will only be known for certain after the asset is sold or scrapped, and this is too late for the purpose of computing annual depreciation. Therefore, IAS 16 requires that the estimates should be reviewed at the end of each reporting period. If either changes significantly, then that change should be accounted for over the remaining estimated useful life.

EXAMPLE 2

An item of plant was acquired for $220,000 on 1 January 20X6. The estimated UL of the plant was five years and the estimated RV was $20,000. The asset is depreciated on a straight line basis. On 31 December 20X6 the future estimate of the UL of the plant was changed to three years, with an estimated RV of $12,000.

At the date of purchase, the plant's depreciable amount would have been $200,000 ($220,000 – $20,000). Therefore, depreciation of $40,000 would have been charged in 20X6, and the carrying amount would have been $180,000 at the end of 20X6. Given the reassessment of the UL and RV, the depreciable amount at the end of 20X6 is $168,000 ($180,000 – $12,000) over three years. Therefore, the depreciation charges in 20X7, 20X8 and 20X9 will be $56,000 ($168,000/3) unless there are future changes in estimates. Where an asset comprises two or more major components with substantially different useful lives, each component should be accounted for separately for depreciation purposes, and each depreciated over its UL.

EXAMPLE 3

On 1 January 20X2, an entity purchased a furnace for $200,000. The estimated UL of the furnace was 10 years, but its lining needed replacing after five years. On 1 January 20X2 the entity estimated that the cost of relining the furnace (at 1 January 20X2 prices) was $50,000. The lining was replaced on 1 January 20X7 at a cost of $70,000.

Requirement

Compute the annual depreciation charges on the furnace for each year of its life.

Solution

20X2–20X6 inclusive: Compute the annual depreciation charges on the furnace for each year of its useful life.

Solution 20X2–20X6 inclusive: The asset has two depreciable components: (i) the lining element (allocated cost $50,000 – UL five years); and (ii) the balance of the cost (allocated cost $150,000 – UL 10 years). Therefore, the annual depreciation is $25,000 ($50,000 x 1/5 + $150,000 x 1/10). At 31 December 20X6, the 'lining component' has a carrying amount of zero.

From 20X7: The $70,000 spent on the new lining is treated as the replacement of a separate component of an asset and added to PPE. The annual depreciation is now $29,000 ($70,000 x 1/5 + $150,000 x 1/10).

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Chapter 4 Property, plant and equipment and tangible fixed assets – Part 2

Executive Summary

In the second of two articles, we consider revaluation of property, plant and equipment (PPE) and its derecognition in accordance with International Accounting Standard (IAS®) 16, *Property, Plant and Equipment* (PPE), outlining the differences in international and UK perspectives.

It also summarises the provisions of International Financial Reporting Standard (IFRS®) 5, *Non-current assets held for sale and discontinued operations*.

Part 2

This is the second of two articles, and considers revaluation of property, plant and equipment (PPE) and its derecognition in accordance with International Accounting Standard (IAS®) 16, *Property, Plant and Equipment* (PPE). It also summarises the provisions of International Financial Reporting Standard (IFRS®) 5, *Non-current assets held for sale and discontinued operations.* The first part of this article (see 'Related links') considered the initial measurement and depreciation of PPE.

Revaluation of PPE – IAS 16 position

General principles

IAS 16 allows entities the choice of two valuation models for PPE – the cost model or the revaluation model. Each model needs to be applied consistently to all PPE of the same 'class'. A class of assets is a grouping of assets that have a similar nature or function within the business. For example, properties would typically be one class of assets, and plant and equipment another. Additionally, if the revaluation model is chosen, the revaluations need to be kept up to date, although IAS 16 is not specific as to how often assets need to be revalued.

When the revaluation model is used, assets are carried at their fair value, defined as 'the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction'.

Revaluation gains

Revaluation gains are recognised in equity unless they reverse revaluation losses on the same asset that were previously recognised in the statement of profit or loss. In these circumstances, the revaluation gain is recognised in the statement of profit or loss. Revaluation changes the depreciable amount of an asset so subsequent depreciation charges are also affected.

EXAMPLE 1

A property was purchased on 1 January 20X0 for $2m (estimated depreciable amount was $1m and it had a useful life 50 years). Annual depreciation of $20,000 was charged from 20X0 to 20X4 inclusive and on 1 January 20X5 the carrying amount of the property was $1.9m. The property was revalued to $2.8m on 1 January 20X5 (estimated depreciable amount was $1.35m and the estimated useful life was unchanged). Show the treatment of the revaluation surplus and compute the revised annual depreciation charge.

Solution

The revaluation surplus of $900,000 ($2.8m – $1.9m) is recognised in the statement of changes in equity by crediting a revaluation reserve. The depreciable amount of the property is now $1.35m and the remaining estimated useful life 45 years (50 years from 1 January 20X0). Therefore, the depreciation charge from 20X5 onwards would be $30,000 ($1.35m x 1/45).

A revaluation usually increases the annual depreciation charge in the statement of profit or loss. In the above example, the annual increase is $10,000 ($30,000 – $20,000). IAS 16 allows (but does not require) entities to make a transfer of this 'excess depreciation' from the revaluation reserve directly to retained earnings.

Revaluation losses

Revaluation losses are recognised in the statement of profit or loss. The only exception to this rule is where a revaluation surplus exists relating to a previous revaluation of that asset. To that extent, a revaluation loss can be recognised in equity.

EXAMPLE 2

The property referred to in Example 1 was revalued on 31 December 20X6. Its fair value had fallen to $1.5m. Compute the revaluation loss and state how it should be treated in the financial statements.

Solution

The carrying amount of the property at 31 December 20X6 would have been $2.74m ($2.8m – 2 x $30,000). This means that the revaluation deficit is $1.24m ($2.74m – $1.5m).

If the transfer of excess depreciation (see above) is not made, then the balance in the revaluation reserve relating to this asset is $900,000 (see Example 1). Therefore $900,000 is deducted from equity and $340,000 ($1.24m – $900,000) is charged to the statement of profit or loss.

If the transfer of excess depreciation is made, then the balance on the revaluation reserve at 31 December 20X6 is $880,000 ($900,000 – 2 x $10,000). Therefore $880,000 is deducted from equity and $360,000 ($1.24m – $880,000) charged to the statement of profit or loss.

Derecognition of PPE – the IAS 16 position

PPE should be derecognised (removed from PPE) either on disposal or when no future economic benefits are expected from the asset (in other words, it is effectively scrapped). A gain or loss on disposal is recognised as the difference between the disposal proceeds and the carrying amount of the asset (using the cost or revaluation model) at the date of

disposal. This net gain is included in the statement of profit or loss – the sales proceeds should not be recognised as revenue.

Where assets are measured using the revaluation model, any remaining balance in the revaluation reserve relating to the asset disposed of is transferred directly to retained earnings. No recycling of this balance into the statement of profit or loss is permitted.

Disposal of assets – IFRS 5 position

IFRS 5 is another standard that deals with the disposal of non-current assets and discontinued operations. An item of PPE becomes subject to the provisions of IFRS 5 (rather than IAS 16) if it is classified as held for sale. This classification can either be made for a single asset (where the planned disposal of an individual and fairly substantial asset takes place) or for a group of assets (where the disposal of a business component takes place). This article considers the implications of disposing of a single asset.

IFRS 5 is only applied if the held for sale criteria are satisfied, and an asset is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continued use. For this to be the case, the asset must be available for immediate sale in its present condition and its sale must be highly probable. Therefore, an appropriate level of management must be committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan must have been initiated. The asset needs to be actively marketed at a reasonable price, and a successful sale should normally be expected within one year of the date of classification.

The types of asset that would typically satisfy the above criteria would be property, and very substantial items of plant and equipment. The normal disposal or scrapping of plant and equipment towards the end of its useful life would be subject to the provisions of IAS 16. When an asset is classified as held for sale, IFRS 5 requires that it be classified separately from all other non-current assets on the statement of financial position under the heading – 'non-current assets held for sale'. No further depreciation is charged as its carrying amount will be recovered principally through sale rather than continuing use.

The existing carrying amount of the asset is compared with its 'fair value less costs to sell' (effectively the selling price less selling costs). If fair value less costs to sell is below the current carrying amount, then the asset is written down to fair value less costs to sell and an impairment loss recognised. When the asset is sold, any difference between the new carrying amount and the net selling price is shown as a profit or loss on sale.

EXAMPLE 4

An asset has a carrying amount of $600,000. It is classified as held for sale on 30 September 20X6. At that date its fair value less costs to sell is estimated at $550,000. The asset was sold for $555,000 on 30 November 20X6. The year end of the entity is 31 December 20X6.

1. How would the classification as held for sale, and subsequent disposal, be treated in the 20X6 financial statements?
2. How would the answer differ if the carrying amount of the asset at 30 September 20X6 was $500,000, with all other figures remaining the same?

Solution 1

1. On 30 September 20X6, the asset would be written down to its fair value less costs to sell of $550,000 and an impairment loss of $50,000 recognised. It would be removed from non-current assets and presented in 'non-current assets held for sale'. On 30 November 20X6 a profit on sale of $5,000 would be recognised.
2. On 30 September 20X6 the asset would be transferred to non-current assets held for sale at its existing carrying amount of $500,000. When the asset is sold on 30 November 20X6, a profit on sale of $55,000 would be recognised.

Where an asset is measured under the revaluation model then IFRS 5 requires that its revaluation must be updated immediately prior to being classified as held for sale. The effect of this treatment is that the selling costs will always be charged to the statement of profit or loss at the date the asset is classified as held for sale.

EXAMPLE 5

An asset being classified as held for sale is currently carried under the revaluation model at $600,000. Its latest fair value is $700,000 and the estimated costs of selling the asset are $10,000. Show how this transaction would be recorded in the financial statements.

Solution

Immediately prior to being classified as held for sale, the asset would be revalued to its latest fair value of $700,000, with a credit of $100,000 to equity. The fair value less costs to sell of the asset is $690,000 ($700,000 – $10,000). On reclassification, the asset would be written down to this value (being lower than the updated revalued amount) and $10,000 charged to the statement of profit or loss.

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Questions

In accordance with IAS 16 Property, Plant and Equipment, which of the following is true?

A If an entity decides to use the revaluation model, then all of its non-current assets must be revalued
B An entity must transfer excess depreciation from the revaluation surplus to retained earnings on an annual basis in respect of any property which it revalues
C If an entity decides to revalue property annually, then this property will not need to be depreciated
D There is no requirement for an entity to revalue property on an annual basis

Answer: D

The correct answer is D.
IAS 16 requires revaluations (where the revaluation model is chosen) to be made with "sufficient regularity" to ensure the carrying amount does not differ materially from the fair value. There is therefore no automatic requirement for an annual revaluation of non-current assets.

Chapter 5 Revenue revisited

Executive Summary

This article considers the application of IFRS 15, Revenue from Contracts with Customers using the five-step model.

You have to understand this IFRS in details as we find a lot of students were not familiar this topic during answering exam paper questions. Examiner usually stressed it in his examiner report in the past attempts.

IFRS 15 replaces the following standards and interpretations:

- IAS 11, Construction Contracts
- IAS 18, Revenue
- IFRIC 13, Customer Loyalty Programmes
- IFRIC 15, Agreements for the Construction of Real Estate
- IFRIC 18, Transfer of Assets from Customers
- SIC-31, Revenue – Barter Transactions Involving Advertising Services

5-step model:

Step 1 – Identification of the contract

Step 2 – Identification of the separate performance obligations

Step 3 – Determine the transaction price

Step 4 – Allocation of the transaction price to the separate performance obligations

Step 5 – Revenue to be recognised as each performance obligation is satisfied

On 28 May 2014, the International Accounting Standards Board (the Board), as a result of the joint project with the US Financial Accounting Standards Board (FASB), issued IFRS®15, *Revenue from Contracts with Customers*. Application of the standard is mandatory for annual reporting periods starting from 1 January 2017 onward (though there is currently a proposal to defer this date to 1 January 2018) and earlier application is permitted.

This article considers the application of IFRS 15, *Revenue from Contracts with Customers* using the five-step model. The new standard introduces some significant changes so you should ensure that you have the latest editions of all study materials.

Historically, there has been a significant divergence in practice over the recognition of revenue, mainly because IFRS standards have contained limited guidance in certain areas. The original standard, IAS® 18, *Revenue*, was issued in 1982 with a significant revision in 1993, however, IAS 18 was not fit for purpose in today's corporate world as the guidance available was difficult to apply to many transactions. The result was that some companies applied US GAAP when it suited their needs.

Users often found it difficult to understand the judgments and estimates made by an entity in recognising revenue, partly because of the 'boilerplate' nature of the disclosures. As a result of the varying recognition practices, the nature and extent of the impact of the new standard will vary between entities and industries. For many transactions, such as those in retail, the new standard will have little effect but there could be significant change to current practice in accounting for long-term and multiple-element contracts.

IFRS 15 replaces the following standards and interpretations:

- IAS 11, *Construction Contracts*
- IAS 18, *Revenue*
- IFRIC 13, *Customer Loyalty Programmes*
- IFRIC 15, *Agreements for the Construction of Real Estate*
- IFRIC 18, *Transfer of Assets from Customers*
- SIC-31, *Revenue – Barter Transactions Involving Advertising Services*

One effect of this for the ACCA exams is that construction contracts (previously excluded from P2) are examinable in Strategic Business Reporting.

The core principle of IFRS 15 is that an entity shall recognise revenue from the transfer of promised good or services to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The standard introduces a five-step model for the recognition of revenue.

The five-step model applies to revenue earned from a contract with a customer with limited exceptions, regardless of the type of revenue transaction or the industry.

Step one in the five-step model requires the **identification of the contract** with the customer. Contracts may be in different forms (written, verbal or implied), but must be enforceable, have commercial substance and be approved by the parties to the contract. The model applies once the payment terms for the goods or services are identified and it is probable that the entity will collect the consideration. Each party's rights in relation to the goods or services have to be capable of identification. If a contract with a customer does not meet these criteria, the entity can continually reassess the contract to determine whether it subsequently meets the criteria.

Two or more contracts that are entered into around the same time with the same customer may be combined and accounted for as a single contract, if they meet the specified criteria. The standard provides detailed requirements for contract modifications. A modification may be accounted for as a separate contract or as a modification of the original contract, depending upon the circumstances of the case.

Step two requires the **identification of the separate performance obligations** in the contract. This is often referred to as 'unbundling', and is done at the beginning of a contract. The key factor in identifying a separate performance obligation is the distinctiveness of the good or service, or a bundle of goods or services. A good or service is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and it is separately identifiable from other elements of the contract.

IFRS 15 requires that a series of distinct goods or services that are substantially the same with the same pattern of transfer, to be regarded as a single performance obligation. A good or service which has been delivered may not be distinct if it cannot be used without another good or service that has not yet been delivered. Similarly, goods or services that are not distinct should be combined with other goods or services until the entity identifies a bundle of goods or services that is distinct. IFRS 15 provides indicators rather than criteria to determine when a good or service is distinct within the context of the contract. This allows management to apply judgment to determine the separate performance obligations that best reflect the economic substance of a transaction.

Step three requires the entity to **determine the transaction price**, which is the amount of consideration that an entity expects to be entitled to in exchange for the promised goods or services. This amount excludes amounts collected on behalf of a third party – for example, government taxes. An entity must determine the amount of consideration to which it expects to be entitled in order to recognise revenue.

The transaction price might include variable or contingent consideration. Variable consideration should be estimated as either the expected value or the most likely amount. The expected value approach represents the sum of probability-weighted amounts for various possible outcomes. The most likely amount represents the most likely amount in a range of possible amounts.

Management should use the approach that it expects will best predict the amount of consideration and it should be applied consistently throughout the contract. An entity can only include variable consideration in the transaction price to the extent that it is highly probable that a subsequent change in the estimated variable consideration will not result in a significant revenue reversal. If it is not appropriate to include all of the variable consideration in the transaction price, the entity should assess whether it should include part of the variable consideration. However, this latter amount still has to pass the 'revenue reversal' test.

Variable consideration is wider than simply contingent consideration as it includes any amount that is variable under a contract, such as performance bonuses or penalties.

Additionally, an entity should estimate the transaction price, taking into account non-cash consideration, consideration payable to the customer and the time value of money if a significant financing component is present. The latter is not required if the time period between the transfer of goods or services and payment is less than one year. In some cases, it will be clear that a significant financing component exists due to the terms of the arrangement.

In other cases, it could be difficult to determine whether a significant financing component exists. This is likely to be the case where there are long-term arrangements with multiple performance obligations such that goods or services are delivered and cash payments received throughout the arrangement. For example, if an advance payment is required for business purposes to obtain a longer-term contract, then the entity may conclude that a significant financing obligation does not exist.

If an entity anticipates that it may ultimately accept an amount lower than that initially promised in the contract due to, for example, past experience of discounts given, then revenue would be estimated at the lower amount with the collectability of that lower amount being assessed. Subsequently, if revenue already recognised is not collectable, impairment losses should be taken to profit or loss.

Step four requires the **allocation of the transaction price to the separate performance obligations**. The allocation is based on the relative standalone selling prices of the goods or services promised and is made at the inception of the contract. It is not adjusted to reflect subsequent changes in the standalone selling prices of those goods or services.

The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately. If that is not available, an estimate is made by using an approach that maximises the use of observable inputs – for example, expected cost plus an appropriate margin or the assessment of market prices for similar goods or services adjusted for entity-specific costs and margins or in limited circumstances a residual approach. The residual approach is different from the residual method that is used currently by some entities, such as software companies.

When a contract contains more than one distinct performance obligation, an entity should allocate the transaction price to each distinct performance obligation on the basis of the standalone selling price.

Where the transaction price includes a variable amount and discounts, it is necessary to establish whether these amounts relate to all or only some of the performance obligations in the contract. Discounts and variable consideration will typically be allocated proportionately to all of the performance obligations in the contract. However, if certain conditions are met, they can be allocated to one or more separate performance obligations.

This will be a major practical issue as it may require a separate calculation and allocation exercise to be performed for each contract. For example, a mobile telephone contract typically bundles together the handset and network connection and IFRS 15 will require their separation.

Step five requires **revenue to be recognised as each performance obligation is satisfied**. This differs from IAS 18 where, for example, revenue in respect of goods is recognised when the significant risks and rewards of ownership of the goods are transferred to the customer. An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur over time or at a point in time. The definition of control includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case, it is deemed to be satisfied over time:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Revenue is recognised in line with the pattern of transfer. Whether an entity recognises revenue over the period during which it manufactures a product or on delivery to the customer will depend on the specific terms of the contract.

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time and revenue will be recognised when control is passed at that point in time. Factors that may indicate the passing of control include the present right to payment for the asset or the customer has legal title to the asset or the entity has transferred physical possession of the asset.

As a consequence of the above, the timing of revenue recognition may change for some point-in-time transactions when the new standard is adopted.

In addition to the five-step model, IFRS 15 sets out how to account for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract and provides guidance to assist entities in applying the model to licences, warranties, rights of return, principal-versus-agent considerations, options for additional goods or services and breakage.

IFRS 15 is a significant change from IAS 18 and even though it provides more detailed application guidance, judgment will be required in applying it because the use of estimates is more prevalent.

For exam purposes, you should focus on understanding the principles of the five-step model so that you can apply them to practical questions.

Written by a member of the *Strategic Business Reporting* examining team

Chapter 6 IFRS 3 – Business combinations

Executive Summary

This article explains the relevance of IFRS 3 to Financial Reporting candidates.

The revised IFRS 3 introduces:

- Restrictions on the expenses that can form part of the acquisition costs
- New principles for the treatment of contingent consideration
- A choice in the measurement of non-controlling interests (which have a knock-on effect to consolidated goodwill), considerable guidance on recognising and measuring the identifiable assets and liabilities of the acquired subsidiary, in particular the illustrative examples discuss several intangibles, such as market-related, customer-related, artistic-related and technology-related assets.

IFRS 3, *Business Combinations* was issued in January 2008 as the second phase of a joint project with the Financial Accounting Standards Board (FASB), the US standards setter, and is designed to improve financial reporting and international convergence in this area. The standard has also led to minor changes in IAS 27, Consolidated and Separate Financial Statements. The requirements of the revised IFRS 3 have been examinable since December 2008. This article relates to the relevance of IFRS 3 to Paper F7, *Financial Reporting*.

This article is also of interest to candidates studying UK-based papers, as under UK regulation consolidated goodwill is calculated using the non-controlling interest's (NCI) proportionate share of the subsidiary's identifiable net assets (referred to as method (ii) below).

The revised IFRS 3 introduces:

- Restrictions on the expenses that can form part of the acquisition costs
- New principles for the treatment of contingent consideration
- A choice in the measurement of non-controlling interests (which have a knock-on effect to consolidated goodwill), considerable guidance on recognising and measuring the identifiable assets and liabilities of the acquired subsidiary, in particular the illustrative examples discuss several intangibles, such as market-related, customer-related, artistic-related and technology-related assets.

Acquisition costs

All acquisition costs, even those directly related to the acquisition such as professional fees (legal, accounting, valuation, etc), must be expensed. The costs of issuing debt or equity are to be accounted for under the rules of IAS 39, *Financial Instruments: Recognition and Measurement*.

Contingent consideration

IFRS 3 defines contingent consideration as: 'Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met' (this would be an asset).

IFRS 3 requires the acquirer to recognise any contingent consideration as part of the consideration for the acquiree. It must be recognised at its fair value which is 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable,

willing parties in an arm's length transaction'. This 'fair value' approach is consistent with the way in which other forms of consideration are valued. Applying this definition to contingent consideration may not be easy as the definition is largely hypothetical; it is highly unlikely that the acquisition date liability for contingent consideration could be or would be settled by 'willing parties in an arm's length transaction'. An exam question would give the fair value of any contingent consideration or would specify how it is to be calculated. The payment of contingent consideration may be in the form of equity, a liability (issuing a debt instrument) or cash.

If there is a change to the fair value of contingent consideration due to additional information obtained after the acquisition date that affects the facts or circumstances as they existed at the acquisition date, it is treated as a 'measurement period adjustment' and the contingent liability (and goodwill) are remeasured. This is effectively a retrospective adjustment and is rather similar to an adjusting event under IAS 10, *Events After the Reporting Period*. Changes in the fair value of contingent consideration due to events after the acquisition date (for example, meeting an earnings target which triggers a higher payment than was provided for at acquisition) are treated as follows:

- Contingent consideration classified as equity shall not be remeasured, and its subsequent settlement shall be accounted for within equity (eg Cr share capital/share premium Dr retained earnings).
- Contingent consideration classified as an asset or a liability that:
  – is a financial instrument and is within the scope of IAS 39 shall be measured at fair value, with any resulting gain or loss recognised either in the statement of profit or loss, or in other comprehensive income in accordance with that IFRS
  – is not within the scope of IAS 39 shall be accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, or other IFRSs as appropriate.

Note that although contingent consideration is usually a liability, it may be an asset if the acquirer has the right to a return of some of the consideration transferred if certain conditions are met.

Goodwill and non-controlling interests

The acquirer (parent) measures any non-controlling interest either:

1. at fair value as determined by the directors of the acquiring company (often called the 'full goodwill' method); or
2. at the non-controlling interest's proportionate share of the acquiree's (subsidiary's) identifiable net assets (this is the UK method).

The differential effect of the two methods is that (i) recognises the whole of the goodwill attributable to an acquired subsidiary, whereas (ii) only recognises the parent's share of the goodwill.

EXAMPLE 1

Parent pays $100m for 80% of Subsidiary which has net assets with a fair value of $75m. The directors of Parent have determined the fair value of the NCI at the date of acquisition was $25m.

Method (i)	Consideration	$
	Parent	100
	NCI	25
		125
	Fair value of net assets	(75)
	Consolidated goodwill on acquisition	50

In the consolidated statement of financial position the non-controlling interests would be shown as $25m.

In the above example the value of the non-controlling interests of $25m as determined by the directors of Parent is proportionate to that of Parent's consideration ($100m x 20%/80%). This is not always (in fact rarely) the case.

Method (ii)	Consideration	$
	Parent	100
	Share of fair value of net assets acquired ($75m x 80%)	(60)
	Consolidated goodwill	40

In the consolidated statement of financial position the non-controlling interest would be shown at its proportionate share of the subsidiary's net assets of $15m ($75m x 20%).

The two methods are an extension of the methodology used in IAS 36, *Impairment of Assets* when calculating the impairment of goodwill of a cash generating unit (CGU) where there is a non-controlling interest.

EXAMPLE 2
Parent owns 80% of Subsidiary (a CGU). Its identifiable net assets at 31 March 2010 are $500.

Scenario 1

	$
Net assets included in the consolidated statement of financial position	500
Consolidated goodwill (calculated under method (i))	200
	700
NCI	140

Scenario 2

	$
Net assets included in the consolidated statement of financial position	500

	$
Consolidated goodwill (calculated under method(ii))	160
	660
NCI	100

An impairment review of Subsidiary was carried out at 31 March 2010.

Required:
For scenarios 1 and 2, calculate the impairment losses and show how they would be allocated if the recoverable amount of Subsidiary at 31 March 2010 if the impairment review concluded that the recoverable of Subsidiary was:
(i) $450
(ii) $550

Answer

Scenario 1
The impairment loss is $250 (700 – 450). This loss will be first applied to goodwill (eliminating it) and then to the other net assets reducing them to $450, ie equal to the recoverable amount of the CGU. The statement of financial position would now be:

	$
Net assets (to be consolidated)	450
Consolidated goodwill	nil
	450
NCI (140 – (250 x 20%)) (see below))	90

Note: IFRS 3 requires that any impairment loss should be written of to the controlling and non-controlling interests on the same basis as that in which profits loss are allocated.

With a recoverable amount of $550, the impairment loss will be $150 and applied to the goodwill reducing it to $50. The statement of financial position would now be:

	$
Net assets (to be consolidated)	500

	$
Consolidated goodwill (under method (i))	50
	550
NCI (140 – (150 x 20%))	110

Scenario 2

Where method (ii) has been used to calculate goodwill and the non-controlling interests, IAS 36 requires a notional adjustment to the goodwill of Subsidiary, before being compared to the recoverable amount. This is because the recoverable amount relates to the value of Subsidiary as a whole (ie including all of its goodwill). The notional adjustment is always based on the non-controlling interest in goodwill being proportional to that of the parent.

	Goodwill $	Net assets $	Total $
Carrying amount – re Parent	160	500	660
Notional adjustment re NCI (see below)	40		40
	200	500	700

If the goodwill of Parent is $160 and this represents 80%, then the goodwill attributable to the NCI is deemed to be $40 ($160 x 20%/80%).

In this case, because the fair value of the non-controlling interests in scenario 1 is proportional to the consideration paid by Parent, the notional adjustment leads to the same impairment losses of $450 for (i) and $550 for (ii) as under scenario 1 (see *). Applying these:

(i) the impairment loss of $250 is again applied to eliminate goodwill and the remaining $50 is applied to reduce the other net assets. The non-controlling interest will be reduced by $10 being its share (20%) of the reduction of other net assets. This gives exactly the same statement of financial position as under scenario 1.

	$
Net assets (to be consolidated)	450
Consolidated goodwill	nil
	450
NCI (100 – 10 (50 x 20%))	90

(ii) the impairment loss of $150 would be applied to goodwill leaving the other net assets unaffected. As only Parent's share of goodwill is recognised, only 80% of the loss is applied, giving:

	$
Net assets	500
Goodwill (160 – (150 x 80%))	40
	540
NCI (unaffected)	100

From this it can be seen that the carrying amount of the CGU is now $540, which is less than the recoverable amount ($550) of the CGU. This is because the recoverable amount takes into account the unrecognised goodwill of the NCI which would be $10 (goodwill of $200 – $150 impairment) x 20%).

The problem with this methodology is that goodwill (or what is subsumed within it) is a very complex item. If asked to describe goodwill, traditional aspects such as product reputation, skilled workforce, site location, market share, and so on, all spring to mind. These are perfectly valid, but in an acquisition, goodwill may contain other factors such as a premium to acquire control, and the value of synergies (cost savings or higher profits) when the subsidiary is integrated within the rest of the group. While non-controlling interests may legitimately lay claim to their share of the more traditional aspects of goodwill, they are unlikely to benefit from the other aspects, as they relate to the ability to control the subsidiary.

*Thus, it may not be appropriate to value non-controlling interests on the same basis (proportional to) as the controlling interests (see method (i) below).

IFRS 3 illustrates the calculation of consolidated goodwill at the **date of acquisition** as:

Consideration paid by parent + non-controlling interest – fair value of the subsidiary's net identifiable assets = consolidated goodwill.

The non-controlling interest in the above formula may be valued at its fair value (method (i)) or its proportionate share of the subsidiary's net identifiable assets (method (ii)).

Subsequent to acquisition the carrying amount of the non-controlling interest (under either method) will change in proportion it is share of the post acquisition profits or losses of the subsidiary. Consolidated goodwill (under either method) will remain the same unless impaired.

The standard recognises that there may be many ways of calculating the fair value of the non-controlling interest (method (i)), one of which may be to use the market price of the subsidiary's shares prior to the acquisition (where this exists). In the Paper F7 exam this is the most common method; an alternative would be to simply give the fair value of the non-controlling interests in the question.

EXAMPLE 3

This comprehensive example is an adaptation of Question 1 from the December 2007 Paper F7 (INT) paper, and calculates goodwill based on the fair value of the non-controlling interests (method (i) above) by valuing the non-controlling interests using the subsidiary's share price at the date of acquisition (see note (iv) of the question).

On 1 October 2006, Plateau acquired the following non-current investments:

Three million equity shares in Savannah by an exchange of one share in Plateau for every two shares in Savannah, plus $1.25 per acquired Savannah share in cash. The market price of each Plateau share at the date of acquisition was $6, and the market price of each Savannah share at the date of acquisition was $3.25.

Thirty per cent of the equity shares of Axle at a cost of $7.50 per share in cash.

Only the cash consideration of the above investments has been recorded by Plateau. In addition, $500,000 of professional costs relating to the acquisition of Savannah are included in the cost of the investment.

The summarised draft statements of financial position of the three companies at 30 September 2007 are:

		Plateau $000	Savannah $000	Axle $000
Assets Non-current assets:				
Property, plant and equipment		18,400	10,400	18,000
Investments in Savannah and Axle		13,250	nil	nil
Financial asset investments		6,500	nil	nil
		38,150	10,400	18,000
Current assets:				
Inventory	6,900	6,200		3,600
Trade receivables	3,200	1,500		2,400

			Plateau $000	Savannah $000	Axle $000
Total assets		48,250	18,100		24,000
Equity and liabilities					
Equity shares of $1 each	10,000		4,000		4,000
Retained earnings					
- at 30 September 2006	16,000		6,000		11,000
- for year ended 30 September 2007	9,250		2,900		5,000
Total assets	35,250		12,900		20,000
Non-current liabilities					
7% loans		5,000	1,000		1,000
Current liabilities		8,000	4,200		3,000
Total equity and liabilities		48,250	18,100		24,000

The following information is relevant:

(i) At the date of acquisition, Savannah had five years remaining of an agreement to supply goods to one of its major customers. Savannah believes it is highly likely that the agreement will be renewed when it expires. The directors of Plateau estimate that the value

of this customer based contract has a fair value of $1m, an indefinite life, and has not suffered any impairment.

(ii) On 1 October 2006, Plateau sold an item of plant to Savannah at its agreed fair value of $2.5m. Its carrying amount prior to the sale was $2m. The estimated remaining life of the plant at the date of sale was five years (straight-line depreciation).

(iii) During the year ended 30 September 2007, Savannah sold goods to Plateau for $2.7m. Savannah had marked up these goods by 50% on cost. Plateau had a third of the goods still in its inventory at 30 September 2007. There were no intra-group payables/receivables at 30 September 2007.

(iv) At the date of acquisition the non-controlling interest in Savannah is to be valued at its fair value. For this purpose Savannah's share price at that date can be taken to be indicative of the fair value of the shareholding of the non-controlling interest. Impairment tests on 30 September 2007 concluded that neither consolidated goodwill nor the value of the investment in Axle had been impaired.

(v) The financial asset investments are included in Plateau's statement of financial position (above) at their fair value on 1 October 2006, but they have a fair value of $9m at 30 September 2007.

(vi) No dividends were paid during the year by any of the companies.

Required:
Prepare the consolidated statement of financial position for Plateau as at 30 September 2007. *(20 marks)*

Tutorial note
Note (iv) may instead have said that the fair value of the NCI at the date of acquisition was $3,250,000. Alternatively, it may have said that the goodwill attributable to the NCI was $500,000. All these are different ways of giving the same information.

Answer
Consolidated statement of financial position of Plateau as at 30 September 2007:

	$000	$000
Assets Non-current assets		
Property, plant and equipment (18,400 + 10,400 – 400 (w (i)))		28,400
Goodwill (w (ii))		5,000
Customer-based intangible		1,000
Investments – associate (w (iii)) – financial asset		10,500 9,000
		53,900
Current assets:		

	$000	$000
Inventory (6,900 + 6,200 – 300 URP (w (iv)))	12,800	
	4,700	17,500
Total assets		71,400
Equity and liabilities		
Equity attributable to equity holders of the parent		
Equity shares of $1 each (w (v))		11,500
Reserves		

	$000	$000
Share premium (w (v))	7,500	
Retained earnings (w (vi))	30,300	37,800
		49,300
Non-controlling interest (w (vii))		3,900
Total equity		53,200
Non-current liabilities		
7% Loan notes (5,000 + 1,000)		6,000

	$000	$000
Current liabilities (8,000 + 4,200)		12,200
Total equity and liabilities		71,400

Workings (figures in brackets are in $000).

(i) **Property, plant and equipment**
The transfer of the plant creates an initial unrealised profit (URP) of $500,000. This is reduced by $100,000 for each year (straight-line depreciation over five years) of depreciation in the post-acquisition period. Thus at 30 September 2007, the net unrealised profit is $400,000. This should be eliminated from Plateau's retained profits and from the carrying amount of the plant.

(ii) **Goodwill in Savannah**

	$000	$000
Controlling interest:		

	$000	$000
Shares issued (3,000/2 x $6)		9,000
Cash (3,000 x $1.25)		3,750
		12,750
Non-controlling interests		
(1 million shares at $3.25)		3,250
Total consideration		16,000
Equity shares of Savannah	4,000	

	$000	$000
Pre-acquisition reserves	6,000	
Customer-based contract	1,000	(11,000)
Consolidated goodwill		5,000

Tutorial note

The consideration given by Plateau for the shares of Savannah works out at $4.25 per share, ie consideration of $12.75m for 3 million shares. This is higher than the market price of Savannah's shares ($3.25) before the acquisition and could be argued to be the premium paid to gain control of Savannah. This is also why it is (often) appropriate to value the NCI in Savannah shares at $3.25 each, because (by definition) the NCI does not have control.

(iii) **Carrying amount of Axle at 30 September 2007**

	$000
Cost (4,000 x 30% x $7.50)	9,000
Share post-acquisition profit (5,000 x 30%)	1,500

	$000
	10,500

(iv) The unrealised profit (URP) in inventory Intra-group sales are $2.7m on which Savannah made a profit of $900,000 (2,700 x 50/150). One third of these are still in the inventory of Plateau, thus there is an unrealised profit of $300,000.

(v) The 1.5 million shares issued by Plateau in the share exchange, at a value of $6 each, would be recorded as $1 per share as capital and $5 per share as premium, giving an increase in share capital of $1.5m and a share premium of $7.5m.

(vi) **Consolidated return earnings**

	$000
Plateau's retained earnings	25,250
Professional costs of acquisition must be expensed	(500)
Savannah's post-acquisition (2,900 – 300 URP) x 75%	1,950

	$000
Axle's post-acquisition profits (5,000 x 30%)	1,500
URP in plant (see (i))	(400)
Gain on financial asset investments (9,000 – 6,500)	2,500
	30,300

(vii) NCI

Fair value at acquisition	3,250
Post-acquisition profit (2,900 – 300 URP)	650

	3,900

Note that subsequent to the date of acquisition, the non-controlling interest is valued at its fair value at acquisition plus its proportionate share of Savannah's (adjusted) post acquisition profits.

Further issues

The original question contained an impairment of goodwill; let's say that this is $1m. IAS 36 (as amended by IFRS 3) requires a goodwill impairment of a subsidiary (if a cash generating unit) to be allocated between the parent and the non-controlling interests in on the same basis as the subsidiary's profits and losses are allocated. Thus, of the impairment of $1m, $750,000 would be allocated to the parent (and debited to group retained earnings reducing them to $29.55m ($30,300,000 – $750,000)) and $250,000 would be allocated to the non-controlling interests, writing it down to $3.65m ($3,900,000 – $250,000). It could be argued that this requirement represents an anomaly. It can be calculated (though not done in this example) that of Savannah's recognised goodwill (before the impairment) of $5m only $500,000 (ie 10%) relates to the non-controlling interests, but the NCI suffers 25% (its proportionate shareholding in Savannah) of the goodwill impairment.

Written by a member of the Paper F7 examining team

Questions

Consolidated financial statements are presented on the basis that the companies within the group are treated as if they are a single economic entity.
Which of the following are requirements of preparing consolidated financial statements?
(1) All subsidiaries must adopt the accounting policies of the parent in their individual financial statements
(2) Subsidiaries with activities which are substantially different to the activities of other members of the group should not be consolidated
(3) All entity financial statements within a group should normally be prepared to the same accounting year end prior to consolidation
(4) Unrealised profits within the group must be eliminated from the consolidated financial statements

A 1 and 3
B 2 and 4
C 3 and 4
D 1 and 2

Answer: C

Chapter 7 The use of fair values in the goodwill calculation

Executive Summary

A central part of the Financial Reporting syllabus is accounting for the acquisition of a subsidiary, which will test the concept of fair value; this is the value that the consideration paid for the subsidiary must be recorded.

Both the consideration paid and the net assets of the subsidiary need to be included at fair value at the date of acquisition

In addition to this, the assets, liabilities and contingent liabilities of the subsidiary must also be consolidated at their fair value. This article considers these values in each element of the calculation.

1. Fair value of consideration
    a. **Payments in cash**
    b. **Deferred cash**
    c. **Contingent consideration**
    d. **Paying in shares**

2. Fair value of net assets
    a. **Fair value adjustments to recognised assets**
    b. **Internally generated assets**
    c. **Contingent liabilities**

The key is to not confuse the rules for accounting for items in a consolidation with the rules for individual accounting standards.

Fair value adjustments are very common in the exam, and candidates should be able to deal with these adjustments, as it is a core area of accounting for subsidiaries.

For ACCA candidates studying *Financial Reporting (FR)*, consolidated financial statements are a key topic. A central part of this syllabus area is accounting for the acquisition of a subsidiary which will test the concept of fair value; this is the value that the consideration paid for the subsidiary must be recorded. In addition to this, the assets, liabilities and contingent liabilities of the subsidiary must also be consolidated at their fair value. This article considers these values in each element of the calculation.

1. Fair value of consideration

It makes logical sense that the amount to be paid for the subsidiary must be recorded at its fair value. Accounting for a payment of cash is simple. However, complexities arise when a parent company pays for the subsidiary in a number of different ways. For the FR exam, it is vital that candidates are able to account for each of these.

(a) Payments in cash

These are the most straight forward types of consideration to deal with, as the entry is relatively simple: Dr goodwill Cr Cash with the amount paid. In an FR exam, this amount is likely to have already been recorded in the parent company's assets as investment in subsidiary. This means that candidates may need to deduct the amount of cash paid from investments and include it within the goodwill calculation.

(b) Deferred cash

In addition to cash paid immediately, there may be an element of deferred cash, being cash payable at a later date. For this to be accounted for as deferred cash, there must be no conditions attached to the payment, or this becomes contingent consideration (discussed further below). For deferred cash, the amount payable needs to be discounted to present value. This reflects the time value of money and represents the amount of money that the parent would have to put aside at the date of acquisition in order to be able to pay for the subsidiary on the due date. This is then included within goodwill and liabilities at the date of acquisition, with the entry being Dr goodwill, Cr liabilities. As this represents the present value of the consideration, this needs to be increased to the full amount over time. This process is called unwinding the discount. Each year the liability is increased by the interest rate used in the discounting. This subsequent increase is taken to finance costs, making the double entry Dr finance cost, Cr Liability.

EXAMPLE

Pratt Co acquired 80% of Swann Co on 1 January 20X1. As part of the deal, Pratt Co agreed to pay the previous owners of Swann Co $10m on 1 January 20X2. Pratt Co has a cost of capital of 10%.

Solution

As Pratt Co gained control of Swann Co on 1 January 20X1, the goodwill needs to be calculated on this date. As part of this, the $10m is payable in 1 year. The present value of $10m in one year is $9.091m ($10m x 1/1.10). This is recorded in goodwill, with an equivalent liability set up within current liabilities, as the amount is payable in 12 months.

By the 31 December 20X1, the amount is now payable in one day. The previous owners of Swann Co will be contacting Pratt Co in one day requesting the payment of $10m. Therefore Pratt Co is required to show a liability of $10m in its financial statements at this date. Currently, Pratt Co is showing a liability of $9.091m. Therefore this needs to be increased by 10% (the interest). This increase of $909k ($9091 x 10%) is added to the liability and recorded as a finance cost.

It is important to note that this does not affect the goodwill calculation in any way. Goodwill is calculated at the date of acquisition, and subsequent changes to the consideration payable are not adjusted in the goodwill calculation.

(c) Contingent consideration
Contingent consideration also relates to amounts payable to the previous owners in the future. However, the key difference is that the payment of these amounts is conditional upon certain events, such as the subsidiary performance hitting certain targets after acquisition.

Therefore these will be recorded as a provision, as the amount payable is likely to have an element of uncertainty (remember that a provision is a liability of uncertain timing or amount). This is where it is important to tread carefully. While this is recorded as a provision in the financial statements, the criteria of IAS® 37 Provisions, contingent liabilities and contingent assets does not apply here. When we are producing consolidated financial statements we must apply the principle of using the fair value of consideration, as stated by IFRS® 3, *Business Combinations*.

The fair value of the contingent consideration payable will be a mix of the likelihood of the event, and a reflection of the time value of money. However, it is important not to overthink things. They key here is that the fair value of the contingent consideration will be given to you in the exam. This needs to be included in the goodwill on the date of acquisition with the double entry Dr goodwill, Cr provision.

Again, the fair value of the consideration is likely to have changed by the year end. This is treated as a subsequent movement in the provision, with the subsequent increase or decrease being taken through the statement of profit or loss. Just like with the deferred consideration, this does not affect the calculation of goodwill in any way.

EXAMPLE
Pratt Co also commits to paying $10m to Swann Co in two years if the results of Swann Co continue to grow by 5% over that period. An external valuer has assessed that this is not likely so estimates the fair value of this to be $4m at 1 January 20X1. At 31 December 20X1, this has increased and now the valuer assesses the fair value to be $6m.

Solution
Many candidates fall into the trap of stating that this is not likely so no liability should be recorded. In the individual financial statements, this would be true, but when there is a conflict between the treatment in consolidated financial statements and the individual

financial reporting treatment, the consolidated rules would take priority. So while the outflow may not be probable, IFRS 3 states that the consideration must be recorded at fair value.

Therefore on 1 January 20X1 the fair value of $4m is added to the consideration in the goodwill calculation and to provisions as a non-current liability.

At 31 December 20X1, this has increased from $4m to $6m. This increase of $2m is not added to goodwill, but is instead expensed to the statement of profit or loss to reflect the increase in the provision with the double entry Dr P/L, Cr provision. As the amount is now potentially payable in one year, this will be moved from non-current liabilities to current liabilities.

(d) Paying in shares

In addition to the potential cash payments outlined above, the parent company may also decide to pay for the subsidiary by giving the subsidiary's previous owners new shares in the parent company. The double entry for this is similar to the double entry for a normal share issue.

The issue of shares at market value usually results in the receipt of cash, the nominal value being taken to share capital and the excess being recorded in share premium/other components of equity. This is similar to what is happening here, but no cash is changing hands. Instead of the parent company receiving cash for the shares, they are receiving a subsidiary.

The double entry for this is therefore to debit the full market value to goodwill, credit the share capital figure in the consolidated statement of financial position with the nominal amount and to take the excess to share premium/other components of equity, also in the consolidated statement of financial position.

EXAMPLE

Pratt Co acquired 80% of Swann Co's $5m share capital, which consisted of $1 ordinary shares. As part of the consideration for Swann Co, Pratt Co gave the previous owners of Swann Co 2 $1 shares in Pratt Co for every 5 shares it acquired in Swann Co. At 1 January 20X1, Pratt Co's shares had a market value of $3.50.

Solution

Pratt Co has acquired 80% of Swann Co's shares, meaning it has acquired 4m shares (80% of the 5m shares in Swann Co). Therefore it issued 1.6m Pratt Co shares, being 4m x 2/5. These 1.6m shares had a fair value of $5.6m (1.6m x $3.50).

To record this, Pratt Co must add the full fair value of the consideration of $5.6m as part of the consideration in the calculation of goodwill. $1.6m must be added to share capital in the consolidated statement of financial position, being 1.6m shares x $1 nominal value. This means that the excess of $4m is added to share premium/other components of equity in the statement of financial position.

2. Fair value of net assets

In addition to recording the consideration paid at fair value, the fair value of the net assets of the subsidiary at acquisition must be assessed as part of the consolidation, in order to give an accurate picture of the goodwill arising on the acquisition.

If a parent company was to buy an individual asset from the subsidiary, say an item of property, this would be done at whatever the market price of the asset is, irrespective of its carrying amount in the selling entity's statement of financial position. This same principle is applied to the acquisition of the entire entity. Upon selling the entity, the previous owners would base the selling price on the fair value of the assets, rather than their carrying amounts. Therefore, the consolidated financial statements must make adjustments to consolidate the subsidiary's assets and liabilities at fair value at the date of acquisition. In the Financial Reporting exam, this could occur in three different ways.

(a) Fair value adjustments to recognised assets
Assets such as property, plant and equipment, or inventory will be recognised in the subsidiary's financial statements at their carrying amounts. Adjustments must be made to reflect the fair value of these assets.

For example, inventory must be held in the financial statements of the subsidiary at the lower of cost and net realisable value, but must be recognised in the consolidated financial statements at fair value on acquisition. Similarly, the subsidiary may hold property under the cost model, but this must be accounted for at fair value in the consolidated financial statements.

In terms of depreciable non-current assets, a fair value adjustment is applied at the date of acquisition, similar to applying the revaluation model under IAS 16, *Property, Plant and Equipment*. However, during the consolidation process, a revaluation surplus is not created. The effect of adding a fair value adjustment to the asset is that the value of goodwill will decrease. This is because goodwill is the difference between the consideration paid and the identifiable net assets of the entity. Therefore as the fair value adjustment increases the net assets, it produces a lower, more accurate picture of the actual goodwill in the subsidiary.

As the group must make these fair value adjustments at acquisition, there is also an additional depreciation adjustment to be made to depreciable assets. The increase to fair value is not recorded in the subsidiary's individual financial statements but is a consolidation adjustment and so the additional depreciation is a consolidation adjustment too. This means that the subsidiary's depreciation in its financial statements is based on the carrying amount of the asset before the fair value adjustment has been made. As the fair value adjustment increases the value of the asset, the additional depreciation on this must also be accounted for.

In the statement of profit or loss, this year's depreciation expense on the fair value adjustment must be included. In the statement of financial position, it is the cumulative depreciation in all the years since acquisition that must be adjusted. In both cases, the subsidiary's profits will reduce following the adjustment for this fair value depreciation. This

means that both the parent's share and the non-controlling interest's share of the post-acquisition profits will also be affected and must be reduced.

(b) Internally generated assets
The subsidiary may also have internally generated assets that are unrecognised in its individual financial statements. This is correct, particularly in relation to intangibles, as most are prohibited from being capitalised under IAS 38, *Intangible Assets*. In the consolidated financial statements these will need to be recognised at fair value if they are identifiable, meaning they could either be separated from the subsidiary or arise from legal or contractual rights.

This means that items such as internally generated brands or research expenditure could be capitalised in the consolidated statement of financial position, despite not meeting the criteria for capitalisation per IAS 38, *Intangible Assets*. Here, we can see again that IFRS 3, *Business Combinations*, overrules the 'usual' rule for individual accounting treatment.

The process of recording the fair value adjustment will be almost identical to that noted above. The only difference is that it may lead to the creation of a new intangible asset which is currently unrecognised. It will still have the effect of increasing non-current assets and reducing goodwill. As this asset has a limited useful life, it must be amortised over that remaining life. If it is deemed to have an indefinite life, it will be subject to an annual impairment review.

(c) Contingent liabilities
This is probably the area that most candidates find difficult in the exam. Many candidates have correctly learned the rule per IAS 37 that contingent liabilities are only disclosed in the notes to the financial statements, and are not recognised in the financial statements themselves as a liability. For individual financial statements, this is completely true. For consolidated financial statements, this is not the case. In this case, these need to be included in the consolidated statement of financial position at fair value.

These contingent liabilities must be recognised in the consolidated financial statements at their fair value as they will have affected the price that a parent company is willing to pay for the subsidiary, This is because the parent company will have offered a lower price for the subsidiary knowing that the subsidiary may have a potential payout to make in the future, even if they do not deem that to have a high probability of being paid.

These contingent liabilities need to be consolidated at fair value as a liability at the date of acquisition. This will reduce the net assets at acquisition, and therefore increase the goodwill. Any subsequent fair value movements in this contingent liability are recognised in the statement of profit or loss, rather than affecting the goodwill calculation.

Summary

As we have seen, both the consideration paid and the net assets of the subsidiary need to be included at fair value at the date of acquisition. More often than not, the fair value of

items will be provided in the Financial Reporting exam, such as the fair value adjustment required to net assets, or the fair value of contingent consideration. For the calculation of items such as deferred cash or an issue of shares, the information will be given which allows candidates to calculate the entries.

The key is to not confuse the rules for accounting for items in a consolidation with the rules for individual accounting standards. As we have seen above, the fair value adjustments will overrule the usual accounting treatment, so this is a vital area to be aware of in order to score well within a consolidation question. Fair value adjustments are very common in the exam, and candidates should be able to deal with these adjustments, as it is a core area of accounting for subsidiaries.

Written by a member of the *Financial Reporting* examining team

Questions

On 1 July 20X5, Pull Co acquired 80% of the equity of Sat Co. At the date of acquisition, goodwill was valued at $10,000 and the non-controlling interest was measured at fair value. In conducting the fair value exercise on Sat Co's net assets at acquisition, Pull Co concluded that property, plant and equipment with a remaining life of ten years had a fair value of $300,000 in excess of its carrying amount. Sat Co had not incorporated this fair value adjustment into its individual financial statements. At the reporting date of 31 December 20X5, the goodwill was fully impaired. For the year ended 31 December 20X5, Sat Co reported a profit for the year of $200,000.

REQUIRED:

What is the Pull Group profit for the year ended 31 December 20X5 that is attributable to non-controlling interests?

A $16.000

B $12,000

C $35,000

D $15,000

Answer: D

The correct answer is D.

Subsidiary profits ($200,000 x 6/12) $100,000;

Write-off of goodwill = (10,000);

Additional depreciation (300,000/10 x 6/12) = (15,000)

100,000 – 10,000 – 15,000 = 75,000 NCI @ 20% 15,000

Chapter 8 Impairment of goodwill

Executive Summary

This article discusses and shows both ways of measuring goodwill following the acquisition of a subsidiary, and how each measurement of goodwill is subject to an impairment review.

Goodwill calculation (2 methods) –

1. The established measurement of goodwill on the acquisition of a subsidiary is the excess of the fair value of the consideration given by the parent over the parent's share of the fair value of the net assets acquired. This method can be referred to as the proportionate method. It determines only the goodwill that is attributable to the parent company.
2. The more recent method, following the revision to IFRS 3, of measuring goodwill on the acquisition of the subsidiary is to compare the fair value of the whole of the subsidiary with all of the fair value of the net assets of the subsidiary acquired. This method can be referred to as the gross or full goodwill method. It determines the goodwill that relates to the whole of the subsidiary, ie goodwill that is both attributable to the parent's interest and the non-controlling interest (NCI).

Basic principles of impairment

An asset is impaired when its carrying value exceeds the recoverable amount. The recoverable amount is, in turn, defined as the higher of the fair value less cost to sell and the value in use; where the value in use is the present value of the future cash flows.

Following the revisions to IFRS 3, *Business Combinations*, in January 2008, there are now two ways of measuring the goodwill that arises on the acquisition of a subsidiary and each has a slightly different impairment process.

This article discusses and shows both ways of measuring goodwill following the acquisition of a subsidiary, and how each measurement of goodwill is subject to an annual impairment review.

How to calculate goodwill

The established measurement of goodwill on the acquisition of a subsidiary is the excess of the fair value of the consideration given by the parent over the parent's share of the fair value of the net assets acquired. This method can be referred to as the proportionate method. It determines only the goodwill that is attributable to the parent company.

The more recent method, following the revision to IFRS 3, of measuring goodwill on the acquisition of the subsidiary is to compare the fair value of the whole of the subsidiary (as represented by the fair value of the consideration given by the parent and the fair value of the non controlling interest) with all of the fair value of the net assets of the subsidiary acquired. This method can be referred to as the gross or full goodwill method. It determines the goodwill that relates to the whole of the subsidiary, ie goodwill that is both attributable to the parent's interest and the non-controlling interest (NCI).

You should note that either method is acceptable and therefore for the FR exam you need to be able to apply both approaches. You will be given a clear indication of which method the examiner wishes you to use.

Consider calculating goodwill

Borough acquires an 80% interest in the equity shares of High for consideration of $500. The fair value of the net assets of High at that date is $400. The fair value of the NCI at that date (ie the fair value of High's shares not acquired by Borough) is $100.

Required
1. Calculate the goodwill arising on the acquisition of High on a proportionate basis.
2. Calculate the gross goodwill arising on the acquisition of High, ie using the fair value of the NCI.

Solution
1. The proportionate goodwill arising is calculated by matching the consideration that the parent has given, with the interest that the parent acquires in the net assets of the subsidiary, to give the goodwill of the subsidiary that is attributable to the parent.

Parent's cost of investment at the fair value of consideration given		$500
Less the parent's share of the fair value of the net assets of the subsidiary acquired	(80% x $400)	($320)
Goodwill attributable to the parent		$180

2. The gross goodwill arising is calculated by matching the fair value of the whole business with the whole fair value of the net assets of the subsidiary to give the whole goodwill of the subsidiary, attributable to both the parent and to the NCI.

Parent's cost of investment at the fair value of consideration given		$500
Fair value of the NCI		$100
Less the fair value of the net assets of the subsidiary acquired	(100% x $400)	($400)
Gross goodwill		$200

Given a gross goodwill of $200 and a goodwill attributable to the parent of $180, the goodwill attributable to the NCI is the difference of $20.

In these examples, goodwill is said to be a premium arising on acquisition. Such goodwill is accounted for as an intangible asset in the group accounts, and as we shall see later, be subject to an annual impairment review.

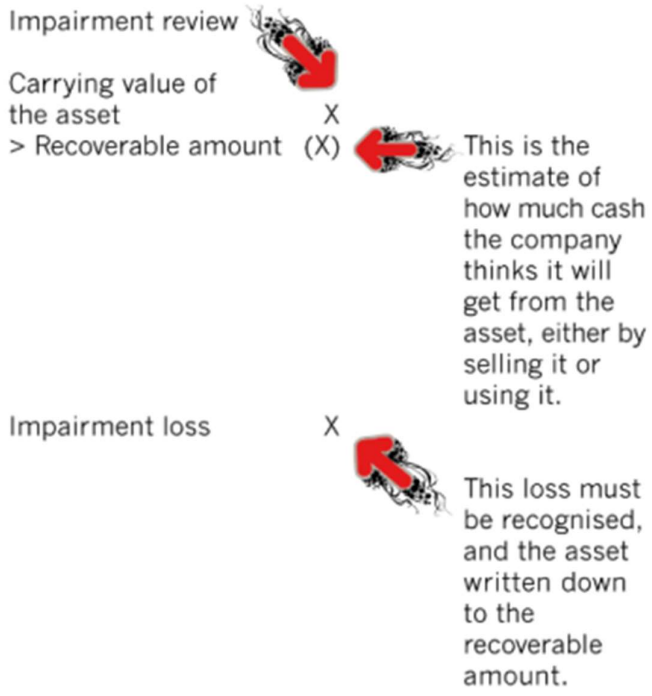
In the event that there is a bargain purchase, ie negative goodwill arises, then this is regarded as a gain and immediately recognised in the group statement of profit or loss on the acquisition date. In subsequent years this will be an adjustment to the group retained earnings.

Basic principles of impairment

An asset is impaired when its carrying value exceeds the recoverable amount. The recoverable amount is, in turn, defined as the higher of the fair value less cost to sell and the value in use; where the value in use is the present value of the future cash flows.

An impairment review calculation looks like this.

This is the net book value, ie the figure that the asset is currently recorded at in the accounts.



Consider an impairment review

A company has an asset that has a carrying value of $800. The asset has not been revalued. The asset is subject to an impairment review. If the asset was sold then it would sell for $610 and there would be associated selling costs of $10. (The fair value less costs to sell of the asset is therefore $600.) The estimate of the present value of the future cash flows to be generated by the asset if it were kept is $750. (This is the value in use of the asset.)

Required
Determine the outcome of the impairment review.

Solution
An asset is impaired when its carrying value exceeds the recoverable amount, where the recoverable amount is the higher of the fair value less costs to sell and the value in use. In this case, with a fair value less cost to sell of only $600 and a value in use of $750 it both follows the rules, and makes common sense to minimise losses, that the recoverable amount will be the higher of the two, ie $750.

Impairment review

Carrying value of the asset	$800
Recoverable amount	($750)
Impairment loss	$50

The impairment loss must be recorded so that the asset is written down. There is no accounting policy or choice about this. In the event that the recoverable amount had exceeded the carrying amount then there would be no impairment loss to recognise and as there is no such thing as an impairment gain, no accounting entry would arise.

As the asset has never been revalued, the loss has to be charged to profit or loss. Impairment losses are non-cash expenses, like depreciation, so in the statement of cash flows they will be added back when reconciling profit before tax to cash generated from operating activities (indirect method) or removed as a non-cash expense to arrive at the cash outflows under the direct method. This is the same treatment as other non-cash expenses like depreciation and amortisation.

Assets are generally subject to an impairment review only if there are indicators of impairment. IAS 36, *Impairment of Assets* lists examples of circumstances that would trigger an impairment review.

External sources

- market value declines
- negative changes in technology, markets, economy, or laws
- increases in market interest rates

- company share price is below book value

Internal sources

- obsolescence or physical damage
- asset is part of a restructuring or held for disposal
- worse economic performance than expected

However certain intangible assets must be assessed for impairment annually, irrespective of whether there are indications of impairment. These are:

- assets with an indefinite useful life
- assets not yet available for use
- goodwill acquired in a business combination

Goodwill and impairment

The asset of goodwill does not exist in a vacuum; rather, it arises in the group accounts because it is not separable from the net assets of the subsidiary that have just been acquired.

The impairment review of goodwill therefore takes place at the level of a cash-generating unit, that is to say a collection of assets that together create an stream of cash independent from the cash flows from other assets. The cash-generating unit will normally be assumed to be the subsidiary. In this way, when conducting the impairment review, the carrying value will be that of the net assets and the goodwill of the subsidiary compared with the recoverable amount of the subsidiary.

When looking to assign the impairment loss to particular assets within the cash generating unit, unless there is an asset that is specifically impaired, it is goodwill that is written off first, with any further balance being assigned on a pro rata basis.

The goodwill arising on the acquisition of a subsidiary is subject to an annual impairment review. This requirement ensures that the asset of goodwill is not being overstated in the group accounts. Goodwill is an asset that cannot be revalued so any impairment loss will automatically be charged against profit or loss. Goodwill is not deemed to be systematically consumed or worn out thus there is no requirement for a systematic amortisation unlike most intangible assets.

Proportionate goodwill and the impairment review

When goodwill has been calculated on a proportionate basis then for the purposes of conducting the impairment review it is necessary to gross up goodwill so that in the impairment review goodwill will include an unrecognised 'notional goodwill' attributable to the NCI.

Any impairment loss that arises is first allocated against the total of recognised and unrecognised goodwill in the normal proportions that the parent and NCI share profits and losses.

Any amounts written off against the notional goodwill will **not** affect the consolidated financial statements and NCI. Any amounts written off against the recognised goodwill will be attributable to the parent only, without affecting the NCI.

If the total amount of impairment loss exceeds the amount allocated against recognised and notional goodwill, the excess will be allocated against the other assets on a pro rata basis. This further loss will be shared between the parent and the NCI in the normal proportion that they share profits and losses.

An example should make this rule clearer.

Consider an impairment review of proportionate goodwill

At the year-end, an impairment review is being conducted on a 60%-owned subsidiary. At the date of the impairment review the carrying value of the subsidiary's net assets were $250 and the goodwill attributable to the parent $300 and the recoverable amount of the subsidiary $700.

Required
Determine the outcome of the impairment review.

Solution
In conducting the impairment review of proportionate goodwill, it is first necessary to gross it up.

Proportionate goodwill	Grossed up	Goodwill including the notional unrecognised NCI
$300 x	100/60 =	$500

Now, for the purposes of the impairment review, the goodwill of $500 together with the net assets of $250 form the carrying value of the cash-generating unit.

Impairment review

Carrying value	
Net assets	$250
Goodwill	$500
	$750
Recoverable amount	($700)
Impairment loss	$50

The impairment loss does not exceed the total of the recognised and unrecognised goodwill so therefore it is only goodwill that has been impaired. The other assets are not impaired. As proportionate goodwill is only attributable to the parent, the impairment loss will not impact NCI.

Only the parent's share of the goodwill impairment loss will actually be recorded, ie 60% x $50 = $30.

The impairment loss will be applied to write down the goodwill, so that the intangible asset of goodwill that will appear on the group statement of financial position will be $270 ($300 – $30).

In the group statement of financial position, the accumulated profits will be reduced $30. There is no impact on the NCI.

In the group statement of profit or loss, the impairment loss of $30 will be charged as an extra operating expense. There is no impact on the NCI.

Gross goodwill and the impairment review

Where goodwill has been calculated gross, then all the ingredients in the impairment review process are already consistently recorded in full. Any impairment loss (whether it relates to the gross goodwill or the other assets) will be allocated between the parent and the NCI in the normal proportion that they share profits and losses.

Consider an impairment review of gross goodwill

At the year-end, an impairment review is being conducted on an 80%-owned subsidiary. At the date of the impairment review the carrying value of the net assets were $400 and the gross goodwill $300 (of which $40 is attributable to the NCI) and the recoverable amount of the subsidiary $500.

Required
Determine the outcome of the impairment review.

Solution
The impairment review of goodwill is really the impairment review of the net asset's subsidiary and its goodwill, as together they form a cash generating unit for which it is possible to ascertain a recoverable amount.

Impairment review

Carrying value	
Net assets	$400
Goodwill	$300
	$700

Carrying value	
Recoverable amount	$500
Impairment loss	$200

The impairment loss will be applied to write down the goodwill, so that the intangible asset of goodwill that will appear on the group statement of financial position, will be $100 ($300 – $200).

In the equity of the group statement of financial position, the accumulated profits will be reduced by the parent's share of the impairment loss on the gross goodwill, ie $160 (80% x $200) and the NCI reduced by the NCI's share, ie $40 (20% x $200).

In the statement of profit or loss, the impairment loss of $200 will be charged as an extra operating expense. As the impairment loss relates to the gross goodwill of the subsidiary, so it will reduce the NCI in the subsidiary's profit for the year by $40 (20% x $200).

Observation

In passing, you may wish to note an apparent anomaly with regards to the accounting treatment of gross goodwill and the impairment losses attributable to the NCI. The goodwill attributable to the NCI in this example is stated as $40. This means that goodwill is $40 greater than it would have been if it had been measured on a proportionate basis; likewise, the NCI is also $40 greater for having been measured at fair value at acquisition.

The split of the gross goodwill between what is attributable to the parent and what is attributable to the NCI is determined by the relative values of the NCI at acquisition to the parent's cost of investment. However, when it comes to the allocation of impairment losses attributable to the write off of goodwill then these losses are shared in the normal proportions that the parent and the NCI share profits and losses, ie in this case 80%/20%.

This explains the strange phenomena that while the NCI are attributed with only $40 out of the $300 of the gross goodwill, when the gross goodwill was impaired by $200 (ie two thirds of its value), the NCI are charged $40 of that loss, representing all of the goodwill attributable to the NCI.

Tom Clendon and Sally Baker are tutors at Kaplan Financial

Questions

On 1 January 20X5, Pratt Co acquired 80% of the equity shares of Sam Co. Pratt Co values noncontrolling interests at fair value and, at the date of acquisition, goodwill was valued at $20,000. At 31 December 20X5, the goodwill was fully impaired.

In conducting the fair value exercise of Sam Co's net assets at acquisition, Pratt Co concluded that property, plant and equipment, with a remaining life of five years, had a fair value of $5,000 in excess of its carrying amount.

Sam Co has not incorporated any of these adjustments into its individual financial statements.
What is the total charged to group retained earnings at 31 December 20X5 as a result of these consolidation adjustments?

A $16,800
B $21,000
C $17,000
D $20,800

Answer: A

The additional depreciation charged as a result of fair value adjustment is:
$5,000/5 = $1,000;
$1,000 (depreciation)+ $20,000 (impairment of goodwill) = $21,000 x 0.8 = $16,800

Chapter 9 Financial Instruments

Executive Summary

International Financial Reporting Standard (IFRS®) 9, Financial Instruments, is a complex standard, especially for users and preparers of financial statements. It is relevant to the Financial Reporting syllabus, so this article takes a high-level review of its application to financial assets, financial liabilities, and convertibles.

There are two types of financial asset (equity and debt instruments), which can be further split into different categories.

In the FR exam, financial liabilities will be held at amortised cost.

Convertible instruments are instruments which give the holder the right to either demand repayment of the principle amount or to write off the debt and instead convert the balance into shares. In the FR exam, you will only have to deal with convertible instruments from the perspective of the issuer, being the person who has received the cash.

Financial instruments is one of the most technical areas of the syllabus, but also one of the central areas which will be further developed in *Strategic Business Reporting*.

International Financial Reporting Standard (IFRS®) 9 Financial Instruments is a complex standard, especially for users and preparers of financial statements. It is therefore no surprise that ACCA candidates also find it complex. Indeed, there is a well-known quote from a previous Chair of the International Accounting Standards Board (the Board) who said: 'If you understand this [standard], you haven't read it properly.'

IFRS 9 is relevant to the *Financial Reporting (FR)* syllabus, and so this article takes a high-level review of its application to the following:

1. Financial assets
2. Financial liabilities
3. Convertibles

1. Financial assets

There are two types of financial asset (equity and debt instruments), which can be further split into different categories.

(a) Equity investments
Equity instruments are likely to be shares that have been purchased in a company, but not enough to give the investee significant influence (associate), control (subsidiary) or joint control (joint venture).

There are two options here, depending on the intention of the entity. The default category is fair value through profit or loss (FVPL).

Equity instruments: fair value through profit or loss (FVPL)
FVPL is the default treatment for equity investments where transaction costs such as broker fees are expensed and not capitalised within the initial cost of the asset. Subsequently, the investment is revalued to fair value at each year end, with the gain or loss being taken to the statement of profit or loss.

Alternatively, equity instruments can be classified as fair value through other comprehensive income (FVOCI). It is important to note that this designation must be made on acquisition and the equity investments cannot retrospectively be treated as FVPL. This is only an option if the equity investment is intended to be a long-term investment.

Equity instruments: fair value through other comprehensive income (FVOCI)
Using FVOCI, the alternative treatment, transaction costs can be capitalised as part of the initial cost of the investment. Similar to FVPL, the instrument would then be revalued to fair value at the year end. The big difference is where the gain or loss is recorded. In FVOCI, the gain or loss is recognised within Other Comprehensive Income and held in an investment reserve. In this way it is similar to the accounting for property, plant and

equipment using the revaluation model. However unlike the treatment for a revaluation surplus, there can be a negative FVOCI reserve.

When the FVOCI instrument is sold, the reserve can be left in equity, or transferred into retained earnings.

(b) Debt instruments

These are usually bonds or loan notes, or other instruments which are likely to carry interest and a capital element of repayment. The treatment of the debt instrument depends on the intention of the entity, and there are three options for categorising debt instruments.

Debt instruments: fair value through other profit or loss (FVPL)

The default category is FVPL, but this is rare within ACCA exams and it is much more common to apply one of the two alternative treatments, being amortised cost or FVOCI.

Debt instruments: amortised cost

To apply this treatment, the instrument must pass two tests; first the business model test and secondly the contractual cash flow characteristics test.

- **Business model test** – the entity must intend to hold the instrument in order to collect the interest payments and receive repayment on maturity.
- **Contractual cash flow characteristics test** – the contractual terms give rise to cash flows which are solely repayments of the interest and principle amount.

In the FR exam, it will only be the first test which may (or may not) be met, so management must decide on their intention for holding the debt instrument. This treatment tends to be the most common in exam scenarios, as it allows the examiner to test the principles of amortised cost accounting.

The principles of amortised cost accounting require that interest must be recorded on the amount outstanding. This is relatively straight forward for many instruments. For example, on a $10m 5% loan, with $10m repayable at the end of a three-year term, interest would simply be recorded as $500,000 a year.

The issues arise when the balance may be repaid at a premium. For example, the terms of the $10m loan, issued on 1 January 20X1, may be that the holder receives interest of 5% a year, but then receives $11m back at the end of the three year term, on 31 December 20X3. This means that the holder is now earning interest in two different ways. Firstly, they are earning the 5% payment each year. Secondly, they are earning another $1m interest over three years in the form of receiving more money back than they invested.

IFRS 9, *Financial Instruments*, requires that a constant rate of interest is applied to this balance to better reflect the reality of the situation. This rate takes into account both the annual payment and the premium payable on redemption. In the FR exam, this rate will be provided in the question. The question will provide information about the effective rate of

interest. Let's say that in this example, the effective rate of interest is 8.08%. This rate is applied to the outstanding balance each year in order to calculate the interest earned on the investment, which is the amount to be recorded in investment income in the statement of profit or loss.

The easiest way to do this is often to use a table showing the movement of the asset.

	Balance 1 Jan $'000	**Interest 8.08% $'000**	**Payment $'000**	**Balance 31 Dec $'000**
20X1	10,000	808	-500	10,308
20X2	10,308	833	-500	10,641
20X3	10,641	859	-500	11,000

The figures in the interest column would be the amounts recorded as investment income in the statement of profit or loss each year. This is increasing to reflect the fact that the amount owed is increasing as it gets closer to redemption.

The balance in the final column reflects the amount owed to the entity at each year end, and shows how the balance outstanding increases from $10m to $11m over the three year period.

The double entries for the asset in year one would be as follows:

1 January 20X1 – The $10m loan is given to the third party. This reduces the entity's cash balance, but creates a long-term receivable of $10m, meaning the entry is Dr Receivable $10m, Cr Cash $10m.

The interest then accrues over the year at the effective rate of 8.09%. This increases the amount of the receivable and is recorded in investment income, so the entry is Dr Receivable $808k, Cr Investment income $808k.

31 December 20X1 – The entity receives a payment of $500,000, being 5% of the original $10m loaned. This figure will be the same each year. This reduces the value owed to the entity, so the entry is Dr Cash $500k, Cr Receivable $500k.

The result of these entries is that the entity has a closing receivable of $10.308m. This will all be held as a non-current asset, as the amount is not receivable until 31 December 20X3.

This would carry on for the next two years, until the full amount is repaid at 31 December 20X3 with the entry Dr Cash $11m, Cr Receivable $11m.

The total interest to be recorded in the statement of profit or loss over the three years is $2.5m, being the $808k + $833k + $859k. This $2.5m represents all the interest earned by the entity over the three years. This consists of the $1.5m annual payments ($500k a year), and the additional $1m received (the difference between loaning the $10m and receiving the $11m).

Debt instruments: fair value through other comprehensive income (FVOCI)
The final possible treatment for a debt instrument is to hold it at fair value through other comprehensive income (FVOCI). Similar to holding the instrument at amortised cost, two tests must be passed in order to hold a debt instrument in this manner.

- **Business model test** – the entity intends to hold the instrument in order to collect the interest payments and receive repayment on maturity, but may sell the asset if the possibility of buying one with a greater return arises.
- **Contractual cash flow characteristics test** – the contractual terms give rise to cash flows which are solely repayments of the interest and principle amount.

Again, it is only the first of these that candidates will need to consider in the FR exam, highlighting that the choice of category will depend on the intention of management.

If the entity chooses to hold the debt instrument under the FVOCI or FVPL category, they will still produce the amortised cost table as above, taking the same figure to investment income. At the year end, the asset would then be revalued to fair value, with the gain or loss being recorded in either the statement of profit or loss if classed as FVPL or in other comprehensive income if classified as FVOCI.

2. Financial liabilities

In the FR exam, financial liabilities will be held at amortised cost. These will be similar to the treatment shown earlier for assets held under amortised cost. Instead of having investment income and an asset, there will be a finance cost and a liability. The major difference in the accounting treatment relates to the initial treatment upon issue of the financial liability. Initially these are recognised at NET PROCEEDS, being the cash received net of any issue costs.

Therefore if an entity looks to raise $10m of funding, but pays a broker $200,000 for raising the finance, the initial double entry is to Dr Cash $9.8m and Cr Liability with the $0.2m. Taking the $200,000 immediately to the statement of profit or loss is incorrect because this fee must be spread over the life of the instrument. This is effectively done by applying the effective interest rate to the outstanding liability, which as we stated earlier will be given to the candidates in the exam.

Here, the effective interest rate on the liability now incorporates up to three elements. It would incorporate the annual interest payable, any premium repayable on redemption, and any issue costs. This is shown in the example below.

EXAMPLE
Oviedo Co issued $10m 5% loan notes on 1 January 20X1, incurring $200,000 issue costs. These loan notes are repayable at a premium of $1m on 31 December 20X3, giving them an effective interest rate of 8.85%.

In the above example, the 5% relates to the coupon rate, which is the amount required as an annual payment each year. This is always based on the face (par) value of the instrument, so means that $500,000 will be payable annually (being 5% of $10m).

As seen in the earlier example relating to financial assets held at amortised cost, the effective interest rate will be applied to the outstanding balance in each period. Again, a table is the easiest way to calculate this, as shown below.

	Balance 1 January $'000	**Interest 8.85% $'000**	**Payment $'000**	**Balance 31 December $'000**
20X1	9,800	867	-500	10,167
20X2	10,167	900	-500	10,567
20X3	10,567	933	-500	11,000

The entries in 20X1 will be as follows:

1 January 20X1 – The loan is issued, meaning that Oviedo Co receives $9.8m, being the $10m less the issue costs. Therefore the entries are Dr Cash $9.8m, Cr Liability $9.8m.

Over the year, interest on the liability is accrued at the effective interest rate of 8.85%, giving the entry Dr Finance cost $867k, Cr Liability $867k.

31 December 20X1 – The payment of $500k is made, giving the entry Dr Liability $500k, Cr Cash $500k.

This leaves a closing liability of $10.167m. This will all be sat as a non-current liability, as none of it will be repayable until 31 December 20X3.

If we look at the interest column, we will see that the total interest paid is $2.7m ($867k + $900k + $933k). This is the total which will be expensed to the statement of profit or loss over the three year period. This amount consists of three elements:

- $1.5m in annual payments ($500k a year)
- $1m premium repaid (issued $10m loan, but repaid $11m)
- $200k issue costs

As we can see, the issue costs have been expensed over three years, rather than being expensed immediately in 20X1.

3. Convertibles

Convertible instruments are instruments which give the holder the right to either demand repayment of the principle amount or to write off the debt and instead convert the balance into shares. In the FR exam, you will only have to deal with convertible instruments from the perspective of the issuer, being the person who has received the cash.

Convertible instruments present a special challenge, as these could ultimately result in the issue of shares or the repayment of the loan, but the choice will be in the hand of the holder. As we do not know whether the holder will choose to receive the cash or convert the instrument into shares, we must reflect an element of both within the financial statements. Therefore these are accounted for initially using **split accounting**, splitting it into the equity and liability components.

The liability component is the first thing to calculate. We work this out by calculating the present value of the payments at the **market rate** of interest (using the interest on an equivalent bond without the conversion option). The discount rates required to do this will be given to you in the exam.

In reality the market rate of interest will be higher than the coupon rate, being the annual amount payable to the holder of the loan. This is because the holder of the loan is willing to accept a lower rate of annual interest compared to the market, in exchange for the option to convert the loan into shares.

Once the liability component has been calculated, the equity component is then worked out. This is simply a balancing figure, and represents the difference between the cash received and the liability component.

EXAMPLE
Oviedo Co issued $10m 5% convertible loan notes on 1 January 20X1. These will either be repaid at par on 31 December 20X3, or converted into shares on that date. Equivalent loan notes without the conversion carry an interest rate of 8%. Relevant discount rates are

shown below.

Amount payable in:	Discount factor at 5%	Discount factor at 8%
1 year	0.952	0.926
2 years	0.907	0.857
3 years	0.864	0.794

it is important to note that the 5% discount rates are a red herring . It is the discount rates for the market rate of interest that are important, i.e. 8%. The only thing we need the 5% for is to work out the annual payment. As these are $10m 5% loan notes, this simply means that Oviedo Co will need to make an annual payment of $500k in relation to these.

Therefore we can work out the value that the market would place on these loan notes by looking at the present value of all the payments, discounted at the market rate of interest. If this is a normal loan, ignoring the conversion, Oviedo Co would pay $500k in years 20X1 to 20X3, and then make a final repayment of $10m on 31 December 20X3.

As the market rate of interest is 8%, the present value of these payments can be calculated. These are calculated in the table below.

Year	Payment $'000	Discount factor 8%	Present value $'000
20X1	500	0.926	463
20X2	500	0.857	428.5
20X3	10,500	0.794	8,337
Total			**9,229**

The present value of all of the payments can be seen as $9.229m. This means that Oviedo Co received $10m, but the present value of the payments to be made have an initial value of only $9.229m. As a result, the holders of the loan notes are effectively losing $771k

compared to if they had simply given Oviedo Co a normal loan at the market rate of interest.

This $771k is the amount of interest the holders are willing to lose in order to have the option to convert the loan into shares. This is taken as the initial value of the equity element.

On 1 January 20X1, the double entry to record the transaction in the records of Oviedo Co are as follows:

Dr Cash $10m – reflecting the full cash received from the issue of the convertibles.

- Cr Liability $9.229m – reflecting the present value of the liability on 1 January 20X1
- Cr Equity $0.771m – reflecting the value of the equity component.

The equity balance would be held as 'convertible options' within other components of equity. Subsequently, this equity amount remains fixed until conversion, but the liability must be held at amortised cost. This must be built back up to $10m over the next 3 years, to reflect the amount which the holder would require if they demand repayment rather than conversion of the loan notes.

	Balance 1 January $'000	**Interest 8.85% $'000**	**Payment $'000**	**Balance 31 December $'000**
20X1	9,229	738	-500	9,467
20X2	9,467	757	-500	9,724
20X3	9,724	776	-500	10,000

As with the financial liability noted earlier, the interest column is taken to the statement of profit or loss each year as a finance cost.

At the end of the three years, Oviedo Co will either repay the $10m liability, or this will be turned into shares, with the $10m balance and the option balance of $771k transferred to share capital and share premium.

Summary

This article has considered the key issues relating to financial instruments. To perform well at FR, it is essential that candidates are able to identify the potential treatments for financial assets, produce amortised cost calculations and understand the accounting entries required for a convertible instrument. This is one of the most technical areas of the syllabus, but also one of the central areas which will be further developed in *Strategic Business Reporting*.

Written by a member of the *Financial Reporting* examining team

Questions

How does IFRS 9 Financial Instruments require investments in equity instruments to be measured and accounted for (in the absence of any election at initial recognition)?

A Fair value with changes going through profit or loss
B Fair value with changes going through other comprehensive income
C Amortised cost with changes going through profit or loss
D Amortised cost with changes going through other comprehensive income

Answer: A

Fair value with changes going through profit or loss. Fair value through OCI would be correct if an election had been made to recognise changes in value through other comprehensive income. Amortised cost is used for debt instruments, not equity instruments.

Chapter 10 IFRS 16, Leases

Executive Summary

The purpose of this article is to summarise the key changes introduced by IFRS 16 from the perspective of the lessee and how these impact on the Financial Reporting exam.

IFRS 16 is a relatively new reporting standard which replaces IAS 17.

IFRS 16 defines a lease as “A contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration”. In order for such a contract to exist the user of the asset needs to have the right to:

- Obtain substantially all of the economic benefits from the use of the asset.
- The right to direct the use of the asset.

The requirements of IFRS 16 will have significant impacts on key accounting ratios of lessees.

The greater recognition of leased assets and lease liabilities on the statement of financial position will reduce return on capital employed and increase gearing.

Initial measures of profit are likely to be reduced, as in the early years of a lease the combination of depreciation of the right of use asset and the finance charge associated with the lease liability will exceed the lease rentals (normally charged on a straight-line basis).

1. Introduction and context setting

International Financial Reporting Standard (IFRS®) 16 – *Leases* - was issued in January 2016 and, in comparison to its predecessor International Accounting Standard (IAS®) 17 makes significant changes to the way in which leasing transactions are reported in the financial statements of lessees (although not in the financial statements of lessors). The purpose of this article is to summarise the key changes introduced by IFRS 16 from the perspective of the lessee and how these impact on their financial reporting.

A *lease* is an agreement whereby the lessor (the legal owner of an asset) conveys to the lessee (the user of the asset) the right to use an asset for an agreed period of time in return for a payment or series of payments.

The approach of IAS 17 was to distinguish between two types of lease. Leases that transfer substantially all the risks and rewards of ownership of an asset were classified as *finance leases*. All other leases were classified as *operating leases*. The lease classification set out in IAS 17 was subjective and there was a clear incentive for the preparers of lessee's financial statements to 'argue' that leases should be classified as operating rather than finance leases in order to enable leased assets and liabilities to be left out of the financial statements.

It was for this reason that IFRS 16 was introduced.

2. IFRS 16 – assets

IFRS 16 defines a lease as "A contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration". In order for such a contract to exist the user of the asset needs to have the right to:

- Obtain substantially all of the economic benefits from the use of the asset.
- The right to direct the use of the asset.

2.1 An 'identified asset'

One essential feature of a lease is that there is an 'identified asset'. This normally takes place through the asset being specified in a contract, or part of a contract. For the asset to be 'identified' the supplier of the asset must not have the right to substitute the asset for an alternative asset throughout its period of use. The fact that the supplier of the asset has the right or the obligation to substitute the asset when a repair is necessary does not preclude the asset from being an 'identified asset'.

Example – identified assets

Under a contract between a local government authority (L) and a private sector provider (P), P provides L with 20 trucks to be used for refuse collection on behalf of L for a 6-year period. The trucks, which are owned by P, are specified in the contract. L determines how they are used in the refuse collection process. When the trucks are not in use, they are kept at L's premises. L can use the trucks for another purposes if it so chooses. If a particular truck needs to be serviced or repaired, P is required to substitute a truck of the same type. Otherwise, and other than on default by L, P cannot retrieve the trucks during the six-year period.

Conclusion: The contract is a **lease**. L has the right to use the 20 trucks for six years which are identified and explicitly specified in the contract. Once delivered to L, the trucks can be substituted only when they need to be serviced or repaired.

2.2 The right to direct the use of the asset

IFRS 16 states that a customer has the right to direct the use of an identified asset if either:

- The customer has the right to direct how and for what purpose the asset is used throughout its period of use; or
- The relevant decisions about use are pre-determined and the customer has the right to operate the asset throughout the period of use without the supplier having the right to change these operating instructions.

Example – the right to direct the use of an asset

A customer (C) enters into a contract with a road haulier (H) for the transportation of goods from London to Edinburgh on a specified truck. The truck is explicitly specified in the contract and H does not have substitution rights. The goods will occupy substantially all of the capacity of the truck. The contract specifies the goods to be transported on the truck and the dates of pickup and delivery.

H operates and maintains the truck and is responsible for the safe delivery of the goods. C is prohibited from hiring another haulier to transport the goods or operating the truck itself.

Conclusion: This contract does **not** contain a lease.

There **is** an identified asset. The truck is explicitly specified in the contract and H does not have the right to substitute that specified truck.

C **does** have the right to obtain substantially all of the economic benefits from use of the truck over the contract period. Its goods will occupy substantially all of the capacity of the truck, thereby preventing other parties from obtaining economic benefits from use of the truck.

However, C does **not** have the right to control the use of the truck because C does not have the right to direct its use. C does **not** have the right to direct how and for what purpose the truck is used. How and for what purpose the truck will be used (i.e. the transportation of specified goods from London to Edinburgh within a specified timeframe) is predetermined in the contract. C has the same rights regarding the use of the truck as if it were one of many customers transporting goods using the truck.

3. Accounting for leases

With a very few exceptions (see section 3.4 for further details) IFRS 16 abolishes the distinction between an operating lease and a finance lease in the financial statements of lessees. Lessees will recognise a right of use asset and an associated liability at the inception of the lease.

IFRS 16 requires that the 'right of use asset' and the lease liability should initially be measured at the present value of the minimum lease payments. The discount rate used to determine present value should be the rate of interest implicit in the lease.

3.1 Recording the asset

The 'right of use asset' would include the following amounts, where relevant:

- Any payments made to the lessor at, or before, the commencement date of the lease, less any lease incentives received.
- Any initial direct costs incurred by the lessee.
- An estimate of any costs to be incurred by the lessee in dismantling and removing the underlying asset, or restoring the site on which it is located (unless the costs are incurred to produce inventories, in which case they would be accounted for in accordance with IAS 2 – *Inventories*). Costs of this nature are recognised only when an entity incurs an obligation for them. IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* would be applied to ascertain if an obligation existed.

3.2 Depreciation

The right of use asset is subsequently depreciated. Depreciation is over the shorter of the useful life of the asset and the lease term, unless the title to the asset transfers at the end of the lease term, in which case depreciation is over the useful life.

3.3 Lease liability

The lease liability is effectively treated as a financial liability which is measured at amortised cost, using the rate of interest implicit in the lease as the effective interest rate.

Example – accounting for leases

A lessee enters into a 20-year lease of one floor of a building, with an option to extend for a further five years. Lease payments are $80,000 per year during the initial term and $100,000 per year during the optional period, all payable at the end of each year. To obtain the lease, the lessee incurred initial direct costs of $25,000

At the commencement date, the lessee concluded that it is not reasonably certain to exercise the option to extend the lease and, therefore, determined that the lease term is 20 years. The interest rate implicit in the lease is 6% per annum. The present value of the lease payments is $917,600.

At the commencement date, the lessee incurs the initial direct costs and measures the lease liability $917,600.

The carrying amount of the right of use asset after these entries is $942,600 ($917,600 + $25,000) and consequently the annual depreciation charge will be $47,130 ($942,600 x 1/20).

The lease liability will be measured using amortised cost principles. In order to help us with the example in the following section, we will measure the lease liability up to and including the end of year ten. This is done in the following table:

Year	Balance b/fwd $	Finance cost (6%) $	Rental $	Balance c/fwd $
1	917,600	55,056	(80,000)	892,656
2	892,656	53,559	(80,000)	866,215

At the end of year one, the carrying amount of the right of use asset will be $895,470 ($942,600 less $47,130 depreciation).

The interest cost of $55,056 will be taken to the statement of profit or loss as a finance cost.

The total lease liability at the end of year one will be $892,656. As the lease is being paid off over 20 years, some of this liability will be paid off within a year and should therefore be classed as a current liability.

To find this figure, we look at the remaining balance following the payment in year two. Here, we can see that the remaining balance is $866,215. This will represent the non-

current liability, being the amount of the $892,656 which will still be outstanding in over a year. The current liability element is therefore $26,441. This represents the $80,000 paid in year two less year two's finance costs of $53,559 (or $892,656-$866,215).

3.4 A simplified approach for short-term or low-value leases

A short-term lease is a lease that, at the date of commencement, has a term of 12 months or less. A lease that contains a purchase option cannot be a short-term lease. Lessees can **elect** to treat short-term leases by recognising the lease rentals as an expense over the lease term rather than recognising a 'right of use asset' and a lease liability. The election needs to be made for relevant leased assets on a 'class-by-class' basis. A similar election – *on a lease-by-lease basis*– can be made in respect of 'low value assets'.

The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the simplified accounting treatment explained above regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value.

An underlying asset can be of low value only if:

(a) The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and

(b) The underlying asset is not highly dependent on, or highly interrelated with, other assets.

A lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. For example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones.

4. Sale and leaseback transactions

4.1 Introduction

The treatment of sale and leaseback transactions depends on whether or not the 'sale' constitutes the satisfaction of a relevant performance obligation under IFRS 15 – *Revenue from Contracts with Customers*. The relevant performance obligation would be the effective 'transfer' of the asset to the lessor by the previous owner (now the lessee).

4.2 Transaction constituting a sale

If the transaction does constitute a 'sale' under IFRS 15 then the treatment is as follows:

- the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.
- The buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in IFRS 16 (these being essentially unchanged from the predecessor standard).

If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

- Any below-market terms shall be accounted for as a prepayment of lease payments; and
- Any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

Example – sale and leaseback

Entity X sells a building to entity Y for cash of $5 million. Immediately before the transaction, the carrying amount of the building in the financial statements of entity X was $3.5 million. At the same time, X enters into a contract with Y for the right to use the building for 20 years, with annual payments of $200,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by X satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15 - *Revenue from Contracts with Customers*. Accordingly, X and Y account for the transaction as a sale and leaseback.

The fair value of the building at the date of sale is $4.5 million. Because the consideration for the sale of the building is not at fair value, X and Y make adjustments to measure the sale proceeds at fair value. The amount of the excess sale price of $500,000 ($5 million - $4.5 million) is recognised as additional financing provided by Y to X.

The annual interest rate implicit in the lease is 5%. The present value of the annual payments (20 payments of $200,000, discounted at 5%) amounts to $2,492,400, of which $500,000 relates to the additional financing and $1,992,400 ($2,492,200 - $500,000) relates to the lease (as adjusted for the fair value difference already identified). The annual payment that would be required to be made 20 times in arrears to repay additional financing of $500,000 when the rate of interest is 5% per annum would be $40,122 ($500,000/12.462 (the cumulative discount factor for 5% for 20 years)). Therefore the residual would be regarded as a 'lease rental' at an amount of $159,878 ($200,000 – $40,122).

Given the IFRS 15 treatment as a 'sale' B would almost certainly regard the lease of the building as an operating lease. This means that B would recognise the 'lease rentals' of $159,878 as income.

4.3 – Transaction not constituting a 'sale'

In these circumstances the seller does not 'transfer' the asset and continues to reconise it, without adjustment. The 'sales proceeds' are recognised as a financial liability and accounted for by applying IFRS 9 – *Financial Instruments*. In the same circumstances, the buyer recognizes a financial asset equal to the 'sales proceeds'.

5. Summary

The requirements of IFRS 16 will have significant impacts on key accounting ratios of lessees. The greater recognition of leased assets and lease liabilities on the statement of financial position will reduce return on capital employed and increase gearing. Initial measures of profit are likely to be reduced, as in the early years of a lease the combination of depreciation of the right of use asset and the finance charge associated with the lease liability will exceed the lease rentals (normally charged on a straight-line basis).

Question

Cornet Co entered into an eight year lease agreement on 1 July 20X4. The lease requires annual payments of $750,000 in arrears. The present value of the lease payments at 1 July 20X4, discounted at a rate of 6% is $4,657,500. Additionally Cornet Co paid directly attributable costs of $37,500 on 1 July 20X4.

What is the total charge to the statement of profit or loss for the year ended 30 June 20X5 in respect of the right-to-use asset?

A. $586,875
B. $866,325
C. $279,450
D. $1,029,450

Answer: B

Right-of-use asset
Cost 1 July 20X4 ($4,657,500+$37,500) = 4,695,000
Depn to 30 June 20X5 ($4,695,000/8) = 586,875

Lease liability
1 July 20X4 6% interest
4,657,500 279,450
Total charge to SOPL = 586875 + 270,450 = 866,325

Chapter 11 IAS 37 – Provisions, contingent liabilities and contingent assets

Executive Summary

This article considers the aims of the IAS® 37, followed by the key specific criteria which must be met for a provision to be recognised. Finally, it will examine some specific issues which are often assessed in relation to the standard.

A provision is a liability of uncertain timing or amount, meaning that there is some question over either how much will be paid or when this will be paid.

IAS 37 stipulates the criteria for provisions, contingent liabilities and contingent assets which must be met in order for a provision to be recognised, so that companies should be prevented from manipulating profits.

According to IAS 37, 3 criteria are required to be met before a provision can be recognised. These are:

1. There needs to be a present obligation from past event
2. There needs to be a reliable estimate
3. There needs to be a probable outflow

Other issues within provisions

1. The time value of money
2. Restructuring costs
3. Onerous contracts
4. Dismantling costs associated with assets
5. Future operating losses

For some ACCA candidates, specific IFRS® standards are more favoured than others. IAS® 37 appears to be less popular than other standards because, usually, answers to Financial Reporting (FR) questions required a balanced discussion of whether criteria are met, as opposed to calculating numbers. However, IAS 37 is often a key standard in FR exams, and candidates must be prepared to wrestle with applying the criteria.

This article will consider the aims of the standard, followed by the key specific criteria which must be met for a provision to be recognised. Finally, it will examine some specific issues which are often assessed in relation to the standard.

The definition of a provision is key to the standard. A provision is a liability of uncertain timing or amount, meaning that there is some question over either how much will be paid or when this will be paid. In the past, these uncertainties may have been exploited by companies trying to 'smooth profits' in order to achieve the results they believe that their various stakeholder may want.

For example, let's take a fictional company, Rey Co. At the start of the year, Rey Co sets a profit target of $10m for the year ended 31 December 20X8. The chief accountant of Rey Co has reviewed the profit to date and realises they are likely to achieve profits of $13m. The accountant knows that if Rey Co reports a profit of $13m, directors will not get any more of a bonus than if they reported $10m. He also knows that the profit target will be set at $14m in the next year.

To avoid this, the accountant may be tempted to make some provisions for some potential future expenses of $3m, with the impact of making the profit seem lower in the current period. As the double entry for a provision is to debit an expense and credit the liability, this would potentially reduce the profit down to $10m. Then in the next year, the chief accountant could reverse this provision, by debiting the liability and crediting the profit or loss. This is effectively an attempt to move $3m profit from the current year into the next period.

Clearly this is not good for the users of the financial statements, as they would have been manipulated and given a false impression of the performance of the business. This is where IAS 37 is used to ensure that companies report only those provisions that meet certain criteria.

IAS 37 stipulates the criteria for provisions, contingent liabilities and contingent assets which must be met in order for a provision to be recognised, so that companies should be prevented from manipulating profits. According to IAS 37, 3 criteria are required to be met before a provision can be recognised. These are:

1. There needs to be a present obligation from past event
2. There needs to be a reliable estimate
3. There needs to be a probable outflow

These criteria will now be examined in further detail to see how they can be applied in practice.

1. Present obligation from a past event

This rule has two parts, first the type of obligation, and second, the requirement for it to come from a past event (something must have already have happened to create the obligation).

(a) Type of obligation

The obligation could be a legal or contractual one, arising from a court case or some kind of contractual arrangement. Most candidates are able to spot this in exams, identifying the presence of a potential obligation of this type.

The second type of obligation is one called a constructive obligation. This is where a company establishes an expectation through an established course of past practice.

Example

Rey Co has a published environmental policy. In this, Rey Co explains that they always replant trees to counter-balance the environmental damage created by their operations. Rey Co has a consistent history of honouring this policy. During 20X8, Rey Co opened a new factory, leading to some environmental damage. Rey Co estimate that the damage will cost $400,000 to restore.

Even if the country has no legal regulations forcing Rey Co to replant trees, Rey Co will have a constructive obligation because it has created an expectation from its publications, practice and history.

(b) Past event

The obligation needs to have arisen from a past event, rather than simply something which may or may not arise in the future.

Example

Rey Co would have to provide for a potential legal case arising from an employee who was injured at work in 20X8 due to faulty equipment. This is because the event arose in 20X8 which could lead to an obligation.

Rey Co could not provide for any possible claims which may arise from injuries in the future. That is because there is no past event which has created the obligation. Similarly, if

Rey Co has to pay to install new safety equipment in the factory in 20X9, there is no present obligation to do this in 20X8, so no provision is required. Rey Co could delay the work until 20X9, or sell the building.

2. Reliable estimate

In an exam, it is unlikely that there will not be a reliable estimate. Likewise it is unlikely that an entity will be able to avoid recording a liability when there is an obligation by claiming there is no way of producing an estimate of the amount. The main rule to follow is that if the item is a one-off item, the best estimate will be the most likely outcome. If the item is made up of a number of items, such as a warranty provision for repairing goods, the expected value should be calculated using the probability of all events happening.

Example – best estimate

Rey Co has received legal advice that the most likely outcome of the court case from the employee is that they will lose the case and have to pay $10m. The legal team think there is an 80% chance of this. They believe there is a 10% chance of having to pay $12m, and a 10% chance of paying nothing.

In this case, Rey Co would provide $10m, being the most likely outcome. It will not be uncommon to take the $12m, thinking that the worst-case scenario should be provided for. Other candidates may calculate an expected value based on the various probabilities.

Example – expected value

Rey Co gives a year's warranty with all goods sold during the year. Past experience shows that Rey Co needs to do no repairs on 85% of the goods. On average, 10% need minor repairs, and 5% need major repairs. Rey Co's manufacturing manager has calculated that if minor repairs were needed on all goods it would cost $100,000, and major repairs on all goods would cost $1m.

Here, the provision would be measured at $60k. The expected cost of minor repairs would be $10k (10% of $100k) and the expected costs of major repairs is $50k (5% of $1m). This is because there will not be a one-off payment, so Rey Co should calculate the estimate of all of the likely repairs.

3. Probable outflow

The final criteria required is that there needs to be a probable outflow of economic resources. There is no specific list of what % likelihood is required for an outflow to be probable. A probable outflow simply means that it is more likely than not that the entity will have to pay money out.

If it appears that there is a possible outflow then no provision is recorded. In this situation, a contingent liability would be reported. A contingent liability is simply a disclosure note shown in the notes to the accounts. There is no double entry recorded in respect of this. Instead, a description of the event should be given to the users with an estimate of the potential financial effect. In addition to this, the expected timing of when the event should be resolved should also be included.

Similar to the concept of a contingent liability is the concept of a contingent asset. This relates to a potential inflow of economic resources which could come into the entity. Like a contingent liability, a contingent asset is simply disclosed rather than a double entry being recorded. Again, a description of the event should be recorded in addition to any potential amount related to this. The key difference is that a contingent asset is only recorded if there is a probable future inflow, rather than a possible one. The table below shows the treatment for an entity depending on the likelihood of an item happening.

Likelihood	Outflow of resources (Rey Co has to pay out)	Inflow of resources (Rey Co may receive income)
Remote	Do nothing	Do nothing
Possible	Contingent liability	Do nothing
Probable	Provision	Contingent asset
Virtually certain	Provision	Asset

It can be seen here that Rey Co could only recognise an asset from a potential inflow if it is virtually certain. In reality a virtually certain inflow is unlikely. For example, in the case of an insurance claim where Rey Co can show they have cover.

Example – Likelihood

Rey Co's legal advisors continue to believe that it is likely that Rey Co will lose the court case against the employee and have to pay out $10m. However, it has come to light that Rey Co may have a counter claim against the manufacturer of the machinery. The legal advisors believe that there is an 80% chance that the counter claim against the manufacturer is likely to succeed, and believe that Rey Co would win $8m.

In this case, Rey Co would include a provision for the $10m loss in liabilities. Even though there is a similar likelihood that Rey Co would win the counterclaim, this is a probably inflow and therefore only a contingent asset can be recorded. This will be disclosed in the notes to

the financial statements rather than being recorded as an asset in the statement of financial position. Whilst this seems inconsistent, this demonstrates the asymmetry of prudence, that losses will be recorded earlier than potential gains.

Other issues within provisions

1. The time value of money

If the time value of money is material, generally if the potential outflow is payable in one year or more, the provision should be discounted to present value initially. Subsequently, the discount on this provision would be unwound over time, to record the provision at the actual amount payable. The unwinding of this discount would be recorded in the statement of profit or loss as a finance cost.

Example

At 31 December 20X8, the legal advisors of Rey Co now believe that the $10m payment from the court case would be payable in one year. Rey Co has a cost of capital of 10%.

On 31 December 20X8, Rey Co should record the provision at $10m/1.10, which is $9.09m. This should be debited to the statement of profit or loss, with a liability of $9.09m recorded.

By 31 December 20X9, when Rey Co is required to make the payment, the liability should be showing at $10m, not $9.09m. Therefore the liability is increased by 10% over the year, giving an increase of $910k which would be recorded in finance costs.

2. Restructuring costs

Restructuring costs associated with reorganising divisions provide two issues. The first is to assess whether an obligation exists at the reporting date. The key here is whether the restructuring has been announced to the affected employees. If the employees have been informed, then an obligation exists and a provision must be made. If the employees have not been informed, then the company could change its mind. Therefore there is no present obligation to incur the costs associated with this.

The second issue consideration is which costs should be included within the provision. These costsshould exclude any costs associated with any continuing activities. Therefore any provision should only include items such as redundancies and closure costs. Ongoing costs such as the costs of relocating staff should be excluded from the provision and should instead be expensed as they are incurred.

3. Onerous contracts

Onerous contracts are those in which the costs of meeting the contract will exceed any benefits which will flow to the entity from the contract. As soon as an entity is aware that a contract is onerous, the full loss should be provided for as a liability in the statement of financial position.

4. Dismantling costs associated with assets

So far, all of the items considered in this article have involved the provision being recorded as a liability with the debit being shown as an expense in the statement of profit or loss. The exception to this is if an entity creates an obligation for future costs due to the construction of a non-current asset. In this case, the provision should be included within the original cost of the asset, as this is directly attributable to the construction of that asset.

Example

Rey Co constructed an oil platform in the sea on 1 January 20X8 at a cost of $150m. As part of obtaining permission to construct the platform, Rey Co has a legal obligation to remove the asset at the end of its useful life. This obligation has a present value of $20m.

Here, Rey Co would capitalise the $170m as part of property, plant and equipment. As only $150m has been paid, this amount would be credited to cash, with a $20m provision set up. Over the useful life of the asset, the $170m will be depreciated. In addition to this, the discount on the provision will be unwound and the provision increased each year.

5. Future operating losses

Future operating losses do not meet the criteria for a provision, as there is no obligation to make these losses. Therefore there cannot be included in the financial statemets.

In summary, IAS 37 is a key standard for FR candidates. Candidates are required to learn the three key criteria for a provision, as they are likely to have to explain these in an exam. Careful attention must also be paid to the calculations involved in the recording of a provision, particularly those around long-term provisions and including them at present value. If candidates are able to do this, then provisions can be an area where they can score highly in the FR exam.

Written by a member of the *Financial Reporting* examining team

Questions

Which of the following statements are correct in accordance with IAS 37 Provisions, contingent liabilities and contingent assets?
(i) Provisions should be made for both constructive and legal obligations.
(ii) Discounting may be used when estimating the amount of a provision.
(iii) A restructuring provision must include the estimated costs of retraining or relocating continuing staff.
(iv) A restructuring provision may only be made when a company has a detailed plan for the restructuring and has communicated to interested parties a firm intention to carry it out.

A All four statements are correct
B (i), (ii) and (iv) only
C (i), (iii) and (iv) only
D (ii) and (iii) only

Answer: B

A restructuring provision must not include the costs of retraining or relocating staff.

Chapter 12 Deferred tax

Executive Summary

This article starts by considering aspects of deferred tax that are relevant to Financial Reporting, before moving on to the more complicated situations that may be tested in Strategic Business Reporting.

Deferred tax is accounted for in accordance with IAS® 12, Income Taxes.

IAS 12 defines a deferred tax liability as being the amount of income tax payable in future periods in respect of taxable temporary differences. So, in simple terms, deferred tax is tax that is payable in the future.

IAS 12 requires that a deferred tax liability is recorded in respect of all taxable temporary differences that exist at the year-end – this is sometimes known as the full provision method.

Deferred tax is consistently tested in the published financial statementsfinancial statements question in the FR exam. Here are some hints on how to deal with the information in the question.

- The deferred tax liability given within the trial balance or draft financial statements will be the opening liability balance.
- In the notes to the question there will be information to enable you to calculate the closing liability for the SFP or the increase/decrease in the liability.

Deferred tax is a topic that is consistently tested in *Financial Reporting* (FR) and is often tested in further detail in *Strategic Business Reporting* (SBR). This article will start by considering aspects of deferred tax that are relevant to FR before moving on to the more complicated situations that may be tested in SBR.

The basics

Deferred tax is accounted for in accordance with IAS® 12, *Income Taxes*. In FR, deferred tax normally results in a liability being recognised within the Statement of Financial Position. IAS 12 defines a deferred tax liability as being the amount of income tax payable in future periods in respect of taxable temporary differences. So, in simple terms, deferred tax is tax that is payable in the future. However, to understand this definition more fully, it is necessary to explain the term 'taxable temporary differences'.

Temporary differences are defined as being differences between the carrying amount of an asset (or liability) within the Statement of Financial Position and its tax base ie the amount at which the asset (or liability) is valued for tax purposes by the relevant tax authority.

Taxable temporary differences are those on which tax will be charged in the future when the asset (or liability) is recovered (or settled).

IAS 12 requires that a deferred tax liability is recorded in respect of all taxable temporary differences that exist at the year-end – this is sometimes known as the full provision method.

All of this terminology can be rather overwhelming and difficult to understand, so consider it alongside an example. Depreciable non-current assets are the typical deferred tax example used in FR.

Within financial statements, non-current assets with a limited useful life are subject to depreciation. However, within tax computations, non-current assets are subject to capital

allowances (also known as tax depreciation) at rates set within the relevant tax legislation. Where at the year-end the cumulative depreciation charged and the cumulative capital allowances claimed are different, the carrying amount of the asset (cost less accumulated depreciation) will then be different to its tax base (cost less accumulated capital allowances) and hence a taxable temporary difference arises.

EXAMPLE 1

A non-current asset costing $2,000 was acquired at the start of year 1. It is being depreciated straight line over four years, resulting in annual depreciation charges of $500. Thus a total of $2,000 of depreciation is being charged. The capital allowances granted on this asset are:

	$
Year 1	800
Year 2	600
Year 3	360
Year 4	240
Total capital allowances	2,000

Table 1 shows the carrying amount of the asset, the tax base of the asset and therefore the temporary difference at the end of each year.

As stated above, deferred tax liabilities arise on taxable temporary differences, ie those temporary differences that result in tax being payable in the future as the temporary difference reverses. So, how does the above example result in tax being payable in the future?

Entities pay income tax on their taxable profits. When determining taxable profits, the tax authorities start by taking the profit before tax (accounting profits) of an entity from their financial statements and then make various adjustments. For example, depreciation is considered a disallowable expense for taxation purposes but instead tax relief on capital expenditure is granted in the form of capital allowances. Therefore, taxable profits are arrived at by adding back depreciation and deducting capital allowances from the accounting profits. Entities are then charged tax at the appropriate tax rate on these taxable profits.

TABLE 1: THE CARRYING VALUE, THE TAX BASE OF THE ASSET AND THEREFORE THE TEMPORARY DIFFERENCE AT THE END OF EACH YEAR (EXAMPLE 1)

Year	Carrying value (Cost - accumulated depreciation)	Tax base (Cost - accumulated capital allowances)	Temporary difference
	$	$	$
1	1,500	1,200	300
2	1,000	600	400
3	500	240	260
4	Nil	Nil	Nil

In the above example, when the capital allowances are greater than the depreciation expense in years 1 and 2, the entity has received tax relief early. This is good for cash flow in that it delays (ie defers) the payment of tax. However, the difference is only a temporary difference and so the tax will have to be paid in the future. In years 3 and 4, when the capital allowances for the year are less than the depreciation charged, the entity is being charged additional tax and the temporary difference is reversing. Hence the temporary differences can be said to be taxable temporary differences.

Notice that overall, the accumulated depreciation and accumulated capital allowances both equal $2,000 – the cost of the asset – so over the four-year period, there is no difference between the taxable profits and the profits per the financial statements.

At the end of year 1, the entity has a temporary difference of $300, which will result in tax being payable in the future (in years 3 and 4). In accordance with the concept of prudence,

a liability is therefore recorded equal to the expected tax payable.

Assuming that the tax rate applicable to the company is 25%, the deferred tax liability that will be recognised at the end of year 1 is 25% x $300 = $75. This will be recorded by crediting (increasing) a deferred tax liability in the Statement of Financial Position and debiting (increasing) the tax expense in the Statement of Profit or Loss.

By the end of year 2, the entity has a taxable temporary difference of $400, ie the $300 bought forward from year 1, plus the additional difference of $100 arising in year 2. A liability is therefore now recorded equal to 25% x $400 = $100. Since there was a liability of $75 recorded at the end of year 1, the double entry that is recorded in year 2 is to credit (increase) the liability and debit (increase) the tax expense by $25.

At the end of year 3, the entity's taxable temporary differences have decreased to $260 (since the company has now been charged tax on the difference of $140). Therefore in the future, the tax payable will be 25% x $260 = $65. The deferred tax liability now needs reducing from $100 to $65 and so is debited (a decrease) by $35. Consequently, there is now a credit (a decrease) to the tax expense of $35.

At the end of year 4, there are no taxable temporary differences since now the carrying amount of the asset is equal to its tax base. Therefore the opening liability of $65 needs to be removed by a debit entry (a decrease) and hence there is a credit entry (a decrease) of $65 to the tax expense. This can all be summarised in the following working.

The movements in the liability are recorded in the Statement of Profit or Loss as part of the taxation charge

Year	1 $	2 $	3 $	4 $
Opening deferred tax liability	0	75	100	65

Year	1 $	2 $	3 $	4 $
Increase/(decrease) in the year	75	25	(35)	(65)
Closing deferred tax liability	75	100	65	0

The closing figures are reported in the **Statement of Financial Position** as part of the deferred tax liability.

Proforma

Example 1 provides a proforma, which may be a useful format to deal with deferred tax within a published financial statements question. The movement in the deferred tax liability in the year is recorded in the Statement of Profit or Loss where:

- an increase in the liability, increases the tax expense
- a decrease in the liability, decreases the tax expense.

The closing figures are reported in the Statement of Financial Position as the deferred tax liability.

The Statement of Profit or Loss

As IAS 12 considers deferred tax from the perspective of temporary differences between the carrying amount and tax base of assets and liabilities, the standard can be said to take a 'balance sheet approach'. However, it will be helpful to consider the effect on the Statement of Profit or Loss.

Continuing with the previous example, suppose that the profit before tax of the entity for each of years 1 to 4 is $10,000 (after charging depreciation). Since the tax rate is 25%, it would then be logical to expect the tax expense for each year to be $2,500. However, income tax is based on taxable profits not on the accounting profits.

The taxable profits and so the actual tax liability for each year could be calculated as in Table 2.

The income tax liability is then recorded as a tax expense. As we have seen in the example, accounting for deferred tax then results in a further increase or decrease in the tax expense. Therefore, the final tax expense for each year reported in the Statement of Profit or Loss would be as in Table 3.

It can therefore be said that accounting for deferred tax is ensuring that the matching principle is applied. The tax expense reported in each period is the tax consequences (ie tax charges less tax relief) of the items reported within profit in that period.

EXAMPLE 1 PROFORMA

	$	
Opening deferred tax liability	X	As given in the trial balance
Increase/(decrease) in the year *Tax rate % x Increase / Decrease in year-end taxable temporary differences*	X/(X)	This is taken to the taxation charge in the Income Statement
Closing deferred tax liability *Tax rate % x Year-end taxable temporary temporary differences*	X	This is reported in the Statement of Financial Position

TABLE 2: TAXABLE PROFIT AND ACTUAL TAX LIABILITY CALCULATION (EXAMPLE 1)

	Year 1 $	Year 2 $	Year 3 $	Year 4 $
Profit before tax	10,000	10,000	10,000	10,000
Depreciation	500	500	500	500
Capital allowances	(800)	(600)	(360)	(240)
Taxable profits	9,700	9,900	10,140	10,260
Tax liability @ 25% of taxable profits	2,425	2,475	2,535	2,565

TABLE 3: FINAL TAX EXPENSE FOR EACH REPORTED INCOME STATEMENT YEAR (EXAMPLE 1)

	Year 1	Year 2	Year 3	Year 4
Income tax	2,425	2,475	2,535	2,565
Increase/(decrease) due to deferred tax	75	25	(35)	(65)
Total tax expense	2,500	2,500	2,500	2,500

The FR exam

Deferred tax is consistently tested in the published financial statementsfinancial statements question in the FR exam. Here are some hints on how to deal with the information in the question.

- The deferred tax liability given within the trial balance or draft financial statements will be the opening liability balance.
- In the notes to the question there will be information to enable you to calculate the closing liability for the SFP or the increase/decrease in the liability.

It is important that you read the information carefully. You will need to ascertain exactly what you are being told within the notes to the question and therefore how this relates to the working that you can use to calculate the figures for the answer.

Consider the following sets of information – all of which will achieve the same ultimate answer in the published financial statements.

EXAMPLE 2

The trial balance shows a credit balance of $1,500 in respect of a deferred tax liability.

The notes to the question could contain one of the following sets of information:

1. At the year-end, the required deferred tax liability is $2,500.
2. At the year-end, it was determined that an increase in the deferred tax liability of $1,000 was required.
3. At the year-end, there are taxable temporary differences of $10,000. Tax is charged at a rate of 25%.
4. During the year, taxable temporary differences increased by $4,000. Tax is charged at a rate of 25%.

TABLE 4: EXAMPLE 2 – PUBLISHED ACCOUNTS QUESTION

Situation 1	$	
Opening deferred tax liability	1,500	*Provided in trial balance*
Increase in the year to be taken to IS as an increase in tax expense	1,000	*Balancing figure*
Closing deferred tax liability to be reported in SFP	2,500	*Provided in information*
Situation 2	$	
Opening deferred tax liability	1,500	*Provided in trial balance*
Increase in the year to be taken to IS as an increase in tax expense	1,000	*Provided in information*
Closing deferred tax liability to be reported in SFP	2,500	*Balancing figure*
Situation 3	$	
Opening deferred tax liability	1,500	*Provided in trial balance*
Increase in the year to be taken to IS as an increase in tax expense	1,000	*Balancing figure*
Closing deferred tax liability to be reported in SFP	2,500	*Calculated from information (25% x $10,000)*
Situation 4	$	
Opening deferred tax liability	1,500	*Provided in trial balance*
Increase in the year to be taken to IS as an increase in tax expense	1,000	*Calculated from information (25% x $4,000)*
Closing deferred tax liability to be reported in SFP	2,500	*Balancing figure*

Situations 1 and 2 are both giving a figure that can be slotted straight into the deferred tax working. In situations 3 and 4 however, the temporary differences are being given. These are then used to calculate a figure which can be slotted into the working. In all situations, the missing figure is calculated as a balancing figure. Table 4 shows the completed workings.

Revaluations of non-current assets

Revaluations of non-current assets (NCA) are a further example of a taxable temporary difference. When an NCA is revalued to its current value within the financial statements, the revaluation surplus is recorded in equity (in a revaluation reserve) and reported as other comprehensive income. While the carrying amount of the asset has increased, the tax base of the asset remains the same and so a temporary difference arises.

Tax will become payable on the surplus when the asset is sold and so the temporary difference is taxable. Since the revaluation surplus has been recognised within equity, to comply with matching, the tax charge on the surplus is also charged to equity. Suppose that in Example 1, the asset is revalued to $2,500 at the end of year 2, as shown in Table 5.

TABLE 5: REVALUED ASSET AT THE END OF YEAR 2 (EXAMPLE 1)

Year 2	Carrying value (Cost - accumulated depreciation)	Tax base (Cost - accumulated capital allowances)	Temporary difference
	$	$	$
Opening balance	1,500	1,200	300
Depreciation charge/capital allowance	(500)	(600)	100
Revaluation	1,500	-	1,500
Closing Balance	2,500	600	1,900

The carrying amount will now be $2,500 while the tax base remains at $600. There is, therefore, a temporary difference of $1,900, of which $1,500 relates to the revaluation surplus. This gives rise to a deferred tax liability of 25% x $1,900 = $475 at the year-end to report in the Statement of Financial Position. The liability was $75 at the start of the year (Example 1) and thus there is an increase of $400 to record.

However, the increase in relation to the revaluation surplus of 25% x $1,500 = $375 will be charged to the revaluation reserve and reported within other comprehensive income. The remaining increase of $25 will be charged to the Statement of Profit or Loss as before.

The overall double entry is:

Dr	Tax expense in Statement of Profit or Loss	$25
Dr	Revaluation reserve in equity	$375
Cr	Deferred tax liability in SFP	$400

The SBR exam

It is important to appreciate that deferred tax can arise in respect of many different types of asset or liability and not just non-current assets as discussed above. Therefore, for SBR it

is more important that candidates understand the principles behind deferred tax so that they can be applied to any given situation. Some of the situations that may be seen are discussed below. In all of the following situations, assume that the applicable tax rate is 25%.

Deferred tax assets

It is important to be aware that temporary differences can result in needing to record a deferred tax asset instead of a liability. Temporary differences affect the timing of when tax is paid or when tax relief is received. While normally they result in the payment being deferred until the future or relief being received in advance (and hence a deferred tax liability) they can result in the payment being accelerated or relief being due in the future.

In these latter situations the temporary differences result in a deferred tax asset arising (or where the entity has other larger temporary differences that create deferred tax liabilities, a reduced deferred tax liability).

Whether an individual temporary difference gives rise to a deferred tax asset or liability can be ascertained by applying the following rule:

Carrying amount of asset / (Liability)	Tax base of asset / (Liability)	=	Temporary difference

If the temporary difference is positive, a deferred tax liability will arise. If the temporary difference is negative, a deferred tax asset will arise.

TABLE 6: IMPAIRMENT OF NON-CURRENT ASSET (EXAMPLE 3)

Carrying value of the asset	Tax base of the asset	Temporary difference	Deferred tax asset or liability?
$	$	$	
2,800	3,500	(700)	Asset

TABLE 7: WRITE DOWN OF INVENTORY (EXAMPLE 4)

Carrying value of the asset	Tax base of the asset	Temporary difference	Deferred tax asset or liability?
$	$	$	
9,000	10,000	(1,000)	Asset

TABLE 8: ACCRUED PENSION CONTRIBUTIONS (EXAMPLE 5)

Carrying value of the asset	Tax base of the asset	Temporary difference	Deferred tax asset or liability?
$	$	$	
(25,000)	Nil	(25,000)	Asset

EXAMPLE 3

Suppose that at the reporting date the carrying amount of a non-current asset is $2,800 while its tax base is $3,500, as shown in Table 6 above.

In this scenario, the carrying amount of the asset has been written down to below the tax base. This might be because an impairment loss has been recorded on the asset which is not allowable for tax purposes until the asset is sold. The entity will therefore receive tax relief on the impairment loss in the future when the asset is sold.

The deferred tax asset at the reporting date will be 25% x $700 = $175.

It is worth noting here that revaluation gains, which increase the carrying amount of the asset and leave the tax base unchanged, result in a deferred tax liability. Conversely, impairment losses, which decrease the carrying amount of the asset and leave the tax base unchanged, result in a deferred tax asset.

EXAMPLE 4

At the reporting date, inventory which cost $10,000 has been written down to its net realisable value of $9,000. The write down is ignored for tax purposes until the goods are sold.

The write off of inventory will generate tax relief, but only in the future when the goods are sold. Hence the tax base of the inventory is not reduced by the write off. Consequently, a deferred tax asset of 25% x $1,000 = $250 as shown in Table 8 should be recorded at the reporting date.

EXAMPLE 5

At the reporting date, an entity has recorded a liability of $25,000 in respect of pension contributions due. Tax relief is available on pension contributions only when they are paid.

The contributions will only be recognised for tax purposes when they are paid in the future. Hence the pension expense is currently ignored within the tax computations and so the liability has a nil tax base, as shown in Table 8. The entity will receive tax relief in the future and so a deferred tax asset of 25% x $25,000 = $6,250 should be recorded at the reporting date.

Group financial statements

When dealing with deferred tax in group financial statements, it is important to remember that a group does not legally exist and so is not subject to tax. Instead, tax is levied on the individual legal entities within the group and their individual tax assets and liabilities are cross-cast in the consolidation process. To calculate the deferred tax implications on consolidation adjustments when preparing the group financial statements, the carrying amount refers to the carrying amount within the group financial statements while the tax base will be the tax base in the entities' individual financial statements.

Fair value adjustments

At the date of acquisition, a subsidiary's net assets are measured at fair value. The fair value adjustments may not alter the tax base of the net assets and hence a temporary difference may arise. Any deferred tax asset/liability arising as a result is included within the fair value of the subsidiary's net assets at acquisition for the purposes of calculating goodwill.

Goodwill

Goodwill only arises on consolidation – it is not recognised as an asset within the individual financial statements. Theoretically, goodwill gives rise to a temporary difference that would result in a deferred tax liability as it is an asset with a carrying amount within the group financial statements but will have a nil tax base. However, IAS 12 specifically excludes a deferred tax liability being recognised in respect of goodwill.

Provisions for unrealised profits (PUPs)

When goods are sold between group companies and remain in the inventory of the buying company at the year-end, an adjustment is made to remove the unrealised profit from the consolidated financial statements. This adjustment also reduces the inventory to the original cost when a group company first purchased it. However, the tax base of the inventory will

be based on individual financial statements and so will be at the higher transfer price. Consequently, a deferred tax asset will arise. Recognition of the asset and the consequent decrease in the tax expense will ensure that the tax already charged to the individual selling company is not reflected in the current year's consolidated Statement of Profit or Loss but will be matched against the future period when the profit is recognised by the group.

EXAMPLE 6

P owns 100% of the equity share capital of S. P sold goods to S for $1,000 recording a profit of $200. All of the goods remain in the inventory of S at the year-end. Table 9 shows that a deferred tax asset of 25% x $200 = $50 should be recorded within the group financial statements.

Measurement of deferred tax

IAS 12 states that deferred tax assets and liabilities should be measured based on the tax rates that are expected to apply when the asset/liability will be realised/settled. Normally, current tax rates are used to calculate deferred tax on the basis that they are a reasonable approximation of future tax rates and that it would be too unreliable to estimate future tax rates.

Deferred tax assets and liabilities represent future taxes that will be recovered or that will be payable. It may therefore be expected that they should be discounted to reflect the time value of money, which would be consistent with the way in which other liabilities are measured. IAS 12, however, does not permit or allow the discounting of deferred tax assets or liabilities on practical grounds.

TABLE 9: PROVISION FOR UNREALISED PROFITS (EXAMPLE 6)

	Carrying value of the asset within group accounts	Tax base of the asset in individual entity accounts	Temporary difference	Deferred tax asset or liability?
	$	$	$	
Cost to S	1,000			
PUP	(200)			
	800	1,000	(200)	Asset

The primary reason behind this is that it would be necessary for entities to determine when the future tax would be recovered or paid. In practice this is highly complex and subjective. Therefore, to require discounting of deferred tax liabilities would result in a high degree of unreliability. Furthermore, to allow but not require discounting would result in inconsistency and so a lack of comparability between entities.

Deferred tax and the framework

As we have seen, IAS 12 considers deferred tax by taking a "balance sheet" approach to the accounting problem by considering temporary differences in terms of the difference between the carrying amounts and the tax values of assets and liabilities – also known as the valuation approach. This can be said to be consistent with the approach taken to recognition in the International Accounting Standards Board's Conceptual Framework for Financial Reporting®(the Conceptual Framework). However, the valuation approach is applied regardless of whether the resulting deferred tax will meet the definition of an asset or liability in its own right.

Thus, IAS 12 considers the overriding accounting issue behind deferred tax to be the application of matching – ensuring that the tax consequences of an item reported within the financial statements are reported in the same accounting period as the item itself.

For example, in the case of a revaluation surplus, since the gain has been recognised in the financial statements, the tax consequences of this gain should also be recognised – that is to say, a tax charge. In order to recognise a tax charge, it is necessary to complete the double entry by also recording a corresponding deferred tax liability.

However, part of the Conceptual Framework's definition of a liability is that there is a 'present obligation'. Therefore, the deferred tax liability arising on the revaluation gain should represent the current obligation to pay tax in the future when the asset is sold. However, since there is no present obligation to sell the asset, there is no present obligation to pay the tax.

Therefore, it is also acknowledged that IAS 12 is inconsistent with the Conceptual Framework to the extent that a deferred tax asset or liability does not necessarily meet the definition of an asset or liability.

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Questions

The following information relates to an entity.
(i) At 1 January 20X8 the carrying amount of non-current assets exceeded their tax written down value by $850,000.
(ii) For the year to 31 December 20X8 the entity claimed depreciation for tax purposes of $500,000 and charged depreciation of $450,000 in the financial statements.
(iii) During the year ended 31 December 20X8 the entity revalued a property. The revaluation surplus was $250,000. There are no current plans to sell the property.
(iv) The tax rate was 30% throughout the year.

What is the provision for deferred tax required by IAS 12 Income Taxes at 31 December 20X8?

A $240,000
B $270,000
C $315,000
D $345,000

Answer: D

Chapter 13 Suspense accounts and error correction

Executive Summary

Suspense accounts and error correction are popular topics for examiners because they test understanding of bookkeeping principles so well.

A suspense account is a temporary resting place for an entry that will end up somewhere else once its final destination is determined.

There are two reasons why a suspense account could be opened:

1. A bookkeeper is unsure where to post an item and enters it to a suspense account pending instructions
2. There is a difference in a trial balance and a suspense account is opened with the amount of the difference so that the trial balance agrees

Some hints on preparing suspense accounts

1. Does a correction involve the suspense account?
2. Which side of the suspense account must an entry go?
3. Look out for errors with two aspects.

Suspense accounts and error correction are popular topics for examiners because they test understanding of bookkeeping principles so well. A suspense account is a temporary resting place for an entry that will end up somewhere else once its final destination is determined. There are two reasons why a suspense account could be opened:

1. A bookkeeper is unsure where to post an item and enters it to a suspense account pending instructions
2. There is a difference in a trial balance and a suspense account is opened with the amount of the difference so that the trial balance agrees (pending the discovery and correction of the errors causing the difference). This is the only time an entry is made in the records without a corresponding entry elsewhere (apart from the correction of a trial balance error – see error type 8 in Table 1). Financial Accounting (previously F3) tested a candidate's working knowledge of these types of error. Financial Reporting (FR - previously F7) tests how these errors are corrected and the suspense account is eliminated before financial statements are prepared.

Types of error

Before we look at the operation of suspense accounts in error correction, we need to think about types of error because not all types of error affect the balancing of the accounting records and hence the suspense account. Refer to Table 1.

Table 1: Types of error

Error type	Suspense account involved?
1 Omission – a transaction is not recorded at all	No
2 Error of commission – an item is entered to the correct side of the wrong account (there is a debit and a credit here, so the records balance)	No

Error type	Suspense account involved?
3 Error of principle – an item is posted to the correct side of the wrong type of account, as when cash paid for plant repairs (expense) is debited to plant account (asset) (errors of principle are really a special case of errors of commission, and once again there is a debit and a credit)	No
4 Error of original entry – an incorrect figure is entered in the records and then posted to the correct account Example: Cash $1,000 for plant repairs is entered as $100; plant repairs account is debited with $100	No
5 Reversal of entries – the amount is correct, the accounts used are correct, but the account that should have been debited is credited and vice versa Example: Factory employees are used for plant maintenance: Correct entry: Debit: Plant maintenance Credit: Factory wages Easily done the wrong way round	No
6 Addition errors – figures are incorrectly added in a ledger account	Yes
7 Posting error a. an entry made in one record is not posted at all b. an entry in one record is incorrectly posted to another Examples: cash $10,000 entered in the cash book for the purchase of a car is:	Yes

Error type	Suspense account involved?
a. not posted at all b. posted to Motor cars account as $1,000	
8 Trial balance errors – a balance is omitted, or incorrectly extracted, in preparing the trial balance	Yes
9 Compensating errors – two equal and opposite errors leave the trial balance balancing (this type of error is rare, and can be because a deliberate second error has been made to force the balancing of the records or to conceal a fraud). Yes, to correct each of the errors as discovered	Yes, to correct each of the errors as discovered

Correcting errors

Errors 1 to 5, when discovered, will be corrected by means of a journal entry between the ledger accounts affected. Errors 6 to 9 also require journal entries to correct them, but one side of the journal entry will be to the suspense account opened for the difference in the records. Type 8, trial balance errors, are different. As the suspense account records the difference, an entry to it is needed, because the error affects the difference. However, there is no ledger entry for the other side of the correction – the trial balance is simply amended.

An illustrative question

The bookkeeping system of Turner is not computerised, and at 30 September 20X8 the bookkeeper was unable to balance the the trial balance. The trial balance totals were: Debit $1,796,100 Credit $1,852,817

Nevertheless, he proceeded to prepare draft financial statements, inserting the difference as a balancing figure in the statement of financial position. The draft statement of profit or loss showed a profit of $141,280 for the year ended 30 September 20X8.

He then opened a suspense account for the difference and began to check through the accounting records to find the difference. He found the following errors and omissions:

1. $8,980 – the total of the sales returns book for September 20X8, had been credited to the purchases returns account.
2. $9,600 paid for an item of plant purchased on 1 April 20X8 had been debited to plant repairs account. The company depreciates its plant at 20% per annum on a straight line basis, with proportional depreciation in the year of purchase.
3. The cash discount totals for the month of September 20X8 had not been posted to the general ledger accounts. The figures were: Discount allowed $836 Discount received $919. For discounts allowed, it was not anticipated that these customers would take advantage of these cash discounts when the invoices were first issued.
4. $580 insurance prepaid at 30 September 20X7 had not been brought down as an opening balance.
5. The balance of $38,260 on the telephone expense account had been omitted from the trial balance.
6. A car held as a non-current asset had been sold during the year for $4,800. The proceeds of sale were entered in the cash book but had been credited to the sales account in the general ledger. The original cost of the car $12,000, and the accumulated depreciation to date $8,000, were included in the motor vehicles account and the accumulated depreciation account. The company depreciates motor vehicles at 25% per annum on a straight line basis with proportionate depreciation in the year of purchase but none in the year of sale.

Required:

(a) Open a suspense account for the difference between the trial balance totals. Prepare the journal entries necessary to correct the errors and eliminate the balance on the suspense account. Narratives are not required. *(10 marks)*

(b) Draw up a statement showing the revised profit after correcting the above errors. *(6 marks)*

Total *(16 marks)*

Note: it is unlikely that this format of question will be used in either the FA or FR exam. Both of these exams can test any of the errors included in the above question but an FA or FR exam question is unlikely to test this learning outcome using such a high concentration of marks. Despite this, the above question is still considered useful for teaching purposes.

The approach to the question should be:

1. Read the requirement paragraph at the end of the question.

2. Begin by opening the suspense account. Which side? More debit is needed to balance the trial balance, so debit the suspense account with $56,717.

Then deal with the errors in order:

1. Sales returns should have been debited to the sales returns account and they have been credited to the purchases returns account. There are two errors here – the wrong account has been used and an entry which should have been a debit has been entered as a credit. The suspense account entry must therefore be for 2 x $8,980 or $17,960.
2. An error of principle – no suspense account entry. Depreciation must be adjusted.
3. Items have not been posted, therefore the suspense account is involved.
4. Effectively a posting error – the suspense account is again involved.
5. A trial balance error must affect the suspense account – but no ledger entry.
6. This one needs thought. Take it one sentence at a time. Is the suspense account involved? No, because we have an error of commission followed by some unrecorded transactions.

Attempt Part (a) of the question before studying the answer as detailed in Table 2. Let's now turn to Part (b). The most convenient format for the answer is two columns for – and +. Set them up and enter the adjustments appropriately. Which of the errors affect the profit? In fact they all do. Attempt Part (b) now before looking at the answer detailed in Table 3.

Table 2: Answer – Part (a)

Suspense Account			
	$		**$**
Difference	56,717	Sales returns	8,980
Discount received	919	Purchases returns	8,980

Suspense Account			
		Revenue (customer cash discounts)	836
	---	Insurance	580
		Telephone (trial balance)	38,260
	57,636		57,636

Journal Entries

		$	**$**
1	Sales returns account	8,980	
	Suspense account		8,980

Suspense Account		
Purchases returns account	8,980	
Suspense account		8,980
2 Plant account	9,600	
Plant repairs account		9,600
Depreciation (statement of profit or loss)	960	
Plant depreciation account		960
3 Revenue (customer cash discounts)	836	

Suspense Account		
Suspense account		836
Suspense account	919	
Discount received account		919
4 Insurance account	580	
Suspense account		580
5 Trial balance (no ledger entry)	38,260	
Suspense account		38,260
6 Sales account	4,800	

Suspense Account		
Motor vehicles disposal account		4,800
Motor vehicles disposal account	12,000	
Motor vehicles asset account		12,000
Motor vehicles depreciation account	8,000	
Motor vehicles disposal account		8,000
Motor vehicles disposal account	800	
Statement of profit or loss		800

Table 3: Answer – Part (b)

Adjustment to profit	-	+
	$	$
Profit as in draft statement of profit or loss		141,280
1 Sales returns adjustment (2 x $8,980)	17,960	
2 Plant: reduction in repairs		9,600
depreciation – 6/12 x 20% x $9,600 960	960	
3 Revenue (customer cash discounts)	836	
Discount received		919

Adjustment to profit	-	+
4 Insurance – opening balance omitted	580	
5 Telephone expense omitted	38,260	
6 Profit on sale of car		800
Proceeds taken out of sales	4,800	-----
	63,396	152,599
		(63,396)
Revised net profit		89,203

Some hints on preparing suspense accounts

- Does a correction involve the suspense account? The type of error determines this. Practice, and study of Table 1 should ensure that you see immediately which errors affect the balancing of the records and hence the suspense account.

- Which side of the suspense account must an entry go? This is one of the most awkward problems in preparing suspense accounts. The best way of solving it is to ask yourself which side the entry needs to be on in the other account concerned. The suspense account entry is then obviously to the opposite side.
- Look out for errors with two aspects. In the illustrative question earlier, error 1 is a case in point. An entry has been made to the wrong account, but also to the wrong side of the wrong account. Both errors must be corrected. It is very easy to fall into the trap of correcting only one of the errors, especially when working quickly under examination conditions.

Chapter 14 Performance appraisal

Executive Summary

Performance appraisal requires good interpretation and a good understanding of what the information means in the context of the question.

You will often be required to make use of ratios to aid interpretation of the financial statements for the current year and to compare them to the results of a prior period, another entity, or against industry averages.

Profitability: 1. ROCE; 2. Asset Turnover; 3. Profit Margins

Liquidity: 1. Current Ratio; 2. Quick Ratio; 3. Receivable Collection Period; 4. Payable Collection Period; 5. Inventory Days; 6. Gearing

Performance appraisal requires good interpretation and a good understanding of what the information means in the context of the question

Performance appraisal is an important aspect of Paper F7, *Financial Reporting* and of interest to Paper P3 students. At this level you are not only required to prepare financial statements but understand the information underpinning the results.

You will often be required to make use of ratios to aid interpretation of the financial statements for the current year and to compare them to the results of a prior period, another entity, or against industry averages.

Increasingly, candidate exam performance is demonstrating a lack of commercial awareness and knowledge that barely stretches past the 'rote learned' phase. Candidates regularly state facts such as 'gross profit margin has increased' or, 'payables days have gone down' but this offers no interpretation of the reason behind the change in ratio. As a result markers find it difficult to award sufficient marks to candidates to achieve a pass.

This article is designed to aid candidates in understanding what is expected to create a solid answer to a performance appraisal question.

Specific problems

When marking this style of question there are some common weaknesses that are identified, some of which are highlighted below:

- limited knowledge of ratio calculations
- appraisal not linked to scenario
- poor understanding of the topic
- limited understanding of what accounting information represents
- lack of commercial awareness
- discursive elements often not attempted
- inability to come to a conclusion
- poor handwriting (often illegible in some instances)
- poor English.

Use the scenario

The majority of questions that feature performance appraisal have an accompanying scenario to the question requirement. A weak answer will make no attempt to refer to this information in the appraisal and, therefore, will often score few marks. It is important that you carefully consider this information and incorporate it into your appraisal because it has been provided for a reason. Do not simply list all the possibilities of why a ratio may have changed; link the reason to the scenario that you have been provided with.

Example

The question scenario may provide you with a set of financial statements and some further information such as details of non-current assets (potentially including a revaluation, a major acquisition or disposal) or measures undertaken during the year in an attempt to improve performance. When constructing your answer you must consider the effect that information such as this would have on the company results.

A major asset disposal would most likely have a significant impact on a company's financial statements in that it would result in a profit or loss on disposal being taken to the statement of profit or loss and a cash injection being received. It is worth noting that while the current year results will be affected by this, it is a one-off adjustment and bears little resemblance to future periods. When calculating ratios the disposal will improve asset turnover as the asset base becomes smaller over which revenue is spread and will, therefore, also improve return on capital employed. The operating margin is likely to be affected also as the profit or loss on disposal will be included when calculating this.

It is often worth calculating some of the results again (eg ROCE or operating profit margin) as part of your interpretation without the one?off disposal information, as arguably this will help make the information more comparable to the results that do not include such disposals (if time is limited a comment about the disposal's effect will be sufficient).

From a liquidity point of view the cash received on disposal of the asset will have aided cash flow during the year - ask yourself what would have happened if the company had not received this cash - ie are they already operating on an overdraft? If so, the cash flow position would be far worse without the disposal cash.

If a revaluation of non-current assets has taken place during the year the capital employed base will grow - this will have the impact of reducing both the asset turnover and return on capital employed ratios without any real change in operating capacity or profitability.

A major asset purchase again would cause both asset turnover and return on capital employed to deteriorate as the capital employed base would grow. It may appear that as a result of the acquisition the company has become less efficient at generating revenue and profit but this may not always be the case.

If, for example, the purchase took place during the latter half of the year, the new asset will not have contributed to a full year's profit and it may be that in future periods the business

will begin to see a better return as a result of the investment. When analysing the performance and position of the company, if management have implemented measures during the year to improve performance it is worth considering whether or not these measures have actually been effective. If, for example, a company chose to give rebates to customers for orders above a set quantity level - this would have the impact of improving revenue at the sacrifice of gross profit margin.

Know the basics

Ratios can generally be broken down into several key areas: profitability, liquidity, gearing and investment. As a student taking the Paper F7 exam you need to know the formulae for the relevant ratios and also what movements in these ratios could possibly mean. Provided below is a brief overview of the key ratios and what movements could indicate - further clarification and understanding can be found through your study text and then by practising past questions (due to the limited space of this article, investment ratios will not be discussed but this does not make them any less important).

Profitability

Return on capital employed (ROCE)

$$\frac{\text{Profit before interest and tax}}{\text{Shareholders' equity + debt}}$$

This ratio is generally considered to be the primary profitability ratio as it shows how well a business has generated profit from its long?term financing. An increase in ROCE is generally considered to be an improvement.

Movements in return on capital employed are best interpreted by examining profit margins and asset turnover in more detail (often referred to as the secondary ratios) as ROCE is made up of these component parts. For example, an improvement in ROCE could be due to an improvement in margins or more efficient use of assets.

Asset turnover

$$\frac{\text{Revenue}}{\text{Total assets - current liabilities}}$$

Asset turnover shows how efficiently management have utilised assets to generate revenue. When looking at the components of the ratio a change will be linked to either a movement in revenue, a movement in net assets, or both.

There are many factors that could both improve and deteriorate asset turnover. For example, a significant increase in sales revenue would contribute to an increase in asset turnover or, if the business enters into a sale and operating lease agreement, then the asset base would become smaller, thus improving the result.

Profit margins

$$\frac{\text{Gross } \textbf{or} \text{ Operating profit}}{\text{Revenue}}$$

The gross profit margin looks at the performance of the business at the direct trading level. Typically variations in this ratio are as a result of changes in the selling price/sales volume or changes in cost of sales. For example, cost of sales may include inventory write downs that may have occurred during the period due to damage or obsolescence, exchange rate fluctuations or import duties.

The operating profit margin (or net profit margin) is generally calculated by comparing the profit before interest and tax of a business to revenue, but, beware in the exam as sometimes the examiner specifically requests the calculation to include profit before tax.

Analysing the operating profit margin enables you to determine how well the business has managed to control its indirect costs during the period. In the exam when interpreting operating profit margin it is advisable to link the result back to the gross profit margin. For example, if gross profit margin deteriorated in the year then it would be expected that operating margin would also fall.

However, if this is not the case, or the fall is not so severe, it may be due to good indirect cost control or perhaps there could be a one-off profit on disposal distorting the operating profit figure.

Liquidity

Current ratio

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

The current ratio considers how well a business can cover the current liabilities with its current assets. It is a common belief that the ideal for this ratio is between 1.5 and 2 to 1 so that a business may comfortably cover its current liabilities should they fall due.

However this ideal will vary from industry to industry. For example, a business in the service industry would have little or no inventory and therefore could have a current ratio of less

than 1. This does not necessarily mean that it has liquidity problems so it is better to compare the result to previous years or industry averages.

Quick ratio (sometimes referred to as acid test ratio)

$$\frac{\text{Current assets - inventory}}{\text{Current liabilities}}$$

The quick ratio excludes inventory as it takes longer to turn into cash and therefore places emphasis on the business's 'quick assets' and whether or not these are sufficient to cover the current liabilities. Here the ideal ratio is thought to be 1:1 but as with the current ratio, this will vary depending on the industry in which the business operates.

When assessing both the current and the quick ratios, look at the information provided within the question to consider whether or not the company is overdrawn at the year-end. The overdraft is an additional factor indicating potential liquidity problems and this form of finance is both expensive (higher rates of interest) and risky (repayable on demand).

Receivables collection period (in days)

$$\frac{\text{Receivables}}{\text{Credit sales}} \times 365$$

It is preferable to have a short credit period for receivables as this will aid a business's cash flow. However, some businesses base their strategy on long credit periods. For example, a business that sells sofas might offer a long credit period to achieve higher sales and be more competitive than similar entities offering shorter credit periods.

If the receivables days are shorter compared to the prior period it could indicate better credit control or potential settlement discounts being offered to collect cash more quickly whereas an increase in credit periods could indicate a deterioration in credit control or potential bad debts.

Payables collection period (in days)

$$\frac{\text{Payables}}{\text{Credit purchases*}} \times 365$$

*(or cost of sales if not available)

An increase in payables days could indicate that a business is having cash flow difficulties and is therefore delaying payments using suppliers as a free source of finance. It is important that a business pays within the agreed credit period to avoid conflict with suppliers. If the payables days are reducing this indicates suppliers are being paid more

quickly. This could be due to credit terms being tightened or taking advantage of early settlement discounts being offered.

Inventory days

$$\frac{\text{Closing (or average) inventory}}{\text{Cost of sales}} \times 365$$

Generally the lower the number of days that inventory is held the better as holding inventory for long periods of time constrains cash flow and increases the risk associated with holding the inventory. The longer inventory is held the greater the risk that it could be subject to theft, damage or obsolescence. However, a business should always ensure that there is sufficient inventory to meet the demand of its customers.

Gearing

$$\frac{\text{Debt}}{\text{Equity}} \quad \text{or} \quad \frac{\text{Debt}}{\text{Debt + equity}}$$

The gearing ratio is of particular importance to a business as it indicates how risky a business is perceived to be based on its level of borrowing. As borrowing increases so does the risk as the business is now liable to not only repay the debt but meet any interest commitments under it. In addition, to raise further debt finance could potentially be more difficult and more expensive.

If a company has a high level of gearing it does not necessarily mean that it will face difficulties as a result of this. For example, if the business has a high level of security in the form of tangible non-current assets and can comfortably cover its interest payments (interest cover = profit before interest and tax compared to interest) a high level of gearing should not give an investor cause for concern.

Conclusion

In the exam make sure all calculations required are attempted so that you can offer possible reasons for any change in the discussion part of the question.

There is no absolute correct answer to a performance appraisal question. What sets a good answer apart from a poor one is the discussion of possible reasons for why (specifically in the given scenario) changes in the ratios may have occurred.

Bobbie Retallack is Kaplan Publishing's content specialist for Paper F7

Chapter 15 How to improve your answer to FR interpretation exam questions

Executive Summary

This article contains useful advice to help improve your answers to analysis questions whether in the context of a group or a single entity.

For some time now, the Financial Reporting (FR) examining team has observed that candidates perform really well in the preparation of financial statements, whether that is in the context of a group or a single entity. Unfortunately, their performance is less strong when they are asked to analyse these financial statements, which unfortunately tends to suggest that they don't fully understand their composition.

The main reasons that analysis questions do not score high marks is because:

- candidates do not provide workings for their ratio calculations and so markers cannot apply the 'own figure rule' when marking. Therefore, if an answer is wrong and there are no workings, candidates get no marks. If the answer is wrong but workings are provided, it is possible that markers can award marks for the parts of the calculation that are correct

- candidates often say that a ratio has increased or decreased but don't provide an explanation of why that might be the case – this may indicate that a candidate does not understand how different parts of the financial statements (and so the ratios) are connected to each other

- candidates do not make use of the information provided in the question scenario and so the answer lacks depth.

Unfortunately, there is little that the examining team can do to help with the last two observations – candidates need to understand what is expected of them and the only way to do this is to practise past exams/revision questions and compare their response to the suggested solution. However, in an effort to encourage candidates to produce workings in their ratio calculations, the examining team have decided to use pre-formatted responses in **some** of the analysis questions, but not all.

So, for example, where candidates are asked to calculate: (i) gross profit margin; (ii) operating profit margin and; (iii) interest cover for Loop Co and then to compare these ratios to a sector average, the pre-formatted response area may look like this:

Ratio	**Working**	**Loop Co**	**Sector Average**
Gross profit margin		To be calculated	30%
Operating profit margin		To be calculated	10%

Interest cover		To be calculated	4 times

This means that candidates do not have to 'build' a table in the response area and that the Sector Average information is pre-populated. When candidates see such a pre-formatted response area, they would be expected to provide their workings in the appropriate column and put their answer in the cell where it currently states 'to be calculated'. It would be better to delete the 'to be calculated' text but you won't lose marks if you don't. However, you should be aware that it is possible to delete **any** text that currently exists in this table (including the sector average information).

Obviously, you will need this information to complete your analysis so, in case you do delete this by mistake, the table has been replicated in the question scenario for your information and the requirement will remind you of this. So, to reiterate, if you delete something by mistake in the response area, don't panic – you will be able to find it again in the scenario on the left-hand-side of the screen. Hopefully, this strategy will help candidates to pick up vital marks in the ratio calculations.

Once you have calculated these ratios, you should look at the requirement to establish what you have been asked to comment on and set up the required headings in the response area; for example, performance and/or liquidity. It's usually best to start at the top of the statement of profit or loss (if provided) and work down because changes/differences in revenue often drive similar changes/differences in other ratios. You should then ask yourself the following questions:

- Is there a difference between the ratio that I have been asked to compare?
- Does the change/difference in this ratio impact other ratios?
- Is there an obvious reason for this? To find the answer, you will need to examine the relationships between different ratios and/or look at the question scenario for a potential explanation.
- Is there anything that the directors of the company can do to resolve this issue?

In following this strategy, candidates can provide answers to analysis questions that have depth and are supported by the evidence provided in the question scenario.

We hope that you find this information useful and that you can use it to improve your answers to analysis questions whether in the context of a group or a single entity.

Written by the Financial Reporting examining team
July 2020

Questions

Fifer Co has a current ratio of 1·2:1 which is below the industry average. Fifer Co wants to increase its current ratio by the year end.
Which of the following actions, taken before the year end, would lead to an increase in the current ratio?

A Return some inventory which had been purchased for cash and obtain a full refund on the cost
B Make a bulk purchase of inventory for cash to obtain a large discount
C Make an early payment to suppliers, even though the amount is not due
D Offer early payment discounts in order to collect receivables more quickly

Answer: C

The correct answer was C. This would cause an equivalent decrease in both current assets and liabilities, so it would therefore have no impact on the ratio. By applying simple figures to this, you could have seen that it had decreased. For example, if current assets were $120,000 and current liabilities were $100,000, this would give the original current ratio of 1.2:1. If an entity paid $20,000 to suppliers, this would make current assets $100,000 and current liabilities $80,000, giving a current ratio of 1.25:1.

Chapter 16 Tell me a story

Executive Summary

This article looks at what the Financial Reporting exam is looking for in the answer to an interpretation question, along with the key weaknesses that are consistently noted in candidate answers.

It then examines some of the different types of scenario that candidates might face in the exam, and some key recommendations of items to consider for each.

Don’t simply comment on the movements in numbers without explaining ‘why’, move away from the ‘textbook’ answers, don’t suggest answers with are not based on the scenario, and make sure you tell the examiner a story.

Analysing financial statements is a key area for the *Financial Reporting* (FR) exam, and is the area of the syllabus that is used to help prepare FR candidates for the *Strategic Business Reporting* (SBR) exam. It is also the area of the syllabus where performance varies most between students; a well prepared candidate can often score extremely high, in contrast to those candidates who have not prepared properly and so score very low, or even zero marks.

A well-rounded accountant must always be so much more than a number-crunching machine. The ability to step back, to discuss and to analyse has always been important to the profession. This is the purpose of the inclusion of this type of question in the FR exam, and it is vital that candidates master this skill in order to perform well.

This article will look at what the FR exam is looking for in the answer to an interpretation question, along with the key weaknesses that are consistently noted in candidate answers. It will then examine some of the different types of scenario that candidates might face in the FR exam, and some key recommendations of items to consider for each. Finally, these recommendations are applied to an example to show the difference between a good and a bad answer.

What the examiner is looking for

Candidates are required to combine the information in the scenario with the numbers that they have been given to produce a coherent understanding of the business and why items have moved. This is the specific skill that prepares candidates for SBR. Their answer needs to give succinct, key reasons for the movements rather than stating that performance has improved because sales or profits have moved.

Think of how a business would be analysed in the real world. If you were looking at the financial statements of a large company (for example Netflix) and noted that revenue had increased year on year, you wouldn't simply state that this was good and leave your answer at that. You would talk about the subscriber numbers or developments into new territories. You could talk about successful programmes, any recent film developments or any significant promotional offers. All of these would contribute to the underlying increase in revenue and should be discussed.

Similarly, in the FR exam, candidates must use the scenario. The exam will give you information in the question, which is there to support you. Just as an analyst commenting on the increased Netflix revenue would be expected to mention the factors outlined earlier, a candidate is expected to use the information in the question to explain the changes in performance or position. Any candidate who does not use this information is likely to score poorly.

A candidate's answer must be balanced. Often, the requirement may have separate elements to it, such as commenting on performance and position, or asking for further information. It is vital that candidates attempt all of the requirements. If 15 marks are

available for analysing performance and position, a good answer should attempt to make 7 or 8 points on both the statement of profit or loss and statement of financial position. An answer that focuses solely on profitability is not sufficiently dealing with the requirement and will not score highly.

Key weaknesses

The examiner's reports often detail the same weaknesses over and over, and these are essential reading to ensure that candidates do not make any of these common mistakes:

Lack of depth – Candidates often identify movements in accounting numbers without ever attempting to discuss the reasons why there has been a movement. Candidates sometimes comment that profitability has increased because the profit margins have improved. This is too brief and does not give any meaningful analysis, which should always seek to explain the underlying reason for the movement.

Lack of use of the scenario – Too many candidates are attempting to rote learn what ratios could mean and apply them to the numbers without any consideration for the information provided. A recent example is where an exam question dealt with a company that had acquired a new subsidiary and formed a group during the year. This meant that candidates were presented with consolidated financial statements for the current year and financial statements for a single entity for the previous year. A significant number of candidates attempted to answer the question without even mentioning the acquisition or that they were comparing financial statements that were not comparable (ie group versus single entity).

Calculations without workings – Candidates are often producing ratio calculations without providing workings behind them. This means that candidates are potentially missing out on numerous marks through the application of the 'own figure' rule. The June 2018 examiner's report contains a large amount of detail on this and should be carefully reviewed by candidates.

Types of scenario

1. Comparison of one entity over two periods

This could examine extracts from the financial statements for the same entity over two time periods. The key things to consider here are any developments or changes in the business between the two years, and whether the performance and position of the entity has improved or deteriorated. As stated above, this always needs to be supported with the reason (or potential reasons) for the improvement or deterioration.

Candidates should also consider one-off events that could skew comparison. If these exist, the question will normally ask you to strip these out of the accounting numbers and recalculate ratios to show the underlying position for comparison. Candidates should also

be considering the impact of any new products, or changes in customers or entries into new markets.

2. Comparison of two entities in the same period

These types of question might be based on two competitor firms and ask candidates to compare their performance or decide which is more suitable to target for acquisition. Candidates should consider if there any differences in accounting policies which might skew the comparison. There may also be useful information about which areas of the market the company targets or information about significant customers.

If the question includes an acquisition, candidates should look at the liquidity of the companies and any possible synergies that could be made through purchasing either of the entities

3. Comparison of an entity with the sector averages

In a scenario such as this, candidates should give consideration to the fact that different entities in the sector will have different margins as they target different ends of the market. Also firms may have different year ends, which could skew the comparison. Finally, consider if the entity in question has different accounting policies to the rest of the sector.

4. Analysis of consolidated financial statements – acquisition of a subsidiary

If a candidate is asked to analyse consolidated financial statements, they must consider group-related issues, rather than treating it the same as the analysis of a single entity. Consideration of the fact that there may be different entities with different margins is necessary, as well as the fact that some transactions such as intra-group sales or unrealised profits will need to be eliminated. There may also be issues to deal with such as goodwill impairment which would not incur in individual financial statements. Finally, analysis of consolidated financial statements could involve either an acquisition of a subsidiary or a disposal of a subsidiary.

In a situation with the acquisition of a subsidiary, it is important to note that the results will not be comparable year-on-year. The current year will have consolidated the results of the subsidiary , whereas, the previous year would not. The subsidiary may be in a different market, with different margins and payment terms, so this could have a significant impact across all of the ratios.

Consideration should also be given as to when the subsidiary was acquired during the year; there may be a mid-year acquisition in which case there will be an impact on both the consolidated Statement of Financial Position (SOFP) and the Statement of Profit or Loss (SOPL). The results in the SOPL will include the profits of the subsidiary since acquisition. The statement of financial position will include the full assets and liabilities of the subsidiary.

This means that ratios using elements of both performance and position will present a complex picture for candidates to analyse. For example, if a subsidiary is acquired six months into the year, then only six months revenue will be included, but the entire receivables balance will be included within the statement of financial position. This would give a false impression of the receivables collection period if this was used to calculate this ratio.

If the subsidiary was purchased at the year-end there will only be an impact on the SOFP (but not the SOPL). There may also be elements of one-off costs incurred associated with the acquisition of the subsidiary. These are unlikely to be repeated, so candidates should consider these and consider calculating ratios excluding these figures.

5. Analysis of consolidated financial statements – disposal of a subsidiary

If a subsidiary has been disposed during the year, then the consolidated SOPL will only contain the results of the subsidiary up until the date of disposal, rather than for the full period. The SOFP will not contain any assets or liabilities of the subsidiary since it has been disposed. Therefore, similar to as noted above, any ratios combining information from the SOPL and the SOFP may not show an accurate picture due to this mismatch. Candidates would be expected to spot this and talk about the limitations of this comparison.

There are lalso ikely to be one-off items relating to the disposal. These might include gains or losses on disposal, any potential closure or redundancy costs, and any professional fees associated with the disposal.

6. Analysis of cash flow information

In questions that require the analysis of cash flow statements, tThe first key figure to discuss is the cash generated from operations. This shows how much cash the business can generate from its core activities, before looking at one-off items such as asset purchases/sales and raising money through debt or equity. The cash generated from operations figure is effectively the cash profit from operations.

Candidates should then consider other cash inflows and outflows from the remainder of the cash flow statement. Consider these in/outflows are one-off items (such as purchases or sales of non-current assets), or regular in/outflows such as interest paid or tax paid.

Candidates should not simply comment on the overall movement in the total cash and cash equivalents figure in the year. An increase in this figure will not simply mean that the entity has performed well in the year. A situation could easily arise where an entity is struggling to generate cash in a period and is forced to sell its owned premises and rent them back in order to continue to trade. This may mean that the entity's overall cash position increases in the period, but is clearly not a sign that the entity has performed well. This should cause significant concern, as the entity cannot sell the premises to raise cash again in the future.

Example

The following financial statement extracts are for Janssen Co for the years ending 31 December 20X7 and 20X8.

	20X8	**20X7**
	$000	$000
Revenue	35,100	42,300
Cost of sales	(24,200)	(27,400)
Gross profit	10,900	14,900
Trade receivables	2,400	1,500

The following information is also relevant.

Janssen Co is a manufacturer of confectionary, selling through supermarkets and small convenience stores. In recent years there has been a decline in demand following concerns over the level of sugar in confectionary products. To combat this, in July 20X8 Janssen Co rebranded some of its chocolate bars as health food supplements and began to sell them to chains of gyms and hotels, in addition to the existing confectionary lines.

Janssen Co reduced the selling price on other items by 10% to combat the falling demand. Janssen Co also outsourced its packaging to a third party, whereas previously Janssen Co had packaged its own goods.

Answer tips

In the exam, most candidates would calculate ratios correctly, as these are pretty straightforward. This would give the following:

	20X8	**20X7**

Gross profit margin	31.0%	35.2%
	(10,900/35,100)	(14,900/42,300)
Receivables collection period	25 days	13 days
	(2,400/35,100 x 365)	(1,500/42,300 x 365)

Remember to provide workings for your ratios as demonstrated above (unless the spreadsheet answer space is used where cell formula might be used to calculate ratios).

The most common errors in the analysis would be to comment on the numbers above without a single consideration of the scenario. Based on these figures, there would be many comments such as:

- Gross profit margin is down, meaning Janssen Co is generating less profits from the core product
- Janssen Co may be managing costs poorly
- Janssen Co may have changed supplier
- Janssen Co may have a risk of irrecoverable debts

These answers do not have sufficient depth to score significant marks. Candidates cannot simply learn what a decrease in the ratios could mean, and apply these generic reasons across each exam diet. None of these bullet points really consider what we know about the entity, and will score poorly because of that. Typically many candidates fail to even comment on the movement in revenue because there is no ratio to calculate. Therefore they would omit it from their analysis, despite it being a key accounting number.

A much better answer would consider what we know about the business, and what we would expect to see happen to the figures. The answer below shows how candidates should be combining the information in the narrative with the figures calculated to come up with the key reasons why accounting numbers have moved.

Revenue – decrease of $7.2m, which is a fall of 17%.

The fall in revenue is likely to be driven by the decreased consumer demand following the concerns over sugar.
We would potentially have expected an underlying decrease in the confectionary revenue as Janssen Co cut the price by 10%. This suggests that the reduction in sale price has not resulted in the increase in volume that Janssen Co may have hoped for.

It may also mean that the move into the new market has been unsuccessful, as the demand for the sports food supplement may not be there.
It is also important to note that the product was only launched in July 20X8 so may not have had time to generate significant sales yet.

A candidate who has commented on the items above is likely to score 4 marks. All of those points are using the scenario, telling the reader a story which is derived directly from the question. This will significantly outscore the student who states that the decline in revenue is a poor sign for the business and not much else.

Gross profit margin – fall of 4%

Whilst the fall in gross margin is a poor sign, this is surprising as Janssen Co has cut the price by 10%, so a fall in gross profit margin of greater than 4% may have been expected.
We are told that Janssen Co has outsourced its wrapping department. This move may have led to a reduction in cost of sales, enabling Janssen Co to offset some of this price reduction.
The new products launched may have a higher gross profit margin than the remaining confectionary products, as they are aimed at a different market.

Candidates who produce comments like those noted above will score significantly higher than those making generic comments regarding cost management. These comments are based around the scenario and are bringing in sensible commentary based on what would be expected to be seen. This is what the exam is looking for, rather than simply stating that a decrease in the margin is a negative thing.

Receivables collection period – increase of 12 days

Previously Janssen Co made the majority of its sales via retail outlets, meaning that there would have been almost no credit terms on the majority of its sales.
The increase in receivables is likely to be due to the new contracts with gyms and hotels, as these are likely to have negotiated credit terms with Janssen Co.
A high proportion of Janssen Co's sales are likely to remain as retail sales, which would aid Janssen Co's cash flows even with this introduction of new credit terms.

These are the kind of comment that will score marks. Comments referring to 'ideal' receivables collection periods of 30 days are likely to not score anything. These are rote learned and not what the examiner is looking for.

Summary

The analysis question is likely to be one that continues to divide candidates. By taking a step back, making sensible points and basing these points on the scenario, candidates will ensure that they are performing towards towards the top end of the range of marks. So, don't simply comment on the movements in numbers without explaining 'why', move away from the 'textbook' answers, don't suggest answers with are not based on the scenario, and make sure you tell the examiner a story!

Written by a member of the *Financial Reporting* examining team

Chapter 17 Analysing a statement of cash flows

Executive Summary

A key part of the Financial Reporting exam is the ability to analyse a set of financial statements. The statement of cash flows is one of the primary financial statements, and Financial Reporting candidates must be able to explain the performance of an entity based on all of the financial statements including the cash flows given.

A good analysis will examine the statement of cash flows in detail and look for the reasons behind the movement, commenting on how the entity's performance is reflected here.

The statement of cash flows contains three sections, namely cash flows from operating activities, investing activities and financing activities, each of which give us useful information about an entity's performance.

A key part of the Financial Reporting exam is the ability to analyse a set of financial statements. The statement of cash flows is one of the primary financial statements, and Financial Reporting candidates must be able to explain the performance of an entity based on all of the financial statements including the cash flows given. To do this, candidates must understand the different sections of the statement and the implications for the business.

One of the first things to note is to not simply comment on the overall movement in the total cash and cash equivalents figure in the year. An increase in this figure does not necessarily mean that the entity has performed well in the year. A situation could easily arise where an entity is struggling to generate cash in a period and is forced to sell its owned premises and rent them back in order to continue. This may mean that the entity's overall cash position increases in the period, but is clearly not a sign that the entity has performed well. This would be a significant concern, as the entity cannot simply sell premises again in the future. There will also be fewer assets owned the entity in the future, meaning that its ability to secure future borrowing may be limited. Any candidate simply commenting that the entity has performed well as the overall cash figure has increased is unlikely to score any marks, as they have not really understood the reasons behind the movement.

A good analysis will examine the statement of cash flows in detail and look for the reasons behind the movement, commenting on how the entity's performance is reflected here. The statement of cash flows contains three sections, namely cash flows from operating activities, investing activities and financing activities, each of which give us useful information about an entity's performance.

Operating activities

The first key figure to address is likely to be cash generated from operations. This shows how much cash the business can generate from its core activities, before looking at one-off items such as asset purchases/sales and raising money through debt or equity. The cash generated from operations figure is effectively the cash profit from operations. The cash generated from operations figure should be compared to the profit from operations to show the quality of the profit.

The closer these two are together, the better the quality of profit. If the profit from operations is significantly larger than the cash generated from operations, it shows that the business is not able to turn that profit into cash, which could lead to problems with short-term liquidity.

When examining cash generated from operations, examine the movements in working capital which have led to this figure. Large increases in receivables and inventories could mean problems for the cash flow of the business and should be avoided if possible. This could mean that the company has potential irrecoverable debts, or may be that a large customer has been taken on with increased payment terms. Either way, the company should have enough cash to pay the payables on time.

Look for large increases in payables. If a company has positive cash generated from operations, but a significant increase in the payables balance compared to everything else, it may be that the company is delaying paying its suppliers in order to improve its cash flow position at the end of the year.

The cash generated from operations figure should be a positive figure. This ensures that the business generates enough cash to cover the day to day running of the company. The cash generated from operations should also be sufficient to cover the interest and tax payments, as the company should be able to cover these core payments without taking on extra debt, issuing shares or selling assets.

Any cash left over after paying the tax and interest liabilities is thought of as 'free cash', and attention should be paid as to where this is spent. Ideally, a dividend would be paid out of this free cash, so that a firm does not have to take out longer sources of finance to make regular payments to its shareholders. Other good ways of using this free cash would be to invest in further non-current assets (as this should generate returns into the future) and paying back loans (as this will reduce further interest payments).

Investing activities

This section of the cash flow focuses on the cash flows relating to non-current assets,

For example, sales of assets can be a good thing if those assets are being replaced. However, as stated earlier, if a company is selling off its premises and is now renting somewhere, this makes the financial position significantly weaker, and banks will be less willing to lend as there are less assets to secure a loan against.

The sale of assets should not be used to finance the operating side of the business or to pay dividends. This is poor cash management, as a company will not be able to continue selling assets in order to survive. This is an indication that a company is shrinking and not growing.

Whilst purchases or sales of non-current assets may be relatively irregular transactions, the presence of interest received, or dividends received may well be recurring cash flows arising from investments the entity holds.

Financing activities

The sources of financing any increases in assets should also be considered. If this can be financed out of operations, then this is the best scenario as it shows the company is generating significant levels of excess cash. Funding these out of long term sources (ie loans or shares) is also fine, as long-term finances are sensible to use for long term assets.

However, when raising long term finance, it is also useful to consider the future consequences. For example, taking out loans will lead to higher interest charges going forward. This will increase the level of gearing in the entity, meaning that finance providers may charge higher interest rates due to the increased risk. It may also mean that loan providers are reluctant to provide further finance if the entity already has significant levels of debt.

Raising funds from issuing shares will not lead to interest payments and will not increase the level of risk associated with the entity. It must also be noted that issuing shares will lead to more shareholders and possibly higher total dividend payments in the future.

In summary, a well-rounded answer will absorb all of the information contained within a statement of cash flows, using this to produce a thorough discussion of an entity's performance. Candidates who are able to do this should perform well on these tasks, and are more likely to have demonstrated a much greater understanding of performance than simply commenting whether the overall cash balance has gone up (or down).

Written by a member of the Financial Reporting examining team

Questions

The carrying amount of property, plant and equipment was $410 million at 31 March 20X1 and $680 million at 31 March 20X2. During the year, property with a carrying amount of $210 million was revalued to $290 million. The depreciation charge for the year was $115 million. There were no disposals. What amount will appear on the statement of cash flows for the year ended 31 March 20X2 in respect of purchases of property, plant and equipment?

Answer: $305 million

In $m
B/f 410; Depreciation (115); Revaluation 80; Purchases (β) 305 = C/f 680