INTERNATIONAL FINANCIAL REPORTING

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International FinancialReporting

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Preface

The purpose of this book is to explain International Financial Reporting Standards (IFRS®Standards) and International Accounting Standards (IAS®Standards) at a level which is appropriate for students who are undertaking an intermediate course of study in financial reporting. It is assumed that the reader has already completed an introductory accountingcourseandisfamiliarwiththebasicsoffinancialaccounting.Thebookhasnotbeen written with any particular syllabus in mind but should be useful to second-year undergraduatesstudyingforadegreeinaccountingandfinanceandtothosewhoarepreparing fortheexaminationsoftheprofessionalaccountingbodies.

IFRS Standards and IAS Standards (referred to in this book as "international standards")havegainedwidespreadacceptancearoundtheworldandmostaccountingstudentsare now required to become familiar with them. The problem is that the standards and their accompanyingdocumentsoccupyover4,000pagesoffineprintandmuchofthiscontent ishighlytechnicalanddifficulttounderstand.Whatisneededisatextbookwhich explainseachstandardasclearlyandconciselyaspossibleandprovidesstudentswith plentyofworkedexamplesandexercises.Thisbooktriestosatisfythatneed.

Thestandardsareofinternationalapplicationbut,forthesakeofconvenience,mostof the monetary amounts referred to in the worked examples and exercises in this book are denominated in £s. Other than this, the book contains very few UK-specific references and shouldberelevantinanycountrywhichhasadoptedinternationalstandards.

EachchapterofthebookconcludeswithasetofexerciseswhichtestthereaderÕsgrasp of the topics introduced in that chapter. Some of these exercises are drawn from the past examinationpapersofprofessionalaccountingbodies.Solutionstomostoftheexercises arelocatedatthebackofthebookbutsolutionstothoseexerciseswhicharemarkedwith anasterisk(*)areintendedforlecturers'useandareprovidedonasupportingwebsite.

This seventh edition is in accordance with all international standards or amendments to standards issued as at 1 January 2019.

AlanMelville
January2019

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I would like to thank the IFRS® Foundation for permission to use extracts from various IASB® standards. This publication contains copyright material of the IFRS Foundation in respect of which all rights are reserved. Reproduced by Pearson Education Limited with the permission of the IFRS Foundation. No permission granted to third parties to reproduce or distribute. For full access to IFRS Standards and the work of the IFRS Foundation, please visit http://eifrs.ifrs.org.

The International Accounting Standards Board, the IFRS Foundation, the author and the publishers do not accept responsibility for any loss caused by acting or refraining from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

I would also like to thank the following accounting bodies for granting me permission to use their past examination questions:

- Association of Chartered Certified Accountants (ACCA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)
- Association of Accounting Technicians (AAT).

I must emphasise that the answers provided to these questions are entirely my own and are not the responsibility of the accounting body concerned. I would also like to point out that the questions which are printed in this textbook have been amended in some cases so as to reflect changes in accounting standards which have occurred since those questions were originally published by the accounting body concerned.

Please note that, unless material is specifically cited with a source, any company names used within this text have been created by me and are intended to be fictitious.

Alan Melville
January 2019

Listofinternationalstandards

A full list of the International Financial Reporting Standards (IFRS®Standards) and the InternationalAccountingStandards(IAS®Standards)whichareinforceatthetimeof writing this book is given below. Standards missing from the list have been withdrawn. Alongsideeachstandardisacross-referencetotherelevantchapterofthebook.

Itisimportanttorealisethatnewormodifiedstandardsareissuedfairlyoften.The reader who wishes to keep up-to-date is advised to consult the website of the International Accounting Standards Board (IASB®) at www.ifrs.org.

InternationalFinancialReportingStandards		*Chapter*
IFRS1	First-timeAdoptionofInternationalFinancialReportingStandards	1
IFRS2	Share-basedPayment	14
IFRS3	BusinessCombinations	6,18
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IAS21	TheEffectsofChangesinForeignExchangeRates	21
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IAS24	RelatedPartyDisclosures	21
IAS26	AccountingandReportingbyRetirementBenefitPlans	–
IAS27	SeparateFinancialStatements	18
IAS28	InvestmentsinAssociatesandJointVentures	20
IAS29	FinancialReportinginHyperinflationaryEconomies	17
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IAS33	EarningsperShare	23
IAS34	InterimFinancialReporting	3
IAS36	ImpairmentofAssets	7
IAS37	Provisions,ContingentLiabilitiesandContingentAssets	12
IAS38	IntangibleAssets	6
IAS40	InvestmentProperty	5
IAS41	Agriculture	–

It should be noted that some of these standards are beyond the scope of this book and are considerednofurtherhere.ThesareIFRS6,IFRS14,IFRS17,IAS26andIAS41.

As well as the international standards, three further IASB documents (none of which are standards) are dealt with in this book. These are:

(a) the *ConceptualFrameworkforFinancialReporting*(see Chapter 2) which sets out a numberofconceptsthatunderliefinancialreportingandwhichisreferredtobythe IASBduringthedevelopmentofnewandamendedstandards

(b) IFRS Practice Statement 1 *ManagementCommentary*, which provides a broad, non-bindingframeworkforthepresentationofamanagementcommentarytoaccompany a set of financial statements (see Chapter 3)

(c) IFRSPracticeStatement2*MakingMaterialityJudgements*,whichprovidesguidance onmakingmaterialityjudgementswhenpreparinggeneralpurposefinancialstatements (see Chapter 3).

Part1

INTRODUCTIONTOFINANCIALREPORTING

Chapter1

Theregulatoryframework

Introduction

Financial reporting is the branch of accounting that deals with the preparation of financial statements. These statements provide information about the financial performance andfinancialpositionofthebusinesstowhichtheyrelateandmaybeofvaluetoawiderange ofusergroups.Morespecifically,theterm"financialreporting"ismostoftenusedtorefer tothepreparationoffinancialstatementsforalimitedcompany.Inthiscase,themain users of the statements are the company's shareholders. However, the information which is contained in financial statements may also be of use to other user groups such as lenders, employees and the tax authorities (see Chapter 2).

The purpose of this book is to explain the rules which govern the preparation of financial statements for organisations which comply with international standards. This first chapter introducesthe*regulatoryframework*withinwhichfinancialstatementsareprepared.The next chapter outlines the main features of a *conceptualframework*setting out the mainconcepts which underlie financial reporting.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- listthemainsourcesofaccountingregulationsandexplaintheneedforregulation
- explaintheterm"generallyacceptedaccountingpractice"(GAAP)
- outlinethestructureandfunctionsoftheInternationalAccountingStandardsBoard (IASB®) and its associated bodies
- explain the purpose of an accounting standard and list the main steps in the standard-setting process adopted by the IASB
- outlinethestructureof aninternational financial reportingstandardor international accounting standard
- explain the main features of IFRS1 *First-*

timeAdoptionofInternationalFinancialReportingStandards.

Theneedforregulation

Smallbusinessorganisationsareusuallymanagedbytheirowners.Thisisgenerallythe case for a sole trader, where the business is run by a single owner-manager, and for partnerships, where the business is owned and managed by its partners. Similarly, smallprivatelimitedcompaniesareoftenmanagedbytheirshareholders,whomightallbe membersofthesamefamily.Inthesecircumstances,theownerorownersofthebusiness cangleanconsiderableamountsoffinancialinformationfromtheirday-to-dayinvolvement in managing its affairs and so do not depend solely upon formal financial statements to provide them with this information.

Incontrast,largebusinesses(whichareusuallylimitedcompanies)aregenerallyowned by one group of people but are managed by a different group. A large public company isownedbyitsshareholders,ofwhomtheremaybemanythousands,butismanagedbya small group of directors. Although some of the shareholders may also act as directors, it is likelythatthelargemajorityofthesshareholdershavenodirectinvolvementinmanaging the company which they own. Such shareholders are almost entirely reliant upon thecompany'sfinancialstatementsforinformationregardingthecompany'sfinancial performanceandpositionandtohelpthemtodeterminewhetherornotthecompanyis beingproperlymanaged.Otherexternalusergroups(suchasthecompany'screditors)are alsodependenttoalargeextentupontheinformationcontainedinfinancialstatements whentryingtomakeeconomicdecisionsrelatingtothecompany.

Iftheformandcontentoffinancialstatementswerenotregulated,itwouldbepossible for incompetent or unscrupulous directors to provide shareholders and other users with financialstatementswhichgaveafalseormisleadingimpressionofthecompany's financialsituation.Thiswouldinevitablycauseuserstomakepooreconomicdecisions andsounderminethewholepurposeofpreparingfinancialstatements.Thereforeitis vital,especiallyinthecaseoflargercompanies,thatfinancialreportingshouldbesubject to a body of rules and regulations.

Sourcesofregulation

Therulesandregulationswhichapplytofinancialreportingmaybecollectivelyreferred to as the "regulatory framework". In practice, most of this framework applies only to companies,butitisimportanttorealisethatfinancialreportingregulationscouldbemade in relation to any class of business entity. Indeed, the international standards which are the subject of this book generally refer to "entities" rather than companies. However, it may be assumedfortheremainderofthebookthatwearedealingprimarilywithfinancial reporting by companies. The regulatory framework which applies to financial reporting by companies consists of the following main components:

(a) legislation

(b) accountingstandards

(c) stock exchange

regulations. Each of these is

explained below.

Legislation

Mostofthedevelopedcountriesoftheworldhaveenactedlegislationwhichgoverns financial reporting by limited companies. This legislation does of course differ from one countrytoanother.IntheUK,forexample,theCompaniesAct2006containsrules relating to matters such as:

- theaccountingrecordswhichcompaniesmustkeep
- therequirementtoprepareannualaccounts(i.e.financialstatements)
- therequirementthattheseaccountsmustgivea"trueandfairview"
- the requirement that the accounts must be prepared in accordance with eitherinternational standards or national standards
- thecircumstancesinwhichgroupaccountsmustbeprepared(seeChapter18)
- thecircumstancesinwhichanauditisrequired
- the company's duty to circulate its accounts to shareholders and to make the accountsavailable for public inspection.

SomeoftheserulehavearisenasaresultofEuropeanUnion(EU)Directives†andthisis alsotrueofthelegislationinothermemberstatesoftheEU.

† *InviewoftheUK'sdecisiontoleavetheEU,itseemslikelythatEUinfluenceoverUKcompanylawwi lleventuallyceasetoexist.*

Accountingstandards

Whilstlegislationgenerallysetsoutthebroadruleswithwhichcompaniesmustcomply when preparing financial statements, detailed rules governing the accounting treatment of transactionsandotheritemsshowninthosestatementsarelaiddownin*accountingstandar ds*. Many of the developed countries of the world have their own standard-setting bodies,eachofwhichisresponsiblefordevisingandpublishingaccountingstandardsfor useinthecountryconcerned.IntheUKthisistheFinancialReportingCouncil(FRC). TheUSAhasaFinancialAccountingStandardsBoard(FASB)andtherearestandard-settersinothercountriessuchasGermany,Japan,Australiaetc.

However,theincreasingglobalisationofbusinesshasfuelledthesearchforasingleset ofaccountingstandards.Thesestandardswouldapplythroughouttheworldandwould greatly improve the consistency of financial reporting. To this end, the International Accounting Standards Board (IASB®) has developed and is continuing to develop a set of international standards which it hopes will attain global acceptance. These standards arealreadyusedinagreatmanycountriesoftheworld(seelaterinthischapter).

Most of the remainder of this book is concerned with the international standards and an introductiontotheworkoftheIASBisgivenlaterinthischapter.

Stockexchangeregulations

Acompanywhoseshares arelisted(or "quoted") onarecognisedstockexchangemust comply with the regulations of that stock exchange, some of which may relate to thecompany's financial statements. A stock exchange may, for example, require its member companies to produce financial statements more frequently than required by law (e.g. topublish interim financial reports at quarterly or half-yearly intervals) or to provide a more detailedanalysisofsomeoftheitemsinitsfinancialstatementsthanisrequiredbylawor by accounting standards.

Generallyacceptedaccountingpractice

The term "generally accepted accounting practice" (GAAP) refers to the complete set of regulations (from all sources) which apply within a certain jurisdiction, together with any general accounting principles or conventions which are usually applied in that jurisdictioneventhoughtheymaynotbeenshrinedinregulations.Sinceaccountingrulesand regulationscurrentlydifferfromonecountrytoanother,itiscorrecttousetermssuchas "UK GAAP", "US GAAP" and so forth. At present, there is no globally accepted set of accountingregulationsandprinciplesbuttheIASBisworkingtowardsthatendandis tryingtoachieveconvergencebetweenthevariousregulationswhichareinforcethrough-outtheworld(seelaterinthischapter).Theterm"internationalGAAP"isusedtoreferto thestandardsissuedbytheIASBandtheprinciplesonwhichthosestandardsarebased.

Adistinctionissometimesdrawnbetweenbig GAAPandlittleGAAP,asfollows:

(a) The term "big GAAP" refers to the accounting regulations which apply to largecompanies(generallylistedcompanies).Thefinancialaffairsofthesecompanies can be very complex and therefore the regulations concerned need to be correspondingly complex.Someoftheinternationalstandardsdescribedinthisbookappeartohave been written mainly with large companies in mind.

(b) The term "little GAAP" refers to the simpler accounting regulations which apply to smaller companies. In the UK, for example, standard FRS102 (the main UK financial reporting standard) contains special rules for "small entities". Furthermore, "micro-entities"maychoosetoadoptFRS105*TheFinancialReportingStandardapplicabletotheMicro-entitiesRegime*,ratherthancomplyingwithFRS102.

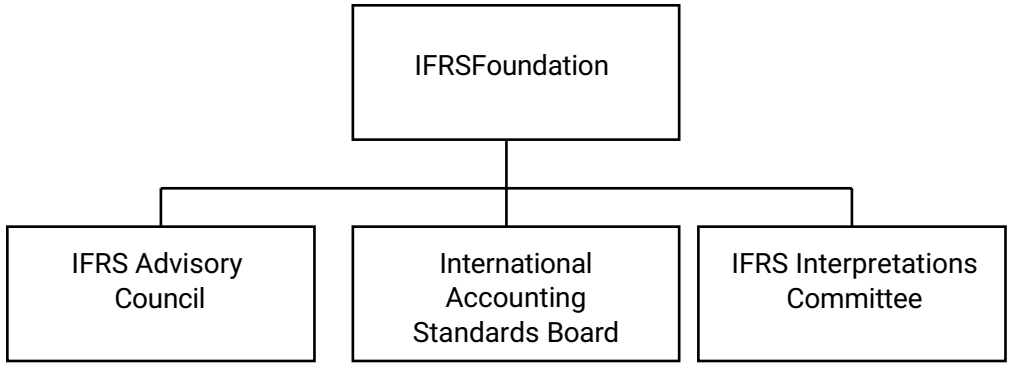
Attheinternationallevel,theIASBhasissuedthe*IFRSforSMEs*®Standard.This isessentiallyasimplifiedversionofthefullinternationalstandardsandisintended for use by small and medium-sized entities (mainly unlisted companies). A briefsummaryoftheSMEsstandardisgiveninChapter25ofthisbook.

TheInternationalAccountingStandardsBoard

International standards are developed and published by the International AccountingStandards Board (IASB) which was formed in 2001 as a replacement for the International Accounting Standards Committee (IASC). Standards published by the IASB are known as InternationalFinancialReportingStandards(IFRS®Standards).Standardspublishedbythe IASC are known as International Accounting Standards (IAS®Standards). Many of theIAS Standards are still in force, since they were adopted by the IASB on its inception. At present, the list of extant standards comprises sixteen IFRS Standards and twenty-four IAS Standards.Afulllistofthesestandardsisgivenatthefrontofthisbook.

The IASB consists of fourteen members, of whom up to three may be part-time. The members of the IASB are chosen for their professional competence and their relevant experienceandareselectedinsuchawaythatabroadgeographicalbalanceismaintained ontheBoard.ThecurrentIASBChairmanisHansHoogervorst.ThepreviousChairman wasSirDavidTweedie,whooccupiedthepositionfortenyearsandwasformerly Chairman of the UK standard-setting organisation.

TheIASBisresponsibletothetrusteesoftheIFRSFoundation,asisshowninthe following diagram:



TheIFRSFoundation

TheconstitutionoftheIFRSFoundationstatesthatitsobjectivesareasfollows:

(a) todevelop,inthepublicinterest,asinglesetofhigh-quality,understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information to make economic decisions;

(b) topromotetheuseandrigorousapplicationofthosestandards;

(c) infulfillingtheobjectivesassociatedwith(a)and(b),totakeaccountof,as appropriate, the needs of a range of sizes and types of entities in diverse economic settings;

(d) to promote and facilitate adoption of the IFRS Standards, being the Standards andIFRIC®Interpretations (see below) issued by the IASB, through the convergence of national accounting standards and IFRS standards.

TheIASB's*PrefacetoInternationalFinancialReportingStandards*statesthattheseare also the objectives of the IASB.

The activities of the IFRS Foundation are directed by twenty-two Trustees who areappointedsubjecttoapprovalbyaMonitoringBoard(seebelow)andwhoaredrawnfrom a diversity of geographical and professional backgrounds. The Trustees are responsible for appointingthemembersoftheIASBandtheotherbodiesshownintheabovediagramand forestablishingandmaintainingthenecessaryfundingfortheirwork.TheTrusteesare alsoresponsibleforreviewingtheeffectivenessoftheIASB.Financialsupportforthe IFRSFoundation'sactivitiesisreceivedfromavarietyofsources,including:

(a) nationalfinancingregimesbaseduponacountry'sGrossDomesticProduct(GDP)

(b) incomefrompublicationsandrelatedactivities

(c) majorinternationalaccountingfirms.

TheMonitoringBoardcompriseshigh-levelrepresentativesofpublicauthoritiessuchas theEuropeanCommissionandtheUSSecuritiesandExchangeCommission.TheTrustees arerequiredtomakeanannualwrittenreporttotheMonitoringBoard.

TheIFRSAdvisoryCouncil

The IFRS Advisory Council provides a forum for participation by organisations andindividuals with an interest in international financial reporting. The Advisory Council comprises thirty or more members drawn from diverse geographical and professional backgrounds and has the following objectives:

(a) toofferadvicetotheIASBwithregardtoitsagendaandpriorities

(b) toinformtheIASBofCouncilmembers'viewsonstandard-settingprojects

(c) toofferotheradvicetotheIASBortotheTrustees.

TheChairmanoftheAdvisoryCouncilcannotbeamemberoftheIASBoritsstaff.

TheIFRSInterpretationsCommittee

The main role of the IFRS Interpretations Committee is to interpret the application of internationalstandards(issuing"IFRICInterpretations")andtoprovidetimelyguidanceon financial reporting matters which are not specifically addressed in the standards. The InterpretationsCommitteehasfourteenvotingmembersandanon-votingChair.

Thestandard-settingprocess

TheIASBdevelopsstandardsbymeansofa"dueprocess"whichinvolvesaccountants, usersoffinancialstatements,thebusinesscommunity,stockexchanges,regulatory authorities,academicsandotherinterestedindividualsandorganisationsthroughoutthe world. The main steps in this process (which are listed in the *PrefacetoInternationalFinancialReportingStandards*) are as follows:

- identificationandreviewofalltheissuesassociatedwiththetopicconcerned
- considerationof thewayinwhichtheIASB*ConceptualFramework*(seeChapter 2) applies to these issues
- a study of national accounting requirements in relation to the topic and an exchange ofviews with national standard-setters
- consultation with the Trustees and the Advisory Council about the advisability ofadding this topic to the IASB's agenda
- publicationofadiscussiondocumentforpubliccomment
- considerationofcommentsreceivedwithinthestatedcommentperiod
- publicationofanexposuredraftforpubliccomment
- considerationofcommentsreceivedwithinthestatedcommentperiod
- approvalandpublicationofthestandard.

Publication of an international standard requires approval by at least nine of the fourteen members of the IASB.

The *Preface*states that the international standards are designed to apply to the general purposefinancialstatementsandotherfinancialreportingofprofit-orientedentities, whethertheseareorganisedincorporateformorinotherforms.Forthisreason,the standardsreferto"entities"ratherthancompanies.Theword"entity"isalsousedinthis book,althoughinpracticetheinternationalstandardsapplyprincipallytocompanies.

Thestructureofaninternationalstandard

AnIFRSStandardoranIASStandardconsistsofasetofnumberedparagraphsandis typicallymadeupofsomeorallofthefollowingsections:

- introduction
- objectivesandscopeofthestandard
- definitionsoftermsusedinthestandard(thesemaybeinanAppendix)
- thebodyofthestandard
- effectivedateandtransitionalprovisions
- approvalbytheIASBandanydissentingopinionsbyIASBmembers.

AstandardmaybeaccompaniedbyaBasisforConclusions,whichisnotpartofthe standarditselfbutwhichsetsouttheconsiderationswhichweretakenintoaccountwhen the standard was devised. There may also be application or implementation guidance and illustrative examples.

Thepurposeofaccountingstandards

Themainpurposeofaccountingstandards(whethernationalorinternational)istoreduce or eliminate variations in accounting practice and to introduce a degree of uniformity into financial reporting. In particular, accounting standards usually set out requirements withregardtotherecognition,measurement,presentationanddisclosureoftransactionsan d otheritemsinfinancialstatements.Themainadvantagesofthisstandardisationareas follows:

(a) **Faithfulrepresentation**.Ifthepreparersoffinancialstatementsareobligedto comply with a set of accounting standards, then it is more likely that the informationgiveninthestatementswillprovideafaithfulrepresentationofthefinancial performanceandfinancialpositionoftheorganisationconcerned.Accounting standards help to ensure that financial reporting is free from bias and that "creative accounting" practices are outlawed.

(b) **Comparability**. It is important that users should be able to compare the financial statements of an organisation over time so as to identify trends in its financialperformanceandposition.Itisalsoimportantthatusersshouldbeabletocomp are thefinancialstatementsofdifferentorganisationsandassesstheirrelativestrengths and weaknesses. Such comparisons will not be meaningful unless all of the financial statementsconcernedhavebeendrawnuponaconsistentbasis.Thisismuchmore likelytobethecaseifaccountingstandardshavebeenobserved.

A more detailed explanation of these and certain other "qualitative characteristics" of the information that is provided in financial statements is given in the IASB *ConceptualFramework*(see Chapter 2).

ItistheviewoftheIASBthatstandardsshouldensurethatlikeitemsareaccountedfor in a like way and that unlike items are accounted for in different ways. Therefore the IFRS StandardsissuedbytheIASBdonotgenerallypermitachoiceofaccountingtreatment. Some of the IAS Standards which were adopted by the IASB on its inception do allow achoice of accounting treatment but the IASB has reconsidered (and will continue to recon- sider) the items for which a choice of treatment is permitted, with a view to reducing the numberofchoicesavailableoreliminatingchoicealtogether.

It could, of course, be argued that accounting standards should allow some degree of flexibilityandthatcompliancewiththesingleaccountingtreatmentpermittedbya standardmightsometimesbeinappropriate.TheIASBtakestheviewthatthissituationis veryunlikelytooccur.However,internationalstandardIAS1(seeChapter3)allowsan entitytodepartfromtherequirementsofastandardinthe"extremelyrarecircumstances" in which compliance would prevent the financial statements from faithfully representing transactions and other items.

Worldwideuseofinternationalstandards

As stated above, the goal of the IFRS Foundation is to develop a set of global accounting standards, promote their use and bring about convergence between national standards and international standards. This goal has not yet been achieved in full but the worldwideinfluenceofinternational standardshasincreasedsignificantlysincetheIASBwasformed and this process seems likely to continue.

Atpresent,over140countriesrequireallormostdomesticlistedcompaniestocomply withIFRSStandards†.Thecountriesconcernedincludeall EU‡memberstatestogether with countries such as Australia, Brazil, Canada, Russia and South Korea. The use of IFRS Standardsispermitted(butnotrequired)inseveralothercountries.Furthermore:

(a) India'snationalstandardsarelargelyconvergedwithIFRSStandards.Mostlistedcompaniesandlargeunlistedcompaniesarerequiredtocomplywiththesestandards.

(b) JapanpermitsmostlistedcompaniestouseIFRSStandards.

(c) ChinahassubstantiallyconvergeditsnationalstandardswithIFRSStandards.

(d) HongKonghasfullyconvergeditsnationalstandardswithIFRSStandards.

(e) TheUSFinancialAccountingStandardsBoard(FASB)hasbeenworkingwiththe IASB on a number of convergence projects and foreign companies listed on US stock exchanges are already permitted to use IFRS Standards. Whether these standards will eventuallybeadoptedforUSdomesticcompaniesremainstobeseen.

† *Notethat,inthiscontext,theterm"IFRSStandards"referstotheinternationalstandardsintheirentirety,includingIFRSStandards,IASStandardsandIFRICInterpretations*.

‡ *TheUKGovernmenthasannouncedthatEU-adoptedIFRSStandardswillbe"transposed"intotheUKcorporatereportingframeworkifandwhentheUKleavestheEU.*

Perhaps understandably, international standards have made rather less impact in relation to unlistedcompanies,whichtendtohavestraightforwardfinancialaffairsandtooperatein onecountryonly.However,over80countriesnowrequireorpermit unlistedcompaniesto usethe*IFRSforSMEs*Standard(seeChapter25)anditistobeexpectedthatfurther countries will adopt this standard in due course.

First-timeadoptionofinternationalstandards

In 2003, the IASB issued IFRS1 *First-timeAdoptionofInternationalFinancialReportingStandards.*Arevisedversionwasissuedin 2010.TheobjectiveofIFRS1istoensurethat anentity'sfirstfinancialstatementswhichcomplywithinternationalstandardsshould contain high-quality information that:

- istransparentforusersandcomparableforallperiodspresented
- providesasuitablestartingpointforaccountingunderinternationalstandards
- canbegeneratedatacostthatdoesnotexceedthebenefitstousers.

ThemainfeaturesofIFRS1areasfollows:

(a) An entity's "first IFRS† financial statements" are defined as the first financial state -ments in which the entity adopts international standards and makes an explicit and unreservedstatementofcompliancewiththosestandards.

† *Thisstandardusestheterm"IFRS"torefertotheinternationalstandardsintheirentirety,incl udingIFRSStandards,IASStandardsandIFRICInterpretations*.

(b) The"firstIFRSreportingperiod"isdefinedasthereportingperiodcoveredbythe first IFRS financial statements.

(c) The "date of transition" to international standards is defined as the beginning of the earliest period for which an entity presents comparative information in its first IFRS financial statements. Most financial statements cover a period of one year and give comparativeinformationforthepreviousyear.Sothedateoftransitionisnormally thedatewhichfallstwoyearsbeforetheendofthefirstIFRSreportingperiod.

(d) When first adopting international standards, an entity must prepare an "opening IFRS statementoffinancialposition"asatthedateoftransition.Thisisthestartingpoint foraccountinginaccordancewithinternationalstandards.TheopeningIFRSstate-mentoffinancialpositionmustcomplywithinternationalstandards*asattheendofthefi rstIFRSreportingperiod*(see below) and should:

(i) recognise all assets and liabilities whose recognition is required by international standards,butnotrecogniseitemsasassetsorliabilitiesifthisisnotpermitted by international standards

(ii) reclassify items which were recognised as one type of asset or liability under previous GAAP but which are classified as a different type of asset or liabilityunder international standards

(iii) applyinternationalstandardsinmeasuringallrecognisedassetsandliabilities.

Notethattheterm"statementoffinancialposition"hasnowreplacedtheterm "balancesheet"throughouttheinternationalstandards(seeChapter3).

(e) The same accounting policies must be used in the entity's opening IFRS statement of financialpositionandinallperiodspresentedinthefirstIFRSfinancialstatements (i.e. the first IFRS reporting period and the comparative period(s)). In general, these accountingpoliciesmustcomplywithallinternationalstandardsineffect*attheendofth efirstIFRSreportingperiod*,evenifsomeofthosestandardswerenotineffect at the date of transition or during some or all of the periods for which information isbeing presented.

(f) ThefirstIFRSfinancialstatementsmustincludethefollowingreconciliations:

(i) a reconciliation of equity (share capital and reserves for a company) as reported underpreviousGAAPwithequityre-

calculatedunderinternationalstandards, for the date of transition and for the end of the last period in which the entity reported under previous GAAP

(ii) a reconciliation of total comprehensive income for the last period in which theentityreportedunderpreviousGAAPwithtotalcomprehensiveincomeasit wouldhavebeencalculatedunderinternationalstandards.

Note that the term "total comprehensive income" refers to an entity's profit or loss
togetherwithcertainothergainsorlossessuchasrevaluationgains(seeChapter3).

(g) IFRS1 grants limited exemptions from some of its requirements where the cost of compliancewouldbelikelytoexceedthebenefitstousersofthefinancialstatements.

EXAMPLE

Acompanywhichhasalwayspreparedfinancialstatementsto31Decembereachyearpreparesit sfirstIFRSfinancialstatementsfortheyearto31December2019.Thesestatementsshowcompa rativefiguresfortheyearto31December2018.

(a) IdentifythefirstIFRSreportingperiodandstatethedateoftransition.

(b) Explaintheproceduretobefollowedinordertopreparethefinancialstatementsfor theyearto31December2019.

(c) Identifythereconciliationswhichthecompanymustincludeinitsfinancialstatementsforth eyearto31December2019.

Solution

(a) ThefirstIFRSreportingperiodistheyearto31December2019.Thedateoftransitiontointern ationalstandardsisthestartofbusinesson1January2018,whichisequivalenttothecloseof businesson31December2017.

(b) Theprocedureisasfollows:

(i) AnopeningIFRSstatementoffinancialpositionasat31December2017mustbeprepar edinaccordancewithallinternationalstandardsthatareeffectiveforaccountingperio dsendingon31December2019.

(ii) Thecompanymustthenpreparearevisedversionofthefinancialstatementsfortheye arto31December2018,againapplyingallinternationalstandardseffectiveforperiods endingon31December2019.Thisprovidescomparativefiguresforthe2019financial statements.

(iii) Thefinancialstatementsfortheyearto31December2019arethenprepared.

(c) Therequiredreconciliationsare:

(i) areconciliationofthecompany'sequity(i.e.sharecapitalandreserves)asreportedund erpreviousGAAPwithequityascalculatedunderinternationalstandards,atboth31De cember2017and31December2018.

(ii) areconciliationofthecompany'stotalcomprehensiveincomeasreportedunderprevi ousGAAPfortheyearto31December2018withtotalcomprehensiveincomeforthatye arascalculatedunderinternationalstandards.

Summary

- The regulatory framework within which the financial statements of companies are prepared consists of a mixture of legislation, accounting standards and (whereapplicable) stock exchange regulations.
- Legislationgenerallysetsoutthebroadruleswithwhichcompaniesmustcomply whenpreparingtheirfinancialstatements.Accountingstandardsprovidedetailedrule sregardingtheaccountingtreatmentoftransactionsandotheritems.
- TheincreasingglobalisationofbusinesshasledtotheestablishmentoftheIASBand thedevelopmentofinternationalstandards.Thesestandardshavenotyetachieved globalacceptancebuttheirinfluencehasincreasedgreatlyinrecentyears.
- Theterm"generallyacceptedaccountingpractice"(GAAP)referstothecompleteset of accounting regulations and principles which are usually applied within a certain jurisdiction.
- The IASB is the standard-setting body of the IFRS Foundation. The IFRS Advisory Council offers advice to the IASB with regard to its agenda and priorities. The IFRS InterpretationsCommitteeisresponsiblefortheinterpretationofinternational standardsandforprovidingtimelyguidanceonmattersnotspecificallyaddressedin the standards.
- The standard-setting process adopted by the IASB involves the publication of adiscussiondocumentandanexposuredraft(withconsiderationofcommentsreceive d at each stage) before the final standard is published.
- The main purpose of accounting standards is to reduce or eliminate variations in accountingpracticeandtointroduceadegreeofuniformityintofinancialreporting.
- IFRS1 *First-timeAdoptionofInternationalFinancialReportingStandards*setsout theprocedurewhichmustbefollowedwhenanentityadoptsinternationalstandards for the first time.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

1.1 Explain the term "regulatory framework" as it applies to financial reporting. Why is this framework needed?

1.2 Outlinethestructureandfunctionsofthefollowingbodies:

(a) theIFRSFoundation (b)theInternationalAccountingStandardsBoard
(c)theIFRSAdvisoryCouncil (d)theIFRSInterpretationsCommittee.

1.3 Explaintheterm"generallyacceptedaccountingpractice"(GAAP).Istherejustone GAAP which is accepted worldwide? If not, why not?

1.4 Outlinethestructureofaninternationalstandard(IFRSStandardorIASStandard).

1.5 Explainthepurposeofaccountingstandards(whethernationalorinternational)and identifytheadvantagesthatstemfromthestandardisationofaccountingpractice.Are there any disadvantages?

1.6 A company adopts international standards for the first time when preparing its financial statementsfortheyearto30June2020.Thesefinancialstatementsshowcomparativ e figures for the previous two years.

Explain the main requirements of IFRS1 *First-timeAdoptionofInternationalFinancialReportingStandards*whichmustbesatisfied whenpreparingthecompany'sfinancial statements for the year to 30 June 2020.

1.7 Theterm "regulatoryframework"referstothebodyofrulesandregulationswhichapply to the financialstatements of limited companies.This framework includes company law, accounting standards and (for listed companies) stock exchange regulations.

(a) State the objectives of the International Accounting Standards Board. Also explain the role of the IFRS Advisory Council and the IFRS Interpretations Committee.

(b) Explaintheterm"GenerallyAcceptedAccountingPractice"(GAAP).*(CIPFA)*

*1.8 The International Accounting Standards Board (IASB) develops international standards by means of a "due process". The main stages of this process are listed in the *PrefacetoInternationalFinancialReportingStandards*.The*Preface*alsostatestheobj ectivesof the IASB and explains the scope of international standards.

(a) StatetheobjectivesoftheIASB.

(b) Explainthescopeofinternationalfinancialreportingstandardsandinternational accounting standards.

(c) ListthemainstagesoftheIASBdueprocess.

*1.9 IFRS1*First-timeAdoptionofInternationalFinancialReportingStandards*laysdownthe procedure which must be followed when an entity prepares its first financial state- ments that comply with IFRS Standards and IAS Standards.

(a) StatetheobjectiveofIFRS1.

(b) Explain the terms "first IFRS reporting period" and "date of transition" as defined by IFRS1.

(c) Acompanyadoptsinternationalstandardsforthefirsttimeinitsfinancialstate- mentsfortheyearto31October2020.Thesefinancialstatementsprovide comparative figures for the previous five years. Explain the requirements of

IFRS1 which must be satisfied when preparing these financial statements.

Chapter2

TheIASBconceptualframework

Introduction

A "conceptual framework" for financial reporting consists of a coherent set of fundamental principleswhichunderpinfinancialaccountingandsoprovideasoundtheoreticalbasisfor the development of accounting standards. Amongst other things, a conceptual framework should consider the objectives of financial statements, the elements from which these statementsarebuilt,thecircumstancesinwhichelementsmaybeshown("recognised")in thefinancialstatementsandthewaysinwhichelementsaremeasuredandpresented.

In the absence of a conceptual framework, accounting standards are more difficult todevelopsinceeachstandardmustbeginfromscratch.Itisalsomorelikelythattherewill beinconsistenciesandcontradictionsbetweenonestandardandanother.

The IASB contribution to the development of a conceptual framework is its *ConceptualFrameworkforFinancialReporting*.Althoughdevisedbyastandard-settingbody,the IASB*ConceptualFramework*isnotitselfanaccountingstandardanddoesnotoverride thestandards.Ifthereisaconflictbetweenthe*ConceptualFramework*andaninter-nationalstandard,thenthestandardprevails.Butthe*ConceptualFramework*identifies certainconceptswhich,intheviewoftheIASB,underliethepreparationandpresentation offinancialstatements.Thepurposeofthischapteristoexplaintheseconcepts.

DevelopmentoftheConceptualFramework

The IASB *ConceptualFramework*replaces the IASC *FrameworkforthePreparationandPresentationofFinancialStatements*whichwasissuedi n1989.Thefirstversionofthe new *ConceptualFramework*was published in 2010 and contained revised material (agreed withtheUSFASB)ontheobjectivesoffinancialreportingandthequalitativecharacter-isticsofusefulfinancialinformation.ThecompletedversionwasissuedinMarch2018.At the same time, some minor amendments were made to those international standards which make explicit reference to the *ConceptualFramework*.

ThecompletedversionoftheIASB*ConceptualFramework*tookimmediateeffectfor the

IASB itself, so that standards issued after March 2018 are based upon the principles expressedinthatversion.Theminoramendmentsmadetoexistingstandards(seeabove) takeeffectasfrom1January2020,thoughearlierapplicationispermitted.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- statethemainpurposesoftheIASB*ConceptualFramework*
- state the objective of general purpose financial reporting and identify the primaryusers of financial reports
- stateandexplainthequalitativecharacteristicsofusefulfinancialinformation
- explain the "going concern" assumption which usually underlies the preparation offinancial statements
- defineeachofthemainelementsoffinancialstatements
- explainthecriteriawhichdeterminewhetherornotanelementshouldberecognised in the financial statements
- explainthemeasurementbaseswhichareidentifiedinthe*ConceptualFramework* andthefactorswhichshouldbeconsideredwhenselectingameasurementbasis
- distinguishbetweenfinancialcapitalmaintenanceandphysicalcapitalmaintenance.

PurposeandstatusoftheIASB*ConceptualFramework*

The IASB *ConceptualFrameworkforFinancialReporting*states the objective of general purposefinancialreportingandsetsouttheconceptsthatunderliethepreparationof generalpurposefinancialreports.Themainpurposesofthe*ConceptualFramework*are:

(a) to assist the IASB in the development of international standards that are based on consistent concepts

(b) toassistthepreparersoffinancialreportstodevelopconsistentaccountingpolicies (see Chapter 4) when no international standard applies to a particular transaction orevent,orwhenaninternationalstandardpermitsachoiceofaccountingpolicy

(c) toassistallpartiestounderstandandinterprettheinternationalstandards.

Asstatedabove, the*ConceptualFramework*isnot itselfaninternational standardanddoes not override the standards. But the *ConceptualFramework*provides the foundation for standardswhichenhancethecomparabilityandqualityoffinancialinformation,providing the information needed to hold management to account and helping investors to identify opportunities and risks. The use of a single set of international standards based on the *ConceptualFramework*alsoreducesfinancialreportingcosts.

Scope

TheMarch2018versionofthe*ConceptualFramework*dealswiththefollowingmatters:

(a) theobjectiveofgeneralpurposefinancialreporting

(b) thequalitativecharacteristicsofusefulfinancialinformation
(c) financialstatementsandthereportingentity
(d) theelementsoffinancialstatements
(e) recognitionandderecognitionoftheelementsoffinancialstatements
(f) measurementoftheelementsoffinancialstatements
(g) presentationanddisclosure
(h) concepts of capital and capital

maintenance. Each of these is explained

below.

Objectiveofgeneralpurposefinancialreporting

The*ConceptualFramework*statesthattheobjectiveofgeneralpurposefinancialreporting is
"*toprovidefinancialinformationaboutthereportingentitythatisusefultoexistingandpotentialinvestors,lendersandothercreditorsinmakingdecisionsaboutprovidingresourcestotheentity*". Such decisions may be concerned with buying, selling or holding equity in the entity (e.g. shares), providing credit to the entity (e.g. loans) or voting on the actions of the entity's management. Existing and potential investors, lenders and othercreditors are referred to collectively as the "primary users" of general purpose financialreports.Inmoredetail,the*ConceptualFramework*statesthat:

(a) Decisions by existing and potential investors depend upon the returns they expect to receive from an investment in the entity concerned (e.g. dividends or increases in the marketvalueoftheentity'sshares).Decisionsbylendersandothercreditorsalso dependuponexpectedreturns(e.g.loaninterestanddebtrepayments).Therefore these"primaryusers"needinformationthatwillhelpthemtoassesstheamount, timing (and degree of uncertainty) of future cash inflows to the entity. This includes informationabouttheentity'seconomicresources,claimsagainsttheentityand changes in those resources and claims.
Decisionsbytheprimaryuserswillalsodependupontheirassessmentofthe entity's management and its "stewardship" of the entity's resources. Thereforeinformation is needed about the efficiency and effectiveness with which the entity's management has used its resources.

(b) Theprimaryuserscannotrequireanentitytoprovideinformationdirectlytothem andsotheyrelyongeneralpurposefinancialreportsformuchoftheinformation which they need. However, these financial reports cannot provide all of the required informationandprimaryuserswillalsoneedtoconsiderinformationfromother sources(e.g.generaleconomicforecasts,industryoutlooksetc.).

(c) General purpose financial reports are not designed to show the value of the

reporting entitybutmayhelpprimaryuserstoestimatetheentity'svalue.

(d) Individual primary users may have differing information needs. When developing international standards, the IASB seeks to ensure that financial reports prepared in accordance with those standards will provide information that meets the needs of the maximumnumberofprimaryusers.However,thereisnothingtopreventanentity from disclosing additional information that might be useful to a particular subset of primary users.

(e) Financialreportsarebasedtosomeextentuponestimates,judgementsandmodels and so cannot be exact. The *ConceptualFramework*establishes the concepts thatunderlie those estimates, judgements and models.

(f) Inadditiontotheprimaryusers, other parties might findgeneral purposefinancial reports useful, although these reports are not primarily intended for their benefit. The *ConceptualFramework*doesnotlisttheseotherpartiesbuttheIASC*Framework*issuedi n1989indicatedthattheusersoffinancialreportsmightalsoinclude:

(i) employees and their representatives, who may use financial reports to help them assesstheprofitabilityandstabilityofanentityandsodeterminetheentity's abilitytoprovideemploymentopportunities,fairpayandretirementpensions

(ii) customers,whomayusefinancialreportstohelpthemassesswhethertheentity islikelytocontinueinbusinessandsoactasareliablesourceofsupply

(iii) governmentsandtheiragencies,whomayusetheinformationprovidedin financialreportstohelpdeterminetaxationpolicies,regulatebusinessand compile national statistics

(iv) the public, who may wish to assess an entity's prosperity and developments in its rangeofactivities,especiallyifthatentitymakesasubstantialcontributionto thelocaleconomy(e.g.byprovidinglocalemploymentorbyitspatronageof local suppliers).

Themanagementofanentityisobviouslyinterestedinfinancialinformationabout thatentity.However,managementisabletoobtainfinancialinformationinternally andsodoes not relyupongeneral purposefinancial reports.

Informationaboutanentity'sresourcesandclaims

Generalpurposefinancialreportsshouldprovideinformationaboutthefinancialpositionof the reporting entity (i.e. information about the entity's economic resources and claimsagainsttheentity).Financialreportsshouldalsoprovideinformationabouttransactio ns andothereventsthatchangetheentity'sfinancialposition.Changesinfinancialposition mayresultfromtheentity'sfinancialperformance(e.g.themakingofaprofit)orfrom othereventssuchasshareissues.Bothofthesetypesofinformationareusefulwhen makingdecisionsaboutprovidingresourcestotheentity.Notethat:

(a) Information about an entity's financial position helps primary users to identify thatentity'sfinancialstrengthsandweaknessesandtoassessitsliquidityandsolvency.

(b) Informationaboutanentity'sfinancialperformancehelpsprimaryuserstounderstand the return that the entity has made on the resources at its disposal and whether those resourceshavebeenmanagedefficientlyandeffectively(sohelpinguserstoassess thestewardshipofmanagement).Informationaboutpastfinancialperformancemay alsobeusefulwhenpredictingfuturereturnsonanentity'seconomicresources.

(c) Financial performance information is prepared on an "accrual accounting" basis. This means that transactions and other events are recognised in the periods in which theyoccur (not necessarily the periods in which cash is received or paid). This approach providesbetterfinancialperformanceinformationthaninformationbasedsolelyon cashreceiptsandpaymentsoccurringduringareportingperiod.

However, information about cash flows during a period is also important, since it indicateshowanentitygeneratesandspendscashandhelpsuserstoassessthe entity's ability to generate future net cash inflows.

(d) Finally, information about changes in an entity's financial position which have notresulted from its financial performance (e.g. changes caused by share issues) is also necessary since it gives users a complete understanding of how and why the entity's financial position has changed.

Thissectionofthe*ConceptualFramework*doesnotspecifyornamethefinancial statementsinwhicheachofthefourclassesofinformationlistedaboveshouldbe presented.However,financialstatementsareintroducedinalatersectionunderthe heading "Financial statements and the reporting entity" (see below) and the four mainfinancialstatementsareidentifiedininternationalstandardIAS1(seeChapter3).

Qualitativecharacteristicsoffinancialinformation

The *ConceptualFramework*identifies six "qualitative characteristics" of useful financial information.Thesecharacteristicsindicatethetypesofinformationthatarelikelytobe mostusefultotheprimaryusersoffinancialreports.Twoofthequalitativecharacteristics are stated to be "fundamental". These are:

- relevance
- faithfulrepresentation.

Theremainingfourqualitativecharacteristicsaredescribedas"enhancing"sincethey furtherenhancetheusefulnessoffinancialinformationthatisalreadyrelevantand faithfullyrepresented.Theenhancingcharacteristicsare:

- comparability
- verifiability
- timeliness
- understandability.

Eachofthesecharacteristicsisexplainedbelow.

Relevance

Thefirstfundamentalqualitativecharacteristicofusefulfinancialinformationisthatit should be relevant to users' decision-making needs(i.e. capable of making a difference to users'decisions).Irrelevantinformationisobviouslynotuseful.Inparticular,information isrelevantifithaspredictivevalueorconfirmatoryvalue,asfollows:

(a) Information has "predictive value" if can help users to predict future outcomes (e.g.future financial performance). In order to have predictive value, information does nothave to take the form of an explicit forecast, since information on past transactions or eventsmaybeusedasabasisforpredictionsaboutthefuture.

(b) Informationhas"confirmatoryvalue"ifitprovidesfeedbackwhichhelpstoconfirm or refute previous predictions.

Therelevanceoffinancialinformationisaffectednotonlybyitsnaturebutalsobyits levelofmateriality.Materialityismainlyconcernedwiththesizeormonetaryamountof anitemandinformationissaidtobe"material"ifomitting,mis-statingorobscuringit could influence users' decisions. Information about an item which is so small as to be immaterial is not relevant to users' needs. The IASB cannot specify a generally applicable materiality threshold, since materiality is entity-specific, but IFRS Practice Statement 2*MakingMaterialityJudgements*(seeChapter3)providesguidanceonthismatter.

Faithfulrepresentation

The second fundamental qualitative characteristic of useful financial information is that itmust faithfully represent the transactions and other events that it purports to represent. A perfectlyfaithfulrepresentationwouldbe*complete*,*neutral*and*freefromerror*.The objectiveoftheIASBistomaximisethesequalitiestoasgreatanextentaspossible.

(a) **Completeness**. Financial information is complete if it includes all of the information required in order that a user should understand the transactions and other events being represented,includingallnecessarydescriptionsandexplanations.

(b) **Neutrality**.Aneutralrepresentationisonethatisunbiased.Financialinformationis notneutralifitismanipulatedinsomewaytoachieveapredeterminedresult,with theaimofincreasingtheprobabilitythattheinformationwillbereceivedfavourably (or unfavourably) by users.

The *ConceptualFramework*states that neutrality is supported by the application of prudence,where"prudence"istheexerciseofcautionwhenmakingjudgements under conditions of uncertainty. Although prudence does not necessarily imply an asymmetric approach to financial reporting (e.g. a tendency to understate assets and incomeortooverstateliabilitiesandexpenses)itisacceptedthatcertainstandards mayadoptsuchanapproachsoastoprovideuserswithinformationwhichisrelevant to

their needs and which gives a faithful representation.

(c) **Freedomfromerror**. Financial information does not have to be 100% accurate but it mustbefreefrommaterialerror.Freedomfromerrorimpliesthattherearenoerrors or omissions in the description of the items being represented and that no errors havebeen made when selecting and applying the process used to produce the reported information.Forinstance,anestimatecanberegardedasfreefromerroraslongas the amount is clearly described as being an estimate, the estimating process is fully explainedandnoerrorsaremadewhenselectingorapplyingthatprocess.

The *ConceptualFramework*makes it clear that the use of reasonable estimates is essential to the preparation of financial information and does not undermine theusefulnessofthatinformation,aslongastheestimatesareclearlyexplained.

Furthermore,financialinformationmustrepresenttheeconomicsubstanceoftransactions andotherevents.Ifthelegalformofsuchtransactionsandeventsdiffersfromtheir economicsubstance,providinginformationonlyabouttheirlegalformwouldnotprovide afaithfulrepresentation.Thisisthe"substanceoverform"concept.

Finally,financialinformationmustbothberelevantandprovideafaithfulrepresenta- tion. A faithful representation of irrelevant information would not help users to make good decisions.Norwouldanunfaithfulrepresentationofrelevantinformation.

Enhancingqualitativecharacteristics

As stated above, the enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability. These characteristics enhance the usefulness of financial informationwhichisalreadybothrelevantandfaithfullyrepresented.

(a) **Comparability**.Thischaracteristicenablesuserstocomparefinancialinformation aboutanentityforareportingperiodwithsimilarinformationaboutotherentitiesfor the same period and with similar information about the same entity for other periods.Suchcomparisonswillhelpuserstomakeeconomicdecisions.

Comparability is improved through consistency. Consistency refers to the use of the sameaccountingtreatmentsforthesametypesofitem,eitherfromperiodtoperiod byonereportingentityorinasingleperiodacrossentities.TheIASBtakestheview thatpermittingalternativeaccountingtreatmentsforanitemdiminishesconsistency and so diminishes comparability. This is an argument in favour of the IASB's stated intention of reducing the number of choices of accounting treatment allowed by internationalstandardsorpossiblyeliminatingchoicealtogether(seeChapter1).

(b) **Verifiability**. Financial information is said to be "verifiable" if independent, knowledgeableobserversareabletoagreethattheinformationconcernedprovidesa faithfulrepresentation.Verificationmaybedirectorindirect.

Direct verification involves direct observation (e.g. counting cash). Indirect verifi - cationinvolveschecktheinputstoamodelandthenrecalculatingtheoutputsof that model. For example, closing inventory measured by the FIFO cost formula

(see Chapter 10) may be verified by checking inventory movements and costs during the reportingperiodandthenusingtheFIFOformulatorecalculateclosinginventory.

(c) **Timeliness**.Financialinformationistimelyifitismadeavailabletousersintimefor ittobecapableofinfluencingtheireconomicdecisions.

(d) **Understandability**. It is clearly desirable that the information provided in financial reportsshouldbeunderstandablebyusers.Incomprehensibleinformationwouldhave novalue.Theunderstandabilityoffinancialinformationisimprovedifitisclassified andpresentedclearlyandconcisely. Butomittingunavoidablycomplexinformation from financial reports on the grounds that it would be difficult to understand is not acceptablesincethiswouldmakethosereportsincomplete.

The *ConceptualFramework*states that financial reports are prepared for users who "haveareasonableknowledgeofbusinessandeconomicactivitiesandwhoreview andanalysetheinformationdiligently".Thesearetheuserswhoshouldgenerallybe able to understand financial reports. However, it is accepted that even well-informedusers may sometimes need the help of an advisor to understand information about complex transactions and other events.

Thecostconstraintonusefulfinancialreporting

The*ConceptualFramework*recognisesthattherearecostconstraintsontheinformation thatcanbeprovidedinfinancialreports.Reportingfinancialinformationimposescosts and obviously these costs should be justified by the benefits of reporting that information. Although the costs of financial reporting are borne initially by the providers of financial reports, these costs are borne ultimately by users (e.g. shareholders) in the form of reduced returns (e.g. lower profits). Users may also bear the additional costs of analysing and interpreting the information provided in financial reports.

When developing an international standard, the IASB assesses whether the benefits of reportingtheinformationrequiredbythatstandardarelikelytojustifythecostsincurred toprovideanduseit.Thisassessmentisconductedinthelightofinformationobtained fromproviders,users,auditorsandothersabouttheexpectedcostsandbenefits.

Financialstatementsandthereportingentity

The remaining sections of the *ConceptualFramework*discuss the information provided in general purpose financial statements, which are one form of general purpose financial reporting.Theobjectiveoffinancialstatementsis"*toprovidefinancialinformationaboutther eportingentity'sassets,liabilities,equity,incomeandexpensesthatisusefultousersoffinan cialstatementsinassessingtheprospectsforfuturenetcashinflowstotheentityandinasse ssingmanagement'sstewardshipoftheentity'seconomicresources*". This informationisprovidedinthefollowingfinancialstatements:

(a) a statement of financial position, which shows (or "recognises") the entity's assets, liabilitiesandequity(i.e.sharecapitalandreservesforacompany)

(b) astatementoffinancialperformance,showingtheentity'sincomeandexpenses

(c) other statements and notes which present information relating to matters such as the entity's cash flows, the contributions received from equity holders (and distributionsmade to them) and the methods, assumptions and judgements used in preparing the financial statements.

Financial statements are prepared for a specified period of time (a "reporting period") and shouldalsoprovidecomparativeinformationforatleasttheprecedingperiod.The financial statements do not typically provide forward-looking information, such asmanagement forecasts. A reporting entity may be a single entity (e.g. a single company) ormaycomprisemorethanoneentity.Forinstance,"consolidated"financialstatementsmay bepreparedfor agroupof companies (seeChapter 18).

Goingconcernassumption

The *ConceptualFramework*states that financial statements are normally prepared on the assumptionthatthereportingentityisa"goingconcern"andwillcontinueinoperationfor the foreseeable future. It is assumed that the entity has neither the intention nor the need to closedownormateriallyreducethescaleofitsoperations.Thisallows(forexample)the netrealisablevalueofinventoriestobebasedupontheirnormalsalepriceanditemssuch asproperty,plantandequipmenttobedepreciatedovertheirnormalusefullives.

However, if an entity is not a going concern, the financial statements will have to bepreparedonadifferentbasisandthatbasisshouldbedisclosed.

Elementsoffinancialstatements

This section of the *ConceptualFramework*identifies the main elements of financialstatementsandoffersadefinitionofeachelement.Themostimportantdefinitions are those of "asset" and "liability" since each of the other elements is defined in terms of its relationship to an entity's assets or liabilities.

Elementsrelatingtofinancialposition

The elements directly related to the measurement of financial position are assets, liabilitiesand equity. These are defined as follows:

(a) **Assets**.Anassetis"*apresenteconomicresourcecontrolledbytheentityasaresultofpastevents*". An economic resource is "*arightthathasthepotentialtoproduceeconomicbenefits*".Notethefollowingpointswithregardtothisdefinition:

- Rights that have the potential to produce economic benefits include the right to receivecash(e.g.atradereceivable),therighttoreceivegoodsorservices(e.g. aprepayment),rightsoverphysicalobjects(e.g.property,plantandequipment orinventories)andtherighttouseintellectualproperty.

- Thereisnorequirementforanitemtobelegallyownedbytheentityinorder that it should be an asset, merely that the item should be controlled by the entity. Thismeansthatcertainleaseditemsmaybeclassedasassets(seeChapter9). Thisisanapplicationoftheprincipleofsubstanceoverform.
- An asset can arise only as the result of a past event. Expected future transactions (e.g.theintentiontobuyanitem)donotgiverisetoassetsatthepresenttime.
- An item cannot be classed as an asset unless it is has the potential of generating futureeconomicbenefitsfortheentity.Butifthispotentialislow,itispossible that the item might not be shown or "recognised" in the entity's statement of financial position (see later in this chapter).

(b) **Liabilities**. A liability is "*apresentobligationoftheentitytotransferaneconomicresourceasaresultofpastevents*". Note that:

- An essential characteristic of a liability is that the entity must be under anobligation.Thismeansthattheentitymusthaveadutyorresponsibilityto transfereconomicresourcestoanotherparty.However,thereisnorequirement thattheobligationshouldbelegallyenforceable,eventhoughthiswould normally be the case. For instance, if it is an entity's policy to rectify faults in its products even after the warranty period has expired, the amounts expected to be expendedinrelationtogoodsalreadysoldareobligationsoftheentity,even though they are not legally enforceable. Such obligations are known as"constructive obligations" (see Chapter 12).
- A further characteristic of a liability is that the obligation must be a *present*obligation, not a future commitment. For instance, a decision by management tobuy an asset in the future does not give rise to a present obligation to pay for the asset, since the decision could be reversed. A present obligation is one that theentity cannot practically avoid.
- Aliabilitycanariseonlyastheresultofapastevent.Apresentobligationexists asaresultofpasteventsonlyiftheentityhasalreadyobtainedeconomic benefits(e.g.byreceivinggoodsorservices)and,inconsequence,isnowunder anobligationtotransfereconomicresources(e.g.bymakingapayment).
- An obligation cannot be classed as a liability unless it is has the potential of requiring the entity to transfer economic resources to another party. But if this potential is low, it is possible that the obligation might not be recognised in the entity'sstatementoffinancialposition(seelaterinthischapter).

(c) **Equity**.Equityis"*theresidualinterestintheassetsoftheentityafterdeductingallitsliabilities*". This is of course an expression of the well-known accounting equation (assets=liabilities+capital).However,theIASBfavourstheterm"equity"rather than "capital". In the case of a company, equity will usually consist of share capital, retained earnings and other reserves.

Elementsrelatingtofinancialperformance

The elements directly related to the measurement of financial performance are income and expenses. These are defined as follows:

(a) **Income**. Income is "*increasesinassets,ordecreasesinliabilities,thatresultinincreasesinequity,otherthanthoserelatingtocontributionsfromholdersofequityclaims*". Note that:

- The term "income" encompasses both revenue which arises in the course of an entity's ordinary activities and also gains (e.g. gains arising on the disposal or revaluation of long-term assets).
- Income is defined in terms of an increase in net assets but does not includeincreasescausedbycontributionsfromequityholders(e.g.shareissues).

(b) **Expenses**. Expenses are "*decreasesinassets,orincreasesinliabilities,thatresultindecreasesinequity,otherthanthoserelatingtodistributionstoholdersofequityclaims*". Note that:

- The term "expenses" encompasses both expenses which arise in the course of an entity's ordinary activities and also losses (e.g. losses arising on the disposal or revaluation of long-term assets).
- Expenses are defined in terms of a decrease in net assets but do not includedecreasescausedbydistributionstoequityholders(e.g.dividends).

Thefactthatincomeandexpensesaredefinedintermsofincreasesordecreasesinnet assetsmeansthatprofits(orlosses)arealsodefinedintheseterms.

Recognitionoftheelementsoffinancialstatements

Recognitionisdefinedas"*theprocessofcapturingforinclusioninthestatementoffinancialposition orthestatement(s)offinancialperformanceanitemthatmeetsthedefinitionofoneoftheelementsoffinancialstatements*".Recognitioninvolvesthe depictionoftheiteminwordsandbyamonetaryamountand"*includingthatamountinoneormoretotalsinthatstatement*". Items which are merely disclosed in the notes that accompanythefinancialstatementshavenotbeenrecognised.

The*ConceptualFramework*statesthatanassetorliabilityshouldberecognisedonlyif the recognition of that asset or liability (and any resulting income, expenses or changes in equity) would provide users of the financial statements with useful information. In otherwords, the information provided must be relevant to user needs and must offer a faithful representation.Whetherrecognisinganassetorliabilityprovidesusefulinformation(ata costthatdoesnotoutweighbenefits)isamatterofjudgementanddependsuponthefacts ofthecase.Recognitionmightnotprovideusefulinformationif(forexample):

(a) thereisuncertaintyastowhethertheassetorliabilityexists,or

(b) theprobabilityofaninfloworoutflowofeconomicbenefitsislow,or

(c) thereisaveryhighlevelof"measurementuncertainty",soitisimpossibletoobtaina reasonableestimateofthemonetaryamountoftheassetorliabilityconcerned.

Anitemwhichqualifiesasanelementbutfailstosatisfytherecognitioncriteriamayinstead warrant disclosure in the notes.

Derecognition

Derecognitionisdefinedas"*theremovalofallorpartofarecognisedassetorliabilityfromane ntity'sstatementoffinancialposition*".Derecognitionshouldoccurwhenthe item concerned no longer meets the definition of an asset or liability. For an asset, this is normallywhentheentitylosescontrolofthatasset.Foraliability,thisisnormallywhen theentitynolongerhasapresentobligationforthatliability.

Measurementoftheelementsoffinancialstatements

Measurementistheprocessofdeterminingthemonetaryamountatwhichanelementisto be shown in the financial statements. The *ConceptualFramework*identifies a number of differentmeasurementbaseswhichcouldbeusedinprinciple.Theseare:

(a) **Historicalcost**.Assetsaremeasuredattheamountpaidtoacquirethem.Unlike current value (see below), historical cost does not reflect changes invalues sincetheassetwasacquired.Butthehistoricalcostofanassetwillnormallybeupdatedo ver time to reflect matters such as the consumption of all or part of the economic benefits provided by the asset (i.e. depreciation) or events that cause all or part of the asset's historicalcosttobeirrecoverable(i.e.impairment(seeChapter7)).

Liabilities are normally measured at the amount of the consideration received in exchange for taking on the obligation concerned. However, in cases where there is no suchconsideration(e.g.taxliabilities)itmaybenecessarytomeasureliabilityat theamount expectedtobepaidtosatisfytheobligation.

(b) **Currentvalue**. The current value basis measures assets and liabilities using information which has been updated to reflect conditions at the measurement date. Thecurrentvalueofanassetorliabilityisnotinanywayrelatedtotheoriginalpriceof the transaction or other event that gave rise to that asset or liability. Current value measurement bases include:

(i) **Fairvalue**. Fair value is defined as "*thepricethatwouldbereceivedtosellanasset,orpaidtotransferaliability,inanord erlytransactionbetweenmarketparticipantsatthemeasurementdate*". Fair value may be determined directly by observing prices in an active market. But if no such market exists, it may be necessary to measure fair value indirectly by using appropriate measurement techniques (see Chapter 5 Appendix).

(ii) **Valueinuse**. The "value in use" of an asset is the present value† of the net cash flows(orothereconomicbenefits)thattheentityexpectstoderivefromuseof the asset and from its eventual disposal. Similarly, the "fulfilment value" of a liabilityisthepresentvalueofthecash(orothereconomicbenefits)thatthe entityexpectstoberequiredtotransferinordertofulfiltheliability.

Notethatthefairvalueofanassetorliabilitymaydifferfromitsvalueinuse (or its fulfilment value) because the former reflects the expectations of market participants,whilstthelatterreflectsentity-specificexpectations.

(iii) **Currentcost**.Thecurrentcostofanassetistheamountthatwouldhavetobe paidtoacquireanequivalentassetatthemeasurementdate(i.e.replacement cost).Thecurrentcostofaliabilityistheamountthatwouldbereceivedfor takingonanequivalent liabilityat themeasurement date.

†*Readerswhoarenotfamiliarwiththeconceptsofdiscountingandpresentvaluearereferredtoth eappendixattheendofthischapterinwhichtheseconceptsareexplained.*

Selectionofmeasurementbasis

The*ConceptualFramework*doesnotprescribetheuseofanyparticularmeasurement basis and states that a consideration of the qualitative characteristics of useful financial information (and the cost constraint) may result in the selection of different measurementbases for different assets, liabilities, income and expenses. The factors which should be consideredwhenchoosingameasurementbasisinclude:

(a) **Relevance**.Thedegreetowhichameasurementbasisprovidesrelevantinformation isaffectedbythecharacteristicsoftheassetorliabilitytowhichitisappliedandthe way in which that asset or liability is expected to contribute to the entity's future cash flows. For instance, if the value of an asset is sensitive to market factors, use of the historicalcostbasiswillnotproviderelevantinformationiftheassetisheldprimarily for sale (so that changes in value are particularly important). Similarly, the use of acurrent value basis in relation to such an asset may not provide relevant information iftheentityconcernedholdstheassetsolelyforuseandhasnointentionofsellingit.

(b) **Faithfulrepresentation**. The degree to which a measurement basis can provide afaithfulrepresentationisaffectedbythelevelofuncertaintyinvolved.Forinstance, use of the fair value basis when measuring an asset will usually provide an uncertain measurementifthereisnoactivemarketforthattypeofasset.Althoughmeasure- ment uncertainty does not necessarily preclude theuse of a measurement basis that providesrelevantinformation,toohighalevelofuncertaintymaymakeitnecessary to consider alternative measurement bases.

A further factor to consider is "measurement inconsistency". This arises if different measurement bases are used for related assets and liabilities, so that the financial

statementsdonotfaithfullyrepresentcertainaspectsoftheentity'sfinancialposition andperformance.Inthiscase,amorefaithfulrepresentationmaybeachievedby usingthesamemeasurementbasisforalloftheassetsandliabilitiesconcerned.

Presentationanddisclosure

The *ConceptualFramework*states that the effective communication of information in an entity'sfinancialstatementsmakesthatinformationmorerelevantandcontributestoa faithful representation of the entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of the information provided. Effective communication requires that:

(a) information is classified in such a way that similar items are grouped together and dissimilar items are separated, and

(b) information is aggregated in such a way that both unnecessary detail and excessive aggregation are avoided.

Theoffsettingofassetsandliabilities(reportinganassetandaliabilityasasinglenet amount)classifiesdissimilaritemstogetherandthereforeisusuallyinappropriate.

Othercomprehensiveincome

Inprinciple,allofanentity'sincomeandexpensesforareportingperiodshouldbetaken into account when calculating the profit or loss for the period. However, the IASB may determinethatcertainitemsofincomeorexpensearisingfromachangeinthecurrent valueofanassetorliability(e.g.arevaluationgain)shouldbeexcludedfromthe calculationorprofitorlossifthiswouldprovidemorerelevantinformationoramore faithful representation. Such items are not shown in the statement of profit or loss but are presentedinsteadas"othercomprehensiveincome"(seeChapter3).

Conceptsofcapitalandcapitalmaintenance

As explained above, the *ConceptualFramework*defines income and expenses in terms of changestoanentity'sequity(orcapital).Thereforeonewayoflookingatprofitistosay thattheprofitorlossforareportingperiodisequaltotheincrease(ordecrease)inthe entity'scapitalduringthatperiod(otherthanincreases/decreasesrelatingtocontributions by the entity's owners or distributions to those owners). In other words, the calculation ofprofit is closely linked to the measurement of capital.

Ingeneral,itcouldbesaidthatanentityhas"maintained"itscapitalifithasasmuch capital at the end of a reporting period as it had at the start of that period. Any amount bywhichcapitalattheendofaperiodexceedstheamountrequiredtomaintainopening capital is profit. The *ConceptualFramework*distinguishes between two main ways of comparinganentity's capital at the beginningand endof a reporting period and so determiningtheprofitforthatperiod.Theseareasfollows:

(a) **Financialcapitalmaintenance**. Under this concept, a profit is earned only if thefinancialormoneyamountofthenetassetsattheendofanaccountingperiodis greater than the financial or money amount of the net assets at the beginning of that period,afteradjustingforanyamountscontributedbyordistributedtoownersduring theperiod.Financialcapitalcanbemeasuredeitherinnominalmonetaryunitsorin units of purchasing power, where purchasing power is determined in accordance with changes in an index of general prices.

(b) **Physicalcapitalmaintenance**.Underthisconcept,aprofitisearnedonlyifthe physicaloperatingcapabilityoftheentityattheendoftheaccountingperiodis greaterthanitsphysicaloperatingcapabilityatthestartoftheperiod,afteradjusting foranyamountscontributedbyordistributedtoownersduringtheperiod.

In practice, most entities use the concept of nominal financial capital maintenance, if only becausethisavoidstheaccountingcomplexitiesassociatedwiththealternatives.

The*ConceptualFramework*statesthatanentity'schoicesofmeasurementbasesand capital maintenance concept determine the accounting model used in the preparation of the financialstatements.However,theIASBdoesnotprescribetheuseofanyparticular model, except in the special case of those entities which are reporting in the currency of a hyperinflationary economy (see Chapter 17). Instead, the *ConceptualFramework*merelypointsoutthateachmodelexhibitsdifferentlevelsofrelevan ceandreliabilityandstates that an entity's management should seek a balance between these characteristics whenchoosing an appropriate model.

EXAMPLE

Atthebeginningofareportingperiod,abusinesshadcashof£1mandcapitalof£1m.Thecashwas spentonacquiringinventorywhichwasallsoldduringtheaccountingperiodfor£1.25m.Therewer enoothertransactions.

(a) Calculatetheprofitfortheperiodinnominalmoneyterms.

(b) Ifthegeneralpricesindexstoodat100onthefirstdayoftheaccountingperiodandat110onthe lastdayoftheperiod,calculatetheprofitfortheperiodintermsofthegeneralpurchasingpowe rofthebusiness.

(c) Ifitwouldcost£1.13mattheendoftheaccountingperiodtoreplacethesoldinventory,calculat etheprofitfortheperiodintermsofthepowerofthebusinesstomaintainitsphysicaloperating capability.

Solution

	Financialcapital maintenance (nominal)	*Financialcapital maintenance (purchasingpower)*	*Physicalcapital maintenance*
	£m	£m	£m
Assetsattheendoftheperiod	1.25	1.25	1.25
Assetsrequiredattheendoftheperiodtobeaswelloffasatthebeginningoftheperiod:			
(a) nominalmonetaryunits	1.00		
(b) generalpurchasingpowerunits(£1mx110/100)		1.10	
(c)physicaloperatingcapability			1.13
Netprofitfortheperiod	0.25	0.15	0.12

Notes:

(a) Innominalmonetaryterms,thebusinessis£0.25mbetteroffattheendoftheperiodthanitwasatthebeginningoftheperiod.Thisistheprofitfigurewhichwouldbeshownbyaconventionalsetoffinancialstatements.

(b) £1.1misneededattheendoftheperiodtogivethesamegeneralpurchasingpoweraswasgivenby£1matthebeginningoftheperiod.Sincethebusinesshascapitalof £1.25mattheendoftheperiod,itsprofitiscalculatedas£1.25m–£1.1m=£0.15m.

(c) £1.13misneededattheendoftheperiodtobuythesameinventoryascouldbeboughtfor£1matthestartoftheperiod.Sincethebusinesshascapitalof£1.25mattheendoftheperiod,itsprofitiscalculatedas£1.25m–£1.13m=£0.12m.

Itcouldbearguedthattheconventionalapproachtoprofitmeasurement(maintenanceofnominalfinancialcapital)hasoverstatedtheprofitfigure.Eventhoughprofitsarestatedtobe£0.25m,nomorethan£0.15mcouldbewithdrawnfromthebusinesswithoutreducingitsgeneralpurchasingpowerandnomorethan£0.12mcouldbewithdrawnwithoutreducingthepowerofthebusinesstoreplaceitsinventoryandmaintainitsphysicaloperatingcapability.Ifconventionally-calculatedprofitswerewithdrawninfulleachyear,thebusinesswouldsufferdepletionofitscapital.Thiswouldleadtoareductionintheoperatingcapabilityofthebusinessand,inthelongrun,toitseventualclosure.

Summary

- The IASB *ConceptualFramework*consists of a set of fundamental principles and definitions which underlie financial accounting. The main purpose of the *ConceptualFramework*istoassisttheIASBinthedevelopmentofinternationalstandards.
- The *ConceptualFramework*states that the objective of general purpose financialreporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providingresourcestotheentity.Theseusersarereferredtoas"primaryusers".
- Generalpurposefinancialreportsprovideinformationaboutthefinancialpositionand financial performance of the reporting entity. Financial performance information should be prepared on the accruals basis but information about cash flows is also important. In addition, information should be provided about changes in an entity's financial position not resulting from its financial performance (e.g. changes caused by share issues or dividend payments).
- Financial information is useful if it possesses certain qualitative characteristics. The fundamental characteristics are relevance and faithful representation. The enhancing characteristicsarecomparability,verifiability,timelinessandunderstandability.
- Financial statements are normally prepared on the going concern basis. But if the reportingentityisnotagoingconcern,thefinancialstatementsshouldbepreparedon a different basis and that basis should be disclosed.
- The main elements of financial statements are assets, liabilities, equity, income and expenses.EachoftheseelementsisdefinedintheConceptualFramework.
- An asset or liability is recognised in the financial statements only if the recognition ofthat asset or liability (and any resulting income, expenses or changes in equity) would provideusersofthefinancialstatementswithusefulinformation.Derecognition occurswhentheitemnolongermeetsthedefinitionofanassetorliability.
- Elements are measured at their historical cost or at a current value. The *ConceptualFramework*providesguidanceastotheselectionofameasurementbasis.
- Certainitemsofincomeorexpensearisingfromachangeinthecurrentvalueofanassetorliabilityarenotshowninthestatementofprofitorlossbutarepresented instead as "other comprehensive income".
- Profits and losses may be measured in terms of changes in the financial amount of an entity's net assets (financial capital maintenance) or in terms of changes in the entity's physical operating capability (physical capital maintenance). Financial capital may be

measuredeitherinnominalmonetaryunitsorinunitsofpurchasingpower.

Appendix

Discountingandpresentvalue

The IASB *ConceptualFramework*states that an asset might be measured at the "presentvalue" of the future cash inflows that the asset is expected to generate. Similarly, a liability might be measured at the present value of the future cash outflows that are expected to be required to settle the liability. Various international standards also refer to the concept of present value, including:

	Chapter
IAS19*EmployeeBenefits*	14
IAS36*ImpairmentofAssets*	7
IAS37*Provisions,ContingentLiabilitiesandContingentAssets*	12
IFRS9*Financialinstruments*	11
IFRS15*RevenuefromContractswithCustomers*	13
IFRS16*Leases*	9

Therefore,anunderstandingofpresentvaluecalculationsisanecessaryprerequisitetoa grasp of these international standards.

Theconceptofpresentvalueisfairlysimpleandisconcernedwiththefactthatmoney has a "time value". For instance, if money can be invested at an interest rate of 10% perannum,each£1investednowwillgrowtobecome£1.10afteroneyear,£1.21aftertwo yearsandsoforth.Sothecurrentequivalent(or"presentvalue")of£1.10tobereceivedin ayear'stimeis£1.Similarly,thepresentvalueof£1.21tobereceivedintwoyears'timeis also£1(assuminginterestat10%perannum)†.

The process of determining the present value of an amount to be received (or paid) in the future is known as "discounting" and involves multiplying the amount concerned by a discountingfactor.Discountingfactorscaneitherbecalculatedorlookedupinasetof presentvaluetables.Inthisbook,discountingfactorsarecalculated.

† *Ifamountstobereceivedorpaidinthefuturearefixedinmoneytermsandwillnotgrowinlinewithi nflation,thediscountingrateusedwillalsoneedtotakeintoaccounttheexpectedratesofinflati oninfutureyears*.

EXAMPLE

Determinethepresentvaluesoftheamountslistedbelow.Theapplicable"discountingrate"is8%(i. e.moneycanbeinvestedataninterestrateof8%perannum).

(a) £1,000tobereceivedinoneyear'stime

(b) £5,000tobereceivedintwoyears'time

(c) £20,000tobereceivedinthreeyears'time.Calculatedisc

ountingfactorstothreedecimalplacesonly.

Solution

(a) £1investednowwillbecome£1.08afteroneyear.Sothepresentvalueofanamounttoberece ivedinoneyear'stimeisequaltothatamountdividedby1.08.Dividingby 1.08isthesameasmultiplyingbyadiscountingfactorof0.926(1/1.08).Sothepresentvalueof£1,0 00tobereceivedinoneyear'stimeis£926(£1,000x0.926).

Check:interestat8%on£926is£74and£926+£74=£1,000.

(b) £1investedat8%willbecome£1x1.08x1.08aftertwoyears.Sothepresentvalueofanamoun ttobereceivedintwoyears'timeisequaltothatamountdividedby$(1.08)^2$.Thisisthesameas multiplyingbyadiscountingfactorof0.857($1/1.08^2$).Thepresentvalueof£5,000tobereceiv edintwoyears'timeis£4,285(£5,000x0.857).

Check:interestat8%on£4,285foroneyearis£343,givingatotalof£4,628.Interestonf4,628f orthesecondyearis£370,givingatotalof£4,998.Thisisnotquite £5,000becausethediscountingfactorwasroundedtothreedecimalplaces.

(c) Thepresentvalueofanamounttobereceivedinthreeyears'timeisequaltothatamountdivid edby$(1.08)^3$.Thisisthesameasmultiplyingbyadiscountingfactorof0.794($1/1.08^3$).Thepre sentvalueof£20,000tobereceivedinthreeyears'timeis £15,880(£20,000x0.794).

Check:interestat8%on£15,880foroneyearis£1,270,givingatotalof£17,150.Interestonf1 7,150forthesecondyearis£1,372,givingatotalof£18,522.Interestonf18,522forthethirdye aris£1,482,givingatotalof£20,004.Thereisaroundingdifferenceof£4.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

2.1 Explain what is meant by a "conceptual framework" for financial reporting and list the main purposes of the IASB *ConceptualFrameworkforFinancialReporting*.

2.2 (a)Statetheobjectiveofgeneralpurposefinancialreporting.

(b) Identifythemainclassesofinformationthatshouldbepresentedingeneralpurpo se financial reports.

(c) Identifytheprimaryusersofgeneralpurposefinancialreportsandanyotherpartie s who might find these reports useful. Explain why each user group might be interested in the information provided in general purpose financial reports.

2.3 Define each of the five elements of financial statements and state the circumstances in whichanelementshouldberecognisedinthefinancialstatements.Alsoexplainwhy each of the following items meets the definition of an asset or a liability:

(a) atradereceivable (b)atradepayable (c)inventory.

2.4 Identifyandexplainthequalitativecharacteristicsofusefulfinancialinformation, distinguishing between fundamental characteristics and enhancing characteristics.

2.5 The*ConceptualFramework*statesthatanentity'schoicesofmeasurementbasesand capital maintenance concept determine the accounting model used in the preparation of thefinancialstatements.Explainthemeasurementbasesandthecapitalmaintenanc e concepts identified in the *ConceptualFramework*.

2.6 Thequalitativecharacteristicsofrelevance,faithfulrepresentationandcomparability which are identified in the IASB *ConceptualFramework*are some of the attributes that make financial information useful to the various users of financial statements.

Explain what is meant by relevance, faithful representation and comparability and how theymakefinancialinformationuseful. *(ACCA)*

***2.7** Assuming that today's date is 1 January 2020, calculate the present value of each of the following (using a discount rate of 7% in each case):

(a) £50,000tobereceivedon1January2023

(b) £100,000tobereceivedon1January2025

(c) £10,000tobereceivedonIJanuaryeachyearfrom2021to2024inclusive.

***2.8** The main role of the International Accounting Standards Board (IASB) is to devise and publishInternationalFinancialReportingStandards(IFRSStandards)andrevised versions of International Accounting Standards (IAS Standards).

IASStandardswereoriginallypublishedbytheIASB'spredecessorbody,the International Accounting Standards Committee (IASC).

TheIASBhasalsopublisheda*ConceptualFrameworkforFinancialReporting*.Thisdocume nt is not an accounting standard.

Required:

(a) Explainthemainpurposesofthe*ConceptualFramework*document.

(b) Identifytheobjectiveofgeneralpurposefinancialreporting,asstatedinthe *ConceptualFramework*.

(c) Identify the primary usersof generalpurpose financialreportsand fourfurtheruser groups. In each case, explain what information each user group would be seeking from the financial reports.

(d) Explainthe"goingconcern"assumptionwhich(accordingtothe*ConceptualFra mework*) underlies the preparation of financial statements.

(e) Identify and explain the qualitative characteristics that make financial information useful.

(f) Explainwhyitisnotalwayspossibletoproducefinancialstatementswhichposse ss all of the qualitative characteristics discussed in (e) above.

Chapter3

Presentationoffinancialstatements

Introduction

Themainpurposeofthischapteristoexplaintherequirementsofinternationalstandard IAS1 *PresentationofFinancialStatements*. The objective of IAS1 is to specify the overall structure and content of general purpose financial statements and so ensure that an entity's financialstatementsforareportingperiodarecomparablewiththoseofotherperiodsand with those of other entities. The standard sets out:

(a) thegeneralfeaturesoffinancialstatements

(b) guidelineswithregardtotheirstructure,and

(c) minimumrequirementsfortheircontent.

ThischapteralsooutlinesthemainrequirementsofIAS34*InterimFinancialReporting*and summarises the guidance provided by the IASB on the inclusion of a "management commentary"inanentity'sannualreportandonthemakingofmaterialityjudgements.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- identifythecomponentsofacompletesetoffinancialstatements
- explainthegeneralfeaturesofasetoffinancialstatements
- explainthestructureandcontentofeachcomponentofasetoffinancialstatements
- distinguish between current and non-current assets and between current and non-current liabilities
- prepareastatementoffinancialposition,astatementofcomprehensiveincomeanda statementofchangesinequity,inaccordancewiththerequirementsofIAS1
- outlinethemainrequirementsofinternationalstandardIAS34
- summarise the guidance provided by IFRS Practice Statement 1 *ManagementCommentary*andIFRSPracticeStatement2*MakingMateriality Judgements.*

Purposeoffinancialstatements

The requirements of IAS1 apply to all general purpose financial statements prepared and presentedinaccordancewithinternationalstandards.Generalpurposefinancialstatements arethoseintendedforuserswhoarenotinapositiontodemandreportsthataretailored for their own particular information needs.

According to IAS1, the objective of such financial statements is "*toprovideinformationaboutthefinancialposition,financialperformanceandcashflowsofanentitythatisusefultoawiderangeofusersinmakingeconomicdecisions*".Tomeetthisobjective, generalpurposefinancialstatementsshouldprovideinformationaboutanentity's:

(a) assets,liabilitiesandequity
(b) incomeandexpenses,includinggainsandlosses
(c) contributionsbyanddistributionstoownersintheircapacityasowners
(d) cashflows.

Thisinformationisgiveninfourprimaryfinancialstatements.Furtherinformationisgiven in the notes which accompany these statements.

Componentsoffinancialstatements

IAS1statesthatacompletesetoffinancialstatementscomprises:

(a) astatementoffinancialpositionasattheendoftheaccountingperiod
(b) astatementofprofitorlossandothercomprehensiveincomefortheperiod
(c) astatementofchangesinequityfortheperiod
(d) astatementofcashflowsfortheperiod
(e) asetofnotes,providinginformationontheentity'ssignificantaccountingpolicies together with other explanatory information
(f) comparativeinformationinrespectofthepreviousperiod(seelaterinthischapter)
(g) a statement of financial position as at the *beginning*of the previous period, in the casethat the entity has applied an accounting policy retrospectively or has made a retro- spectiverestatementofitemsinitsfinancialstatements(seeChapter4).

ThesetitleshavereplacedthemoretraditionaltitlesusedinpreviousversionsofIAS1 (e.g."balancesheet")andarethoughtbytheIASBtoreflectmorecloselythefunctionof eachstatement.However,entitiesareallowedtousetitlesforthefinancialstatements otherthanthoseusedinthestandardiftheysowish.Inparticular,IAS1statesthatan entitymayusethetitle"statementofcomprehensiveincome"ratherthan"statementof profit or loss and other comprehensive income". For the sake of brevity, this is the practice adopted throughout this textbook.

Thestructureandcontentofmostofthesestatementsisspecifiedin IAS1.Butthestatementofcashflowsisdealtwithby IAS7 *StatementofCashFlows* (seeChapter16).The notes which accompany the four primary statements are an integral part of the financial statementsandsofallwithinthescopeof IAS1andallotherinternationalstandards.

In addition to the financial statements, IAS1 recognises that an entity's annual report may contain a management review which explains the main features of the entity's financialpositionandperformance.Suchareviewisoutsidethescopeofinternationalstandardsbut theIASBhasissuedanon-bindingPracticeStatementtoassistentitiesthatwishtoinclude a"managementcommentary"intheirannualreports(seelaterinthischapter).

Generalfeatures

Undertheheading"generalfeatures", IAS1setsoutanumberofgeneralruleswhichrelate to the presentation of financial statements. Many of these are clearly based upon principles establishedinthe *ConceptualFramework* (seeChapter2).Themainareasdealtwithin this part of IAS1 are:

(a) fairpresentationandcompliancewithinternationalstandards
(b) goingconcernbasisandaccrualbasis
(c) materialityandaggregation
(d) offsetting
(e) frequencyofreporting
(f) comparativeinformation
(g) consistency of presentation.

Each of these is considered

below.

Fairpresentationandcompliancewithinternationalstandards

Financialstatementsmustpresentfairlythefinancialposition,financialperformanceand cash flows of the entity concerned. This requires that the effects of transactions and otherevents should be faithfully represented in accordance with the definitions and recognition criteriaforassets,liabilities,incomeandexpensessetoutinthe *ConceptualFramework*.It isassumedthattheapplicationofinternationalstandardswillresultinfinancialstatements that achieve a fair presentation. An entity which produces financial statements that complywithinternationalstandardsmustmakeanexplicitandunreservedstatementtothat effect inthenotes. Afair presentationalsorequirestheentityto:

(a) selectandapplyappropriateaccountingpoliciesinaccordancewiththerequirements of international standard IAS8 (see Chapter 4)

(b) provideinformationthatisrelevant,reliable,comparableandunderstandable

(c) providefurtherdisclosuresifcompliancewithinternationalstandardsisinsufficienttoenableuserstounderstandtheimpactoftransactionsandotherevents.

On very rare occasions, compliance with a requirement in an international standard may producemisleadinginformationandsoconflictwiththeobjectiveoffinancialstatements. In these circumstances, the entity should depart from that requirement and the notes should disclosethattheentityhascompliedwithinternationalstandardsexceptthatithas departedfromaparticularrequirementinordertoachieveafairpresentation.Thenotes shouldidentifythetitleofthestandardconcerned,thenatureofthedeparture,thereason for the departure, the accounting treatment that the standard would have required, the accountingtreatmentactuallyadoptedandthefinancialimpactofthedeparture.

Goingconcernbasisandaccrualbasis

FinancialstatementsshouldbepreparedonthegoingconcernbasisseeChapter2unless the entity intends to cease trading or has no realistic alternative but to do so. If there are significantdoubtsastowhethertheentityisagoingconcern,theuncertaintieswhichgive rise to these doubts should be disclosed. If financial statements are *not* prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statementsarepreparedandthereasonsthattheentityisnotregardedasagoingconcern.

Financial statements other than the statement of cash flows should be prepared using the accrual basis of accounting (see Chapter 2). The statement of cash flows is an obvious exceptiontothisrulesince,bydefinition,itispreparedonacashbasis(seeChapter16).

Materialityandaggregation

IAS1 states that information is material if "*omitting,mis-statingorobscuringitcouldreasonablybeexpectedtoinfluencedecisionsthattheprimaryusersofgeneralpurposefinancialstatementsmakeonthebasisofthosefinancialstatements*". Materialityshould be judged in context and either the size or the nature of an item (or both) could determine whetherornottheitemismaterial.FurtherguidanceisprovidedinIFRSPractice Statement2*MakingMaterialityJudgements*(seelaterinthischapter).

Ingeneral,financialstatementsarepreparedbyanalysingtransactionsandotherevents into classes and then aggregating (i.e. totalling) each of these classes to produce line items whichappearinthestatements.Forinstance,allsalestransactionsareaggregatedintoa single revenue figure shown in the statement of comprehensive income. IAS1 requires thateach material class of similar items should be presented separately in the financial state-ments.Ifanitemisnotindividuallymaterial,itmaybeaggregatedwithotherlineitems.

IAS1 states that there is no need to disclose informationrequiredbyaninternational standardiftheinformationisnotmaterial.Similarly,IAS8seeChapter4statesthereis no need to apply an accounting policy required by an international standard if the effect of applyingthepolicywouldbeimmaterial.Thismeansthatcompliancewithstandardscan beachievedwithouthavingtoapplycomplexaccountingtreatmentstoinsignificantitems.

Offsetting

In general, assets and liabilities should be reported separately in the statement of financial positionandshouldnotbeoffsetagainstoneanother.Similarly,incomeandexpenses

shouldbereportedseparatelyinthestatementofcomprehensiveincome.IAS1takesthe view that offsetting should not be allowed, since this would normally detract from users'ability to understand transactions and other events.

However, this general rule does not apply in a specific instance if another international standardpermits or requires offsettinginthat instance.

Frequencyofreporting

Financialstatementsshouldnormallybepresentedatleastannually.Ifanentitychanges itsaccountingdateandsopresentsasetoffinancialstatementsforaperiodwhichis longerorshorterthanoneyear,theentityshoulddisclose:

(a) thereasonforusingaperiodthatislongerorshorterthanoneyear

(b) the fact that the comparative amounts given for the previous period are not directly comparable with those given for the current period.

Comparativeinformation

Ingeneral,IAS1requiresthatentitiesshouldpresent(asaminimum)comparative information in respect of the previous period for all amounts reported in the financial statements. Comparatives should also be given for narrative information if this would be relevanttoanunderstandingofthecurrentperiod'sfinancialstatements.

Consistencyofpresentation

Inordertomaintaincomparability,thewayinwhichitemsarepresentedandclassifiedin thefinancialstatementsshouldgenerallybeconsistentfromoneaccountingperiodtothe next. However, this rule does not apply if:

(a) it is apparent that a different presentation or classification would be more appropriate,
followingeitherasignificantchangeinthenatureoftheentity'soperationsora review of its financial statements

(b) adifferentpresentationorclassificationisrequiredbyaninternationalstandard.

Structureandcontentoffinancialstatements

The majority of IAS1 is concerned with the structure and content of an entity's financial statements. The standard requires that certain items should be shown in the statement of financial position, the statement of comprehensive income and the statement of changes in equity.Otheritemsshouldbeshowneitherinthesestatementsorinthenotes.IAS1does notdealwiththestatementofcashflows,sincethisisthesubjectofIAS7*StatementofCashFlows*(seeChapter16).Themainheadingsinthispartof IAS1are:

(a) identificationofthefinancialstatements

(b) thestatementoffinancialposition

(c) thestatementofprofitorlossandothercomprehensiveincome

(d) thestatementofchangesinequity

(e) thenotes.

Eachoftheseisconsideredbelow.

Identificationofthefinancialstatements

The first point made in this part of IAS1 is that the financial statements should be clearly identified as such and distinguished from any other information which may be given in the same published document (e.g. a management review). Since international standards applyonlytothefinancialstatements,itisimportantthatuserscandistinguishinformationth at hasbeenpreparedinaccordancewithstandardsfrominformationthathasnot.

Furthermore,eachcomponentofthefinancialstatementsshouldbeclearlyidentifiedand thefollowinginformationshouldbedisplayedprominentlyandrepeatedwherenecessary forapropertunderstandingoftheinformationpresented:

(a) thenameofthereportingentity

(b) whetherthefinancialstatementsareforasingleentityoragroup(seeChapter18)

(c) thedateoftheendofthereportingperiodortheperiodcoveredbythesetoffinancial statements or notes

(d) thepresentationcurrencyused

(e) thelevelofroundingused(e.g.£000or£m).

Thestatementoffinancialposition

A statement of financial position (formerly referred to as a balance sheet) shows an entity's assets, liabilities and equity.

AnimportantrequirementofIAS1withregardtothestatementoffinancialpositionis thatcurrentandnon-currentassetsshouldbepresentedseparatelyandthatcurrentand non-currentliabilitiesshouldalsobepresentedseparately.Foranentitywhichsupplies goodsorserviceswithinaclearlyidentifiableoperatingcycle,thisseparationprovides useful information by:

(a) distinguishing the net assets that are continuously circulating as working capital from those used in the long-term, and

(b) highlightingtheassetsthatareexpectedtoberealisedwithinthecurrentoperating cycleandtheliabilitiesthatareddueforsettlementwithinthesameperiod.

IAS1establishesasetofcriteriawhichshouldbeusedtodistinguishbetweencurrentand non-current assets and another set of criteria which should be used to distinguish between current and non-current liabilities.

Currentandnon-currentassets

Anassetisclassifiedasacurrentasset†ifitsatisfies*any*ofthefollowingcriteria:

(a) itisexpectedtoberealised,orisintendedforsaleorconsumption,withintheentity's normal operating cycle

(b) itisheldprimarilyforthepurposeofbeingtraded

(c) itisexpectedtoberealisedwithintwelvemonthsafterthereportingperiod

(d) itiscashoracashequivalentasdefinedbystandardIAS7(seeChapter16)unlessit is restricted from being exchanged or from being used to settle a liability for at least twelve months after the reporting period.

Anassetthatsatisfiesnoneofthesecriteriaisanon-currentasset.Theoperatingcycleof an entity is defined as "*thetimebetweentheacquisitionofassetsforprocessingandtheirrealisationincashorcash equivalents*".Ifanentity'snormaloperatingcyclecannotbe clearly identified, it is assumed to be twelve months. Note that current assets include itemssuch as inventories and trade receivables that are expected to be realised during the normal operatingcycle,eveniftheyarenotexpectedtoberealisedwithintwelvemonths.

IAS1doesnotrequiretheuseoftheterms"current"and"non-current"andother descriptions could be used so long as their meaning is clear. However, these terms are used extensively in practice.

† *Anassetinitiallyclassifiedasnon-currentshouldnotbereclassifiedascurrentuntilitmeetsthe"heldforsale"criteriasetoutininternationalstandardIFRS5(seeChapter8).*

Currentandnon-currentliabilities

Aliabilityisclassifiedasacurrentliabilityifitsatisfies*any*ofthefollowingcriteria:

(a) itisexpectedtobesettledintheentity'snormaloperatingcycle

(b) itisheldprimarilyforthepurposeofbeingtraded

(c) itisduetobesettledwithintwelvemonthsafterthereportingperiod

(d) theentitydoesnothaveanunconditionalright‡todefersettlementoftheliabilityfor at least twelve months after the reporting period.

A liability that satisfies none of these criteria is a non-current liability. Current liabilities include items such as trade payables and accrued expenses that are expected to be settledduring the normal operating cycle, even if they are not expected to be settled within twelve months.Currentliabilitiesalsoincludeitemssuchasbankoverdrafts,dividendspayable andtaxeswhicharenotsettledaspartofthenormaloperatingcyclebutwhicharedueto be settled within twelve months.

‡ *InFebruary2015,theIASBissuedanexposuredraftofaproposedamendmenttoIAS1.Inthisexposuredraft,thewords"anunconditionalright"areamendedto"arightattheendofthereportingperiod".Theexposuredraftalsogivesexamplesofcircumstancesinwhichsucharightiscreated.T*

heprogressofthisproposalmaybefollowedonwebsitewww.ifrs.org.

Informationtobepresentedinthestatementoffinancialposition

IAS1doesnotspecifyanyparticularformatforthestatementoffinancialposition.Nor doesitprescribetheorderinwhichitemsshouldbeshown.Butthestandarddoesprovide alistoflineitemsthatshouldbepresentedseparatelyinthestatementiftheirsizeor natureissuchthatseparatepresentationisrelevanttoanunderstandingoftheentity's financial position. Additional line items, headings and subtotals should also be presentedwhererelevant.ThemainlineitemslistedbyIAS1areasfollows:

	Chapterofthisbook
(a)property,plantandequipment	5
(b)investmentproperty	5
(c)intangibleassets	6
(d)financialassets	11
(e)investmentsaccountedforbytheequitymethod	20
(f) inventories	10
(g)tradeandotherreceivables	11
(h)cashandcashequivalents	16
(i) assetsclassifiedas"heldforsale"	8
(j) tradeandotherpayables	11
(k)provisions	12
(l) financialliabilities	11
(m)currenttaxassetsandliabilities	15
(n)deferredtaxassetsandliabilities	15
(o)liabilitiesincludedindisposalgroupsheldforsale	8
(p)non-controllinginterests	18
(q)issuedequitycapitalandreserves	11

The order of the items and the descriptions used may be amended in accordance with thenature of the entity and its transactions, so as to provide relevant information. As indicated
above,eachoftheseitemsisaddressedinlaterchaptersofthisbook.Item(p)willarise only if the entity is a member of a group.

Formatofthestatementoffinancialposition

Although IAS1 does not prescribe a format for the statement of financial position, the implementationguidancethataccompaniesthestandardincludesanillustrationwhich showsonewayinwhichthestatementmaybepresented.Aslightlysimplifiedversionof thisillustrationisshowninFigure3.1below.Thisillustrativeformatisnotprescriptive and other formats may be used if appropriate.

XYZplc-Statementoffinancialpositionasat31December2019

	2019 £000	2018 £000
ASSETS		
Non-currentassets		
Property,plantandequipment	xxx	xxx
Intangibleassets	xxx	xxx
Investments	xxx	xxx
	xxx	xxx
Currentassets		
Inventories	xxx	xxx
Tradereceivables	xxx	xxx
Cashandcashequivalents	xxx	xxx
	xxx	xxx
Totalassets	xxx	xxx
EQUITYANDLIABILITIES		
Equity		
Sharecapital	xxx	xxx
Retainedearnings	xxx	xxx
Otherreserves	xxx	xxx
Totalequity	xxx	xxx
Non-currentliabilities		
Long-termborrowings	xxx	xxx
Deferredtax	xxx	xxx
Long-termprovisions	xxx	xxx
Totalnon-currentliabilities	xxx	xxx
Currentliabilities		
Tradeandotherpayables	xxx	xxx
Short-termborrowings	xxx	xxx
Currenttaxpayable	xxx	xxx
Short-termprovisions	xxx	xxx
Totalcurrentliabilities	xxx	xxx
Totalliabilities	xxx	xxx
Totalequityandliabilities	xxx	xxx

Figure3.1 Illustrativeformatofthestatementoffinancialposition

Informationinthestatementoffinancialpositionorinthenotes

IAS1 requires that the line items presented in the statement of financial position should be analysed into sub-classifications, either in the statement itself or in the notes. These sub- classifications should be appropriate to the entity but also depend to some extent on the requirementsofotherinternationalstandards.Forinstance,property,plantandequipment is analysed in accordance with IAS16 *Property,PlantandEquipment*(see Chapter 5) and inventoriesareanalysedinaccordancewithIAS2*Inventories*(seeChapter10).

IAS1 also requires further disclosures with regard to share capital and reserves. These disclosuresmaybegiveninthestatementoffinancialpositionorthestatementofchanges in equity, or in the notes. The disclosures include:

(a) foreachclassofsharecapital:
    (i) thenumberofsharesauthorisedandtheparvaluepershare
    (ii) thenumberofsharesissuedandfullypaid,andissuedbutnotfullypaid
    (iii) areconciliationofthenumberofsharesoutstandingatthebeginningandendof the accounting period
    (iv) therights,preferencesandrestrictionsattachingtothatclassofshares
(b) adescriptionofthenatureandpurposeofeachreserve.

Thestatementofcomprehensiveincome

The statement of comprehensive income is a financial statement which shows an entity's income and expenses for the reporting period and summarises its financial performance forthatperiod.Asmentionedearlierinthischapter,IAS1referstothisfinancialstatementas the "statement of profit or loss and other comprehensive income". However, entities are permitted to use alternative titles for the financial statements if they so wish and the shortertitle"statementofcomprehensiveincome"isusedthroughoutthisbook.

Mosttypesofincomeandexpensesaretakenintoaccountwhencalculatinganentity's profit or loss for a reporting period. However, international standards require that certain classesofincomeorexpenseshouldbedisregardedwhencalculatingprofitorlossand should instead be presented in the statement of comprehensive income under the heading"other comprehensive income". For instance:

(a) IAS16 *Property,PlantandEquipment*generally requires that surpluses arising on the revaluation of tangible non-current assets should be presented as other comprehensive income (see Chapter 5).
(b) IAS38*IntangibleAssets*makesasimilarrequirementinrelationtosurplusesarising ontherevaluationof intangibleassets (seeChapter 6).

Despiteitsname,"othercomprehensiveincome"canincludeexpensesaswellasincome and can therefore be negative.

Structureofthestatementofcomprehensiveincome

IAS1requiresthatallitemsofincomeorexpensethatarerecognisedinanaccounting period should be presented in *either*:

(a) a single statement of comprehensive income (with an "other comprehensive income" sectionfollowingthecalculationofprofitorlossfortheperiod),or

(b) twoseparatestatements,comprising:

  (i) astatementwhichshowstheentity'sprofitorloss,and

  (ii) asecondstatementwhichbeginswiththeprofitorlossfortheperiodandshows the entity's other comprehensive income.

In either case, the entity must present figures showing its profit or loss, the total of its other
comprehensiveincome(ifany)andits"totalcomprehensiveincome"fortheperiod,which isequaltothesumofitsprofitorlossanditsothercomprehensiveincome.

Informationpresentedinthestatementofcomprehensiveincome

Aswiththestatementoffinancialposition,IAS1doesnotprescribeaspecificformatfor thestatementofcomprehensiveincome.Instead,thestandardprovidesalistoflineitems that should be presented separately in this statement (in addition to items required by other
internationalstandards).Furtherlineitems,headingsandsubtotalsshouldbepresented whererelevant.ThemainitemslistedbyIAS1areasfollows:

	Chapterofthisbook
(a)revenue	13
(b)financecosts	9,11
(c)profitsorlossesaccountedforbytheequitymethod	20
(d)taxexpense	15
(e)asingleamountforthetotalofdiscontinuedoperations	8
(f) eachclassofothercomprehensiveincome	5,6,11,14,21

Theorderoftheitemsandthedescriptionsusedmaybeamendedwherethisisnecessary toexplaintheentity'sfinancialperformance.AnimportantfurtherrequirementofIAS1is that an entity should *not*present any items of income or expense as "extraordinary" items,eitherinthestatementofcomprehensiveincomeorinthenotes.

Classificationofothercomprehensiveincome

IAS1requiresthatanentity'sothercomprehensiveincome(seeabove)shouldbepresented in two categories. These are:

(a) itemsofothercomprehensiveincomewhich,ifcertainconditionsaresatisfied,will be"reclassifiedtoprofitorloss"inasubsequentreportingperiod(i.e.theywilltake partinthecalculationoftheprofitorlossforthatperiod)

(b) itemsofothercomprehensiveincomewhichwillnotbereclassifiedtoprofitorloss.

Itemsthatmaybereclassifiedtoprofitorlossarefewandtendtoberathertechnicalin nature (e.g. certain foreign exchange differences). The only items of other comprehensive incomethat will occur inpractical exercises inthis bookareitems whichcannot be reclassified to profit or loss (e.g. revaluation surpluses).

Groupsofcompanies

If the financial statements are for a group of companies, the statement of comprehensive income must also disclose:

(a) the amount of the profit or loss for the period which is attributable to non-controlling interestsandtheamountwhichisattributabletotheownersoftheparentcompany

(b) theamountofthetotalcomprehensiveincomefortheperiodwhichisattributableto non-controllinginterestsandtheamountwhichisattributabletotheownersofthe parent company.

The financial statements of groups of companies and the meaning of terms such as "non- controllinginterest"areexplainedinChapters18and19ofthisbook.

Informationinthestatementofcomprehensiveincomeorinthenotes

Inadditiontotheitemswhichmustbepresentedinthestatementofcomprehensive income, further items of income and expense should be disclosed separately (either in the statement itself or in the notes) if material. The entity must also present an analysis ofexpenses using a classification based on either:

(a) thenatureoftheexpenses,or

(b) thefunctionoftheexpenseswithintheentity.

Entitiesareencouragedtopresentthisanalysisinthestatementofcomprehensiveincome but it may be presented instead in the notes which accompany the financial statements. An analysis which is based on the nature of the expenses might include headings such as depreciation, employee benefits, motor expenses etc. An analysis based on function would normallyclassifyexpensesintocostofsales,distributioncostsandadministrative expenses. An entity which analyses expenses by function must also provide additional informationonthenatureofexpenses,includingdepreciationandemployeebenefits.

Formatofthestatementofcomprehensiveincome

TheimplementationguidancewhichaccompaniesIAS1providestwomainillustrationsof thestatementofcomprehensiveincome.Oneoftheseshowsasinglestatementwith expenses analysed by function and the other shows two separate statements with expenses analysedbynature.Simplifiedversionsoftheseillustrationsareshowninfigures3.2a, 3.2band3.2cbelow.Aswiththestatementoffinancialposition,IAS1makesitclearthat theseformatsareonlyillustrationsandthatotherformatsmaybeusedifappropriate.

XYZplc-Statementofcomprehensiveincomeforyearto31December2019

	2019 £000	2018 £000
Revenue	xxx	xxx
Costofsales	(xxx)	(xxx)
Grossprofit	xxx	xxx
Otherincome	xxx	xxx
Distributioncosts	(xxx)	(xxx)
Administrativeexpenses	(xxx)	(xxx)
Otherexpenses	(xxx)	(xxx)
Financecosts	(xxx)	(xxx)
Profitbeforetax	xxx	xxx
Taxexpense	(xxx)	(xxx)
PROFITFORTHEYEAR	xxx	xxx
Othercomprehensiveincome:		
***Itemsthatwillnotbereclassifiedtoprofitorloss*:**		
Gainsonpropertyrevaluation	xxx	xxx
Investmentsinequityinstruments	xxx	xxx
Taxrelatingtoitemsthatwillnotbereclassified	(xxx)	(xxx)
Othercomprehensiveincomefortheyearnetoftax	xxx	xxx
TOTALCOMPREHENSIVEINCOMEFORTHEYEAR	xxx	xxx

Figure3.2a Singlestatementofcomprehensiveincome(expensesanalysedbyfunction)

XYZplc-Statementofprofitorlossforyearto31December2019

	2019 £000	2018 £000
Revenue	xxx	xxx
Otherincome	xxx	xxx
ChangesininventoriesoffinishedgoodsandWIP	(xxx)	(xxx)
Rawmaterialandconsumablesused	(xxx)	(xxx)
Employeebenefitsexpense	(xxx)	(xxx)
Depreciationandamortisationexpense	(xxx)	(xxx)
Impairmentofproperty,plantandequipment	(xxx)	(xxx)
Otherexpenses	(xxx)	(xxx)
Financecosts	(xxx)	(xxx)
Profitbeforetax	–	–
	xxx	xxx
Taxexpense	(xxx)	(xxx)
PROFITFORTHEYEAR	–	–
	xxx	xxx

Figure3.2b Separatestatementofprofitorloss(expensesanalysedbynature)

XYZplc-Statementofcomprehensiveincomeforyearto31December2019

	2019 £000	2018 £000
Profitfortheyear	xxx	xxx
Othercomprehensiveincome:		
Itemsthatwillnotbereclassifiedtoprofitorloss:		
Gainsonpropertyrevaluation	xxx	xxx
Investmentsinequityinstruments	xxx	xxx
Taxrelatingtoitemsthatwillnotbereclassified	(xxx)	(xxx)
Othercomprehensiveincomefortheyearnetoftax	xxx	xxx
TOTALCOMPREHENSIVEINCOMEFORTHEYEAR	xxx	xxx

Figure3.2c Separatestatementofcomprehensiveincome

Thestatementofchangesinequity

Astatementofchangesinequityshowshoweachcomponentofequityhaschangedduring anaccountingperiod.Inthecaseofacompany,thecomponentsofequitywillbeshare capital and each of the company's reserves. IAS1 requires that the following items arepresented in the statement of changes in equity:

(a) totalcomprehensiveincomefortheperiod

(b) for each component of equity, the effects of any retrospective application of anaccountingpolicyorretrospectiverestatementofitems,inaccordancewithinter-national standard IAS8 (see Chapter 4)

(c) foreachcomponentofequity,areconciliationoftheopeningandclosingbalanceof thatcomponent,separatelydisclosingchangesresultingfrom:

  (i) profitorloss

  (ii) othercomprehensiveincome

  (iii) transactions with the owners of the entity, separately showing distributions toowners(e.g.dividends)andcontributionsbyowners(e.g.shareissues).

Furtherinformationmustbeprovidedeitherinthestatementofchangesinequityorinthe notes. This information consists of:

(d) foreachcomponentofequity,ananalysisofothercomprehensiveincomebyitem

(e) theamountofdividendspershare.

TheimplementationguidancetoIAS1providesanillustrationofthestatementofchanges inequity.AsimplifiedversionofthisillustrationisshowninFigure3.3.

XYZplc-Statementofchangesinequityfortheyearto31December2019

	Share capital £000	*Retained earnings* £000	*Revaluation reserve* £000	*Total equity* £000
Balanceat1January2018	xxx	xxx	xxx	xxx
Changesinequityfor2018				
Totalcomprehensiveincome		xxx		xxx
Dividends		(xxx)		(xxx)
Balanceat31December2018	xxx	xxx	xxx	xxx
Balanceat1January2019	xxx	xxx	xxx	xxx
Changesinequityfor2019				
Changesinaccountingpolicy		xxx		xxx
Restatedbalance	xxx	xxx	xxx	xxx
Issueofsharecapital	xxx			xxx
Totalcomprehensiveincome		xxx	xxx	xxx
Dividends		(xxx)		(xxx)
Balanceat31December2019	xxx	xxx	xxx	xxx

Figure3.3 Statementofchangesinequity

Tutorialnotes:

(a) Thisstatementofchangesinequityisfortheyearto31December2019.Thefirstfewlinesofthestatementshowcomparativefiguresfor2018.

(b) Intheyearto31December2018,thecompany'sretainedearningswereincreasedbytheprofitfortheyearbutreducedbydividendspaidtoshareholders.Therewerenootherchangesinequity.

(c) Thecompanychangedanaccountingpolicyintheyearto31December2019andthisnecessitatedanadjustmenttoretainedearningsbroughtforward(seeChapter4).Otherchangesinequityduring2019wereasfollows:

  (i) Sharecapitalincreasedbecauseofashareissueduringtheyear.

  (ii) Retainedearningswereincreasedbytheprofitfortheyearbutwerereducedbydividendspaidtoshareholders.

  (iii) Therevaluationreserveincreased(presumablybecausetherewasarevaluationgainduringtheyear).Thisgainwouldhavebeenpresentedinthestatementofcomprehensiveincomeas"othercomprehensiveincome".

Thenotestothefinancialstatements

As mentioned earlier in this chapter, the notes which accompany the statement of financial position, the statement of comprehensive income, the statement of cash flows and thestatementofchangesinequityareanintegralpartofthefinancialstatementsandso fall withinthescopeofinternationalstandards.IAS1statesthatthenotesshould:

(a) present information about the basis of preparation of the financial statements and the accounting policies which have been used, including:
  – themeasurementbasesusedinpreparingthefinancialstatements
  – otheraccountingpoliciesrelevanttoanunderstandingofthefinancialstatements
(b) disclose information required by international standards, to the extent that this is not presented elsewhere in the financial statements
(c) provide any additional information which is relevant to an understanding of any of the financial statements.

Thenotesshouldbepresentedinasystematicmannerandshouldbecross-referencedto the four primary financial statements. The notes normally begin with a statement ofcompliance with international standards. There should then be a section on significant accountingpolicies,followedbysupportinginformationforlineitemspresentedinthe fourprimarystatementsandfurtherdisclosuresasnecessary.

Sourcesofestimationuncertainty

Whendeterminingtheamountatwhichassetsorliabilitiesshouldbeshownor"carried"in thefinancialstatements,itmaybenecessarytoestimatetheeffectsofuncertainfuture events(suchastechnologicalchange)andmakeassumptions.Ifthereisasignificantrisk thattheseuncertainfutureeventsmaycauseamaterialadjustmenttothecarryingamount of assets or liabilities within the next financial year, IAS1 requires that the notes to thefinancialstatementsshouldexplainthekeysourcesofestimationuncertaintyanddisclos e the assumptions that have been made.

Otherdisclosures

Otherdisclosuresrequiredinthenotesinclude:

(a) theamountofanydividendsproposedbeforethefinancialstatementswereauthorised forissuebutnotrecognisedduringtheperiod(seeChapter12)
(b) theamountofanyunrecognisedcumulativepreferencedividends
(c) unlessdisclosedelsewhere,theentity'sdomicileandlegalform,itscountryof incorporation,theaddressofitsregisteredofficeandthenatureofitsoperations.

Ifanentityisasubsidiary(seeChapter18)itshoulddisclosethenameofitsparentandthe name of the ultimate parent of the group.

Interimfinancialreporting

IAS34*InterimFinancialReporting*appliesifanentitypublishesaninterimfinancial report that is stated to comply with international standards. An interim financial report is defined by IAS34 as "*afinancialreportcontainingeitheracompletesetoffinancialstatements...orasetofcondensedfinancialstatements...foraninterimperiod*".An interimperiodisaperiodwhichislessthanafullfinancialyear.

Thestandardsdonotactuallyrequireentitiestopublishinterimfinancialreports.But someentitieswhosesharesarepubliclytradedmightberequiredtodosobygovernments or stock exchanges. Other entities might do so voluntarily. In these cases, interim financial reports might be presented half-yearly or quarterly in addition to the annual report. Interim financial reports that are stated to comply with international standards must satisfy the requirementsofIAS34.Abriefsummaryoftheserequirementsisasfollows:

(a) An interim financial report may consist of a complete set of financial statements as defined in IAS1. Alternatively, an entity may provide a "condensed" set of financial statements consisting of a condensed version of each of the four primary statements together with selected explanatory notes.

The condensed financial statements should include, at a minimum, each of the headings and subtotals that were included in the entity's most recent annual financial statements. Additional items should be presented if their omission would make the condensedstatementsmisleading.Unfortunately,theterm"headingsandsubtotals"is not defined in IAS34 and so is open to interpretation. In practice, condensed financial statementstendtofollowthesameformatascompletefinancialstatements,sothat the"condensed"natureofthestatementsisconfinedlargelytothenotes.

(b) Basicanddilutedearningspersharefigures(seeChapter23)shouldbepresentedin thestatementofcomprehensiveincome,whethercompleteorcondensed.

(c) Theselectednotesshouldexplainanyeventsthataresignificanttoanunderstanding of changes in the entity's financial position or performance since the previous annual reportingperiod.Thereshouldalsobeastatementthatthesameaccountingpolicies havebeenusedintheinterimfinancialstatementsasinthemostrecentannual statements(oradescriptionofthenatureandeffectofanychangesinpolicy).

Further information should be provided about matters such as the seasonalityof the entity'soperations,thenatureandamountofanyunusualitems,thenatureand amount of any changes made to estimatesfrom previous periods, any share issuesor issue/repaymentofdebtsecurities,anydividendspaidandanysignificanteventsaftert heinterimperiodwhichwerenotreflectedintheinterimfinancialstatements.

(d) Thesameaccountingpoliciesshouldbeappliedintheinterimfinancialstatementsas in

the annual financial statements, except for changes in accounting policy which aremade after the most recent annual statements and which will be reflected in the next annual statements.

Managementcommentary

IFRSPracticeStatement1*ManagementCommentary*wasissuedin2010toassistentities thatwishtoincludea"managementcommentary"intheirannualreport.Suchacomment-aryfallsoutsidethescopeofinternationalstandardsandthePracticeStatementisnotitself a standard. However, the Statement does provide a broad, non-binding framework for the presentation of a management commentary relating to financial statements prepared in accordance with international standards.

Amanagementcommentaryisanarrativereportwhichexplainstheamountspresented in an entity's financial statements and sets those statements in context. It also provides an analysisoftheentity'sfutureprospectsandmaycontainotherinformationnotpresentedin the financial statements. The inclusion of a management commentary in the annual report allows management to comment on the entity's performance. It also gives management an opportunity to explain its objectives and its strategies for achieving those objectives. This should help the users of the financial statements to understand the entity's financial performance,evaluateitsprospectsandassesstheactionsofitsmanagement.Abrief summaryoftheguidancegiveninthePracticeStatementisasfollows:

(a) A management commentary should be clearly identified and distinguished from other information (e.g. the financial statements). The extent to which the Practice Statementhas been followed should be explained. An assertion that a management commentary complieswiththePracticeStatementcanbemadeonlyifitiscompliedwithinfull.

(b) A management commentary should provide a context for the financial statements. It should give management's view of what has happened, why it has happened and the implications for the future. It should also explain the main trends and factors that arelikelytoaffecttheentity'sperformance,positionandprogressinthefuture.

(c) The commentary should include "forward-looking" information which focuses on the extenttowhichtheentity'sfinancialperformance,liquidityandfinancialposition may change in the future (and why).

(d) A management commentary should also include information that is essential to an understanding of:

    (i) thenatureofthebusiness

    (ii) management'sobjectivesandstrategies

    (iii) theentity'smostsignificantresources,risksandrelationships

    (iv) thecritical performancemeasures andindicators that areusedbymanagement to evaluatetheentity'sperformanceagainstitsstatedobjectives.

Amanagementcommentaryshouldbeclearandstraightforward.Theinformationprovided shouldpossessthefundamentalqualitativecharacteristicsofrelevanceand

faithfulrepresentationdescribedinthe*ConceptualFramework*(seeChapter2)andshould also maximise the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability.

Makingmaterialityjudgements

IFRS Practice Statement 2 *MakingMaterialityJudgements*was issued in 2017 to provide entities with non-mandatory guidance on making materiality judgements. The Practice Statementisnotitselfastandardbutisapplicablewhenpreparinggeneralpurpose financial statements which comply with international standards. A brief summary of the guidance provided in the Statement is as follows:

(a) TheStatementbeginsbyrepeatingthedefinitionof"materialinformation"givenin the*ConceptualFramework*.Informationismaterialif"*omitting,mis-statingorobscuringitcouldreasonablybeexpectedtoinfluencedecisionsthattheprimaryusersofgeneralpurposefinancialreportsmakeonthebasisofthosereports*".A similar definition is given in IAS1 (see earlier in this chapter). Materiality is entity-specificanddependsuponthenatureormagnitude,orboth,oftheitemsconcerned.

(b) The making of materiality judgements is "pervasive" in the preparation of financial statements.Suchjudgementsarerequiredwhenmakingdecisionsrelatingto recognition,measurement,presentationanddisclosure.Furthermore,therequirement s ofinternationalstandardsdonotneedtobeappliedtoimmaterialitems.

(c) When making materiality judgements, an entity must consider the types of decisions which the primary users (e.g. investors and lenders) might make on the basis of the financial statements and the information needed in order to make those decisions. In general, users need information about the economic resources of the entity, claimsagainsttheentityandchangesinthoseresourcesandclaims.Informationisalso neededabouttheefficiencyandeffectivenessoftheentity'smanagement.

(d) The Statement then presents a possible four-step process for the making of materiality judgements. The four steps are as follows:

Step1. Identify information that has the potential to be material i.e. information that primaryusersmightneed.Thisstepinvolvesconsideringtherequirementsof the relevant international standards. It also involves considering the common informationneedsofprimaryuserstoidentifyanyfurtherinformationthat mightbeneeded,inadditiontothatspecifiedintheinternationalstandards.

Step2. Assess whether the potentially material information isindeed material. This requirestakingintoaccountbothquantitativeandqualitativefactors.

Step3.Organisetheinformationwithinthedraftfinancialstatementsinsuchaway thatitiscommunicatedclearlyandconciselytoprimaryusers.

Step4.Reviewthedraftfinancialstatementsandconsidermaterialityasawhole,on the basis of the complete set of financial statements.

TheStatementconcludesbyprovidingguidanceonthemakingofmaterialityjudgements in certain specific cases. These include materiality judgements relating to the

comparative informationprovidedforpriorperiodsandthecorrectionoferrors.

Summary

- A complete set of financial statements consists of a statement of financial position, a statement of comprehensive income, a statement of changes inequity, a statement ofcash flows and a set of notes.
- Transactions and other items should be faithfully represented in the financial state-ments.Theapplicationofinternationalstandardsnormallyensuresthis.
- Financialstatementsshouldbepreparedonthegoingconcernbasis(unlessthisdoes not apply) and on the accruals basis.
- The presentation and classification of items in the financial statements should be consistentbetweenaccountingperiods.Comparativeinformationshouldbedisclosed inrespectofthepreviousperiodforallamountsreportedinthefinancialstatements.
- Financial statements should be clearly identified and labelled. Financial statementsshould normally be presented at least annually.
- IAS1doesnotspecifyaparticularformatforthefinancialstatements.
- Currentandnon-currentassetsandliabilitiesshouldbeshownseparatelyinthe statementoffinancialposition.IAS1definestheterms"current"and"non-current".
- IAS1 lists the main line items that should be presented in the statement of financial position.Thestandardalsolistsfurtherdisclosuresthatshouldbemadeinthe statement of financial position or in the notes.
- IAS1 also lists the main line items that should be presented in the statement of comprehensiveincomeandrequiresananalysisofexpenses(bynatureorby function)tobeshowninthestatementitselforinthenotes.
- The statement of changes in equity shows the changes in each component of equityduringanaccountingperiod.Thestatementshowstotalcomprehensiveincome for theperiodanddisclosestransactionsbetweentheentityanditsowners.
- Thenotestothefinancialstatementsprovideinformationaboutmeasurementbases andaccountingpolicies,togetherwithsupportinginformationforlineitemsinthe main financial statements and further information which is required by international standardsorwhichisrelevanttoanunderstandingofthefinancialstatements.
- International standard IAS34 prescribes the minimum content of an interim financial report(ifoneispublished)butdoesnotrequireentitiestopublishsuchareport.
- IFRS Practice Statement 1 *ManagementCommentary*provides a broad, non-binding frameworkforthepresentationofamanagementcommentary.
- IFRS Practice Statement 2 *MakingMaterialityJudgements*provides non-mandatory guidance on making materiality judgements.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

3.1 Internationalstandard IAS1 listsvarious "generalfeatures"relating to the presentation of financial statements. These are:

(a) fairpresentationandcompliancewithinternationalstandards
(b) goingconcernbasisandaccrualbasis
(c) materialityandaggregation
(d) offsetting
(e) frequencyofreporting
(f) comparativeinformationandconsistencyofpresentation.

ExplainthemainrequirementsofIAS1inrelationtoeachofthesematters.

3.2 (a) Distinguishbetweencurrentassetsandnon-currentassets.
(b) Distinguishbetweencurrentliabilitiesandnon-currentliabilities.
(c) Explainwhythesedistinctionsareuseful.

3.3 ThetrialbalanceofTanhosierLtdasat31March2020isasfollows:

	£000	£000
Sales		50,332
Purchases	29,778	
Property,plantandequipment-cost	59,088	
Property, plant and equipment - accumulated depreciation		
25,486 Inventories as at 1 April 2019	7,865	
Interest	200	
Accruals		426
Distributioncosts	8,985	
Administrativeexpenses	7,039	
Retainedearningsasat1April2019		23,457
Tradereceivables	9,045	
Cashatbank	182	
8%bankloanrepayable2023		5,000
Sharecapital		10,000
Sharepremium		5,000
Tradepayables		2,481
	122,182	122,182

Thefollowingfurtherinformationisavailable:

(i) The share capital of the company consists of ordinary shares with a nominal value of £1 each. No dividends are to be paid for the current year.
(ii) ThesalesfigureinthetrialbalanceincludessalesmadeoncreditforApril2020amounting to £3,147,000.
(iii) Closing inventories on 31 March 2020 cost £8,407,000. Included in this figure are inventories that cost £480,000, but which can be sold for only £180,000.

(iv) Transportcostsof£157,000relatingtoMarch2020arenotincludedinthetrial balance as the invoice was received after the year end.

(v) Loaninterestforthelastsixmonthsoftheyearhasnotbeenpaidoraccountedfor.

(vi) Thecorporationtaxchargefortheyearhasbeencalculatedas£235,000.

Draft the statement of comprehensive income of Tanhosier Ltd for the year to 31 March 2020andastatementoffinancialpositionatthatdate. *(AmendedfromAAT)*

3.4 Explainthepurposeandstructureofastatementofchangesinequity.

3.5 Listthemaintypesofinformationwhichshouldbeprovidedinthenoteswhichaccompany and form an integral part of the financial statements.

3.6 Thefollowingtrialbalancehasbeenextractedfromthebooksof Walrusplcasat31 March 2020:

	£000	£000
Land,atcost	120	
Buildings,atcost	250	
Equipment,atcost	196	
Vehicles,atcost	284	
Goodwill,atcost	300	
Accumulateddepreciationat1April2019:		
Buildings		90
Equipment		76
Vehicles		132
Inventoryat1April2019	107	
Tradereceivablesandpayables	183	117
Allowanceforreceivables		8
Bankbalance		57
Corporationtax		6
Ordinarysharesof£1each		200
Retainedearningsat1April2019		503
Sales		1,432
Purchases	488	
Directors'fees	150	
Wagesandsalaries	276	
Generaldistributioncosts	101	
Generaladministrativeexpenses	186	
Dividendpaid	20	
Rentsreceived		30
Disposalofvehicle		10
	2,661	2,661

Thefollowinginformationisalsoavailable:

1. Non-depreciable land was valued at £300,000 on 31 March 2020 and this valuation is to be incorporated into the accounts for the year to 31 March 2020.

2. Thecompany'sdepreciationpolicyisasfollows:

   Buildings 4% p.a. straight line
   Equipment
   40%p.a.reducingbalance Vehicles
   25% p.a. straight line

   In all cases, a full year's depreciation is charged in the year of acquisition and no depreciation is charged in the year of disposal. None of the assets had been fully depreciated by 31 March 2019.

3. On 1 February 2020, a vehicle used entirely for administrative purposes was sold for £10,000. The sale proceeds were banked and credited to a disposal account but nootherentriesweremadeinrelationtothisdisposal.Thevehiclehadcost £44,000inAugust2016.Thiswastheonlydisposalofanon-currentassetmade during the year to 31 March 2020.

4. Depreciationisapportionedasfollows:

	Distribution costs	*Administrative expenses*
Buildings	50%	50%
Equipment	25%	75%
Vehicles	70%	30%

5. Thecompany'sinventoryat31March2020isvaluedat£119,000.

6. Tradereceivablesincludeadebtof£8,000whichistobewrittenoff.Theallowance for receivables is to be adjusted to 4% of the receivables which remain after this debt has been written off.

7. Corporation tax for the year to 31 March 2019 was over-estimated by £6,000. The corporation tax liability for the year to 31 March 2020 is estimated to be £30,000.

8. One-quarter of wages and salaries were paid to distribution staff and the remaining three-quarters were paid to administrative staff.

9. Generaladministrativeexpensesincludebankoverdraftinterestof£9,000.

10. A dividend of 10p per ordinary share was paid on 31 December 2019. No further dividends are proposed for the year to 31 March 2020.

Required:

Prepare the following financialstatements forWalrus plc in accordance with the require- ments of international standards:

(a) astatementofcomprehensiveincomefortheyearto31March2020

(b) astatementoffinancialpositionasat31March2020

(c) astatementofchangesinequityfortheyearto31March2020. *(CIPFA)*

*3.7 Chilwell Ltd prepares financial statements to 31 October each year. The company's trial balance at 31 October 2019 is as follows:

	£	£
Landatvaluation	250,000	
Buildingsatcost	300,000	
Equipmentandmotorvehiclesatcost	197,400	
Allowancesfordepreciationat1November2018:		
Buildings		60,000
Equipmentandmotorvehicles		105,750
Disposalofvehicle		18,000
Inventoryat1November2018	87,520	
Tradereceivablesandpayables	71,500	103,290
Allowancefordoubtfulreceivablesat1November2018		1,520
Bankbalance		10,390
Taxation	8,400	
9%Loanstock(repayable2023)		120,000
Purchasesandsales	483,230	1,025,420
Returnsinwardsandoutwards	27,110	12,570
Directors'fees	50,000	
Wagesandsalaries	102,400	
Generaladministrativeexpenses	143,440	
Generaldistributioncosts	107,050	
Royaltiesreceived		10,270
Interestpaid	6,220	
Dividendspaid	35,000	
Ordinarysharesof£1		80,000
Revaluationreserve		75,000
Retainedearningsat1November2018		247,060
	1,869,270	1,869,270

Thefollowinginformationisalsoavailable:

1. Landisnon-depreciableandistoberevaluedat£280,000on31October2019.
2. Thebuildingswereacquiredon1November2008.Atthattime,theirusefullife was estimated to be 50 years and it was decided to adopt the straight-line methodofdepreciation,assumingnoresidualvalue.On1November2018,itwas determined that the useful life of the buildings would end on 31 October 2048. The estimate of residual value remains unchanged.
3. Equipment and vehicles are depreciated at 25% per annum on the reducing balance basis.Afullyear'sdepreciationischargedintheyearofacquisition.No depreciation is charged in the year of disposal. In June 2019, a distribution vehicle which had cost £64,000 in February 2015 was sold for £18,000. This amount was debitedtothebankaccountandcreditedtoadisposalaccount,butnofurtherentri es have yet been made with regard to this disposal.
4. Depreciationofbuildingsshouldbesplit70:30betweenadministrativeexpenses anddistributioncosts.Depreciationofequipmentandvehiclesshouldbesplit40: 60 between administrative expenses and distribution costs.

5. Thecostofinventoryat31October2019is£92,280.
6. Tradereceivablesincludebaddebtsof£2,000whichshouldbewrittenoff.The allowance for doubtful receivables should then be adjusted to 2% of the remaining trade receivables.
7. Thecompany'staxliabilityfortheyearto31October2018wasunderestimatedby £8,400.Theliabilityfortheyearto31October2019 isestimatedtobe£20,000and falls due on 1 August 2020.
8. The loan stock was issued on 1 January 2019. Interest is payable half-yearly on 30 June and 31 December. The interest due on 30 June 2019 was paid on the due date. Accrued interest at 31 October 2019 has not yet been accounted for.
9. Directors'feesaretobetreatedasadministrativeexpenses.Wagesandsalaries should be split 50:50 between administrative expenses and distribution costs.
10. A 1 for 2 bonus issue of ordinary shares was made on 1 July 2019, financed out of retained earnings. No entries have yet been made in relation to this issue.

Required:

PreparethefollowingfinancialstatementsforChilwellLtdinaccordancewiththe requirements of international standards:

(a) astatementofcomprehensiveincomefortheyearto31October2019

(b) astatementofchangesinequityfortheyearto31October2019

(c) astatementoffinancialpositionasat31October2019.

Formalnotestotheaccountsarenotrequired,butallworkingsshouldbeshown.

(CIPFA)

Chapter4

Accountingpolicies,accountingestimatesanderrors

Introduction

The purpose of this chapter is to explain the main features of international standard IAS8 *AccountingPolicies,ChangesinAccountingEstimatesandErrors*.Thisstandardlays down criteria for the selection of accounting policies and prescribes the circumstances inwhichanentitymaychangeanaccountingpolicy.Thestandardalsodealswiththe accountingtreatmentanddisclosureofchangesinaccountingpolicies,changesin accountingestimatesandcorrectionsofpriorperioderrors.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- define the term "accounting policy" and explain how an entity should select itsaccounting policies
- explainthecircumstancesinwhichanentitymaychangeanaccountingpolicy
- account for a change in an accounting policy and list the disclosures which must bemade when an accounting policy is changed
- explain what is meant by an accounting estimate and account for a change in anaccounting estimate
- definetheterm"priorperioderror"
- accountforthecorrectionofapriorperioderrorandlistthedisclosureswhichmust be made when a prior period error is corrected.

Accountingpolicies

IAS8definesaccountingpoliciesas"*thespecificprinciples,bases,conventions,rulesandpracticesappliedbyanentityinpreparingandpresentingfinancialstatements*".Theuse

of the word "policies" suggests that entities are allowed to choose between alternative accountingtreatments.However,someofanentity'saccountingpolicieswillbedictated byaninternationalstandardwhichpermitsnochoiceoftreatment.Forinstance:

(a) IAS2*Inventories*requiresthatinventoriesaremeasuredatthelowerofcostandnet realisable value (see Chapter 10).

(b) IAS37*Provisions,ContingentLiabilitiesandContingentAssets*preventsentities fromrecognisingcontingentassetsandliabilities(seeChapter12).

(c) IAS38*IntangibleAssets*preventsentitiesfromrecognisinginternally-generatedgoodwill intheir financial statements (seeChapter 6).

Butsomestandardsdopermitachoice.Forinstance:

(a) IAS2*Inventories*allowsthecostof"interchangeable"inventoryitemstobeassigned by using either the first-in, first out (FIFO) cost formula or the weighted average cost formula (see Chapter 10).

(b) IAS16*Property,PlantandEquipment*allowsitemsofproperty,plantandequipment tobemeasuredusingeitherthecostmodelortherevaluationmodel(seeChapter5).

(c) Similarly,IAS38*IntangibleAssets*allowsintangibleassetstobemeasuredusing eitherthecostmodelortherevaluationmodel(seeChapter6).

International standard IAS1 (see Chapter 3) requires entities to disclose their significant accountingpoliciesinthenoteswhichformapartofthefinancialstatements.Guidanceon the selection of accounting policies is given in IAS8.

Selectionofaccountingpolicies

IAS8providesthefollowingguidanceontheselectionofaccountingpolicies:

(a) If an international standard (or IFRIC Interpretation made by the IFRS Interpretations Committee)specificallyappliestoanitem,theaccountingpolicywhichisappliedto thatitemshouldbedeterminedbyapplyingtherelevantstandardorinterpretation.

(b) Ifthereisnointernationalstandardorinterpretationwhichspecificallyappliestothe itemconcerned,managementshoulduseitsjudgementinselectinganaccounting policythat resultsininformation whichisrelevant andprovidesafaithful represent-ation(seeChapter2).Inmakingthisjudgement,managementshouldreferto:

   (i) the guidance provided by international standards and interpretations which dealwith similar and related issues

   (ii) thedefinitions,recognitioncriteriaandmeasurementconceptsforassets, liabilities,incomeandexpensesgiveninthelASB*ConceptualFramework*.

   Managementmayalsoconsiderthepronouncementsof otherstandard-settingbodies withasimilarconceptualframeworktothelASB*ConceptualFramework*andmay refer to accounting literature and accepted industry practices, as long as these do not

conflictwithinternationalstandards,interpretationsortheConceptualFramework.

IAS8 also stresses the need for the *consistent*application of accounting policies. Having selectedanaccountingpolicyinrelationtoanitem,thatpolicyshouldbeapplied consistently to all similar items.

Changesinaccountingpolicies

IAS8allowsanentitytochangeoneofitsaccountingpoliciesonlyifthechange:

(a) isrequiredbyaninternationalstandardorIFRICInterpretation;or
(b) resultsinthefinancialstatementsprovidingreliableandmorerelevantinformation thanwouldbethecaseiftheaccountingpolicywerenotchanged.

Theusersoffinancialstatementsneedtobeabletocompareanentity'sfinancial statements from one accounting period to another. Therefore the same accounting policies shouldbeusedfromoneperiodtothenextunlesstheaboveconditionsaresatisfied.

Accountingforachangeinaccountingpolicy

Ifachangeinaccountingpolicyresultsfromtheinitialapplicationofaninternational standardorIFRICInterpretation,thechangeshouldbeaccountedforinaccordancewith thetransitionalprovisions(ifany)whichareprovidedinthatstandardorinterpretation.

However, if there are no transitional provisions or if the change in policy has been made voluntarilysoastoimprovetherelevanceofthefinancialstatements,IAS8requiresthat thechangeshouldbeaccountedfor*retrospectively*.Thisentailsthefollowingsteps:

(a) Comparative figures for the previous period (or previous periods if comparatives are provided for more than one period) must be adjusted and presented "*asifthenewaccountingpolicyhadalwaysbeenapplied*".
(b) The opening balance of each affected component of equity (usually retained earnings) mustbeadjusted.Thisadjustmenttakesplaceinthestatementofchangesinequity.

Retrospective application maintains comparability between accounting periods and this approachmustusuallybeadoptedunlessitisimpracticabletodoso.

An important exception to this requirement arises in the case of property, plant andequipment(IAS16)andintangibleassets(IAS38)whereanentitychangesfromthecost modeltotherevaluationmodel.Inthiscase,theinternationalstandardsrequirethatthe changeisaccountedforprospectivelyratherthanretrospectively(seeChapters5and6).

Additionalcomparativeinformationtobepresented

Anentitywhichaccountsforachangeinanaccountingpolicyretrospectivelymustpresent arestatedstatementoffinancialpositionasatthe*beginning*ofthepreviousperiod(unless thechangeinpolicydoesnothaveamaterialeffectonthatstatement).

If the entity normally provides comparative figures for the previous period only, this represents an additional requirement.

EXAMPLE1

Acompanybegantradingon1January2017,preparingaccountsto31Decembereachyear.Asat31December2019,thecompanyadoptedanewaccountingpolicywithregardtothemeasurementofinventories.Ifthenewpolicyhadbeenappliedinpreviousyears,thecompany'sinventoryat31December2017wouldhavebeen£150,000higherthantheamountoriginallycalculated.Similarly,theinventoryat31December2018wouldhavebeen£400,000higherthantheamountoriginallycalculated.

Anextractfromthedraftstatementofcomprehensiveincomefortheyearto31December2019(beforeaccountingretrospectivelyforthechangeinaccountingpolicy)isasfollows:

	2019	2018
	£000	£000
Profitbeforetaxation	2,600	1,900
Taxation	520	380
Profitaftertaxation	2,080	1,520

Retainedearningswereoriginallyreportedtobe£2,360,000on31December2018.Nodividendswerepaidinanyyear.Itmaybeassumed(forthesakeofsimplicity)thatthecompany'staxationexpenseisalwaysequalto20%ofitsprofitbeforetax.

(a) Rewritetheextractfromthecompany'sstatementofcomprehensiveincomefortheyearto31December2019,showingrestatedcomparativefiguresfor2018.

(b) Prepareanextractfromthecompany'sstatementofchangesinequityfortheyearto31December2019,showingchangestoretainedearnings.

Solution

(a) Ifthenewaccountingpolicyhadalwaysbeenapplied,openinginventoryfortheyearto31December2019wouldhavebeen£400,000higher.Thiswouldhavecausedanincreaseof£400,000incostofsalesfortheyearandadecreaseof£400,000inpre-taxprofits.Similarly,pre-taxprofitsfortheyearto31December2018wouldhavebeenincreasedby£400,000butreducedby£150,000,givinganoverallincreaseof £250,000.Thereforetheextractfromthecompany'sstatementofcomprehensiveincomefortheyearto31December2019isasfollows:

		(restated)
	2019	2018
	£000	£000
Profitbeforetaxation	2,200	2,150
Taxation	440	430
Profitaftertaxation	1,760	1,720

Thesefiguresshowanincreaseinprofitbetween2018and2019ofapproximately2%,whereastheoriginalfigures(whichweredistortedbythechangeinaccountingpolicy)suggestedincorrectlythatprofithadrisenbynearly37%.

(b) Profitaftertaxfor2018wasoriginallystatedtobe£1,520,000.Therestatedfigure(seeabove) is£1,720,000,anincreaseof£200,000.

Profitaftertaxfor2017wouldhavebeen£150,000higherifthenewaccountingpolicyhadalw aysbeenapplied.Thetaxliabilitywouldhaveincreasedby£30,000(20%of £150,000)andsoprofitaftertaxwouldhavebeen£120,000higher.

Intotal,therefore,retainedearningsat31December2018wouldhavebeen£320,000higherif thenewaccountingpolicyhadalwaysbeenapplied.Theextractfromthestatementofchang esinequityfortheyearto31December2019isasfollows:

	Retainedearnings
	£000
Balanceb/fasoriginallystated	2,360
Changeinaccountingpolicy	320
Restatedbalance	2,680
Profitfortheyear	1,760
Balancec/f	4,440

Ifthechangeinaccountingpolicyhadnotbeenaccountedforretrospectively,theretainedear ningsfigureat31December2019wouldstillhavebeen£4,440,000(£2,360,000+£2,080,000) .However,thedistributionofearningsoverthethreeyearsconcernedwouldhavebeendiffere ntandmisleading.

Disclosureofachangeinaccountingpolicy

Themaindisclosuresrequiredonachangeinaccountingpolicyareasfollows:

(a) for a change in accounting policy caused by the initial application of an international standard or IFRIC Interpretation:
   - thetitleoftherelevantstandardorinterpretationand(ifapplicable)thefactthat thechangehasbeenaccountedforinaccordancewithtransitionalprovisionsand a description of those provisions

(b) foravoluntarychangeinaccountingpolicy:
   - the reasons which suggest that application of the new policy will provide reliableand more relevant information

(c) forallchangesinaccountingpolicy:
   - thenatureofthechange
   - for the current period and for each prior period presented, the amount of the adjustmentmadetoeachaffecteditemin thefinancialstatementsandthe amountofanyadjustmenttotheentity'searningspershare(seeChapter23)
   - if retrospective application of the new policy has proved to be impracticable, a descriptionofthecircumstancesthathaveledtothisconditionandadescription ofhow(andfromwhen)thechangeinpolicyhasbeenapplied.

Accountingestimates

IAS8statesthat"*manyitemsinfinancialstatementscannotbemeasuredwithprecisionbutcanonlybeestimated*". Estimates may be required in relation to items such as doubtful receivables,theusefullivesofdepreciableassets,thenetrealisablevalueofinventories andsoforth.IAS8alsostatesthat"*theuseofreasonableestimatesisanessentialpartofthepreparationoffinancialstatementsanddoesnotunderminetheirreliability*".

Bydefinition,estimatescannotbeprecise.Thereforeanestimatemadeinthepastmay needtoberevisedifchangesoccurtotheconditionsonwhichtheoriginalestimatewas basedorifnewinformationbecomesavailable.Forinstance,ifnewinformationis received concerning the solvency of a customer, a trade receivable which was previously estimatedtobe50%collectiblemightnowbeestimatedasbeingonly25%collectible.

IAS8 requires an entity which changes an accounting estimate to account for the change *prospectively*, not retrospectively. This means that the effect of the change should be dealtwithintheentity'sfinancialstatementsforthecurrentperiodand(ifapplicable)future periods.Butthestandarddoesnotrequire(orpermit)therestatementofcomparative figures for prior periods. This is totally different from the required treatment of changes in accounting policy. If it is difficult to distinguish a change in an accounting policy from a changeinanaccountingestimate,IAS8requiresthatthechangeconcernedshouldbe treated as a change in an accounting estimate.

Disclosureofchangesinaccountingestimates

IAS8 requires disclosure of the nature and amount of a change in an accounting estimatewhich has an effect in the current period or is expected to have an effect in future periods. However, this requirement is subject to the materiality rule in IAS1. This rule states that a specificdisclosurerequiredbyastandardorIFRICInterpretationneednotbeprovided"*ifthein formationresultingfromthatdisclosureisnotmaterial*"(seeChapter3).

Priorperioderrors

Financialstatementsdonotcomplywithinternationalstandardsiftheycontainmaterial errors. Potential errors may be discovered before the financial statements are finalised, inwhichcasetheycanbecorrectedbeforethestatementsareauthorisedforissue.However, itispossiblethatanerrormaynotbedetecteduntilasubsequentaccountingperiod.Such an error is referred to as a "prior period error".

IAS8 defines prior period errors as "*omissionsfrom,andmisstatementsin,theentity'sfinancialstatementsforoneormoreprior periodsarisingfromafailuretouse,ormisuseof,reliableinformationthat:*

(a) wasavailablewhenfinancialstatementsforthoseperiodswereauthorisedforissue;an

d

(b) couldreasonablybeexpectedtohavebeenobtainedandtakenintoaccountintheprepar ationandpresentationofthosefinancialstatements".

Such errors could be caused by mathematical mistakes, mistakes in applying accounting policies,oversightsormisinterpretationsoffactsorbyfraud.IAS8requiresthatmaterial priorperioderrorsshouldbecorrected*retrospectively*.Theapproachissimilartothat adopted for a change in accounting policy and involves:

(a) restatingcomparativefiguresforthepriorperiod(s)inwhichtheerroroccurred,or

(b) iftheerroroccurredbeforetheearliestpriorperiodforwhichcomparativesare presented,restatingtheopeningbalancesofassets,liabilitiesandequityforthe earliest prior period presented.

In any case, an entity which corrects a prior period error retrospectively must present a statementoffinancialpositionasatthe*beginning*ofthepreviousperiod(unlessthe correctionoftheerrordoesnothaveamaterialeffectonthatstatement).

EXAMPLE2

Whilstpreparingitsfinancialstatementsfortheyearto31December2019,acompanydiscoversth at(becauseofanarithmeticerror)itsinventoryat31December2018wasoverstatedby£50,000.T hisisamaterialamount.

Anextractfromthecompany'sdraftstatementofcomprehensiveincomefortheyearto31Decem ber2019(beforecorrectingtheerror)showsthefollowing:

	2019	2018
	£000	£000
Sales	940	790
Costofgoodssold	750	540
Grossprofit	190	250
Otherexpenses	120	110
Profitbeforetaxation	70	140
Taxation	14	28
Profitaftertaxation	56	112

Retainedearningswereoriginallyreportedtobe£382,000on31December2018.Nodividendswer epaidinanyyear.Itmaybeassumedthatthecompany'staxationexpenseisalwaysequalto20%ofi tsprofitbeforetax.

(a) Prepareanextractfromthecompany'sstatementofcomprehensiveincomefortheyearto31 December2019,showingrestatedcomparativefiguresfor2018.

(b) Prepareanextractfromthecompany'sstatementofchangesinequityfortheyearto31Dece mber2019,showingchangestoretainedearnings.

Solution

(a) Theextractfromthestatementofcomprehensiveincomefortheyearto31December2019is asfollows:

	2019	(restated) 2018
	£000	£000
Sales	940	790
Costofgoodssold	700	590
Grossprofit	240	200
Otherexpenses	120	110
Profitbeforetaxation	120	90
Taxation	24	18
Profitaftertaxation	96	72

(b) Theretainedearningscolumnofthestatementofchangesinequityfortheyearto31Decemb er2019isasfollows:

	£000
Balanceb/fasoriginallystated	382
Correctionofpriorperioderror(72–112)	(40)
Restatedbalance	342
Profitfortheyear	96
Balancec/f	438

Note:

Retrospectiveadjustmentofthepriorperioderrorrevealsthatprofitsaftertaxhaverisenin2019.Ift hecomparativesfor2018hadnotbeenrestated,thefinancialstatementswouldhavegiventheinc orrectimpressionthatprofitsaftertaxhadfallenduring2019.

Disclosureofpriorperioderrors

Whenanentitycorrectsamaterialpriorperioderror,IAS8requiresthatthefollowingdisclosuressh ouldbemadeinthenotestothefinancialstatements:

(a) thenatureofthepriorperioderror

(b) foreachpriorperiodpresented,theamountofthecorrectiontoeachaffectedlineitem inthefinancialstatementsand,ifapplicable,theamountofanycorrectiontothe entity's earnings per share (see Chapter 23)

(c) theamountofthecorrectionatthebeginningoftheearliestpriorperiodpresented

(d) ifretrospectiverestatementisimpracticableforaparticularpriorperiod,adescription ofthecircumstancesthathaveledtothisconditionandadescriptionofhow(and from when) the error has been corrected.

Summary

- IAS8dealswithaccountingpolicies,changesinaccountingestimatesandthe correction of prior period errors.
- Accountingpoliciesarethespecificprinciples,bases,conventions,rulesandpractices appliedbyanentityinpreparingandpresentingitsfinancialstatements.
- IFRS Standards issued by the IASB do not generally permit any choice of accounting treatment but some of the IAS Standards which were adopted by the IASB on itsinception do offer a choice. Therefore an entity's accounting policies will usually be a mixtureofpoliciesrequiredbystandardsandpolicieschosenbytheentity.
- IAS8providesguidanceontheselectionofaccountingpolicies.
- Accounting policies should be applied consistently and should be changed only if the changeisrequiredbyaninternationalstandardorIFRICInterpretation,orifitresults in reliable and more relevant information.
- A change in accounting policy should be accounted for retrospectively. This involves restatingcomparativefiguresforeachpriorperiodpresented.Detailsofthechange must bedisclosedinthenotes tothefinancial statements.
- A change in an accounting estimate should be accounted for prospectively and (if material) disclosedinthenotes tothefinancial statements.
- Materialpriorperioderrorsshouldbeaccountedforretrospectivelyanddisclosedin the notes to the financial statements.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

4.1 (a) Distinguishbetweenaccountingpoliciesandaccountingestimates.
(b) Explainhowachangeinanaccountingpolicyshouldbeaccountedfor.
(c) Explainhowachangeinanaccountingestimateshouldbeaccountedfor.

4.2 (a) Explain how an entity should select its accounting policy in relation to an item ifthere is no applicable international standard or IFRIC Interpretation.
(b) Inwhatcircumstancesmayanentitychangeoneofitsaccountingpolicies?

4.3 Listthedisclosureswhichmustbemadeifanaccountingpolicyischanged.

4.4 (a) Explain what is meant by a "material prior period error" and explain how such an error should be corrected.

(b) Listthedisclosuresrequiredwhenamaterialpriorperioderroriscorrected.

4.5 H Ltd began trading on 1 January 2016, preparing financial statements to 31 December
eachyear.During2019,thecompanydecidedtochangeitsaccountingpolicywithregar dtooneofitsoperatingexpenses.Totaloperatingexpensescalculatedusingthe previous accounting policy and shown in the company's financial statements for the first three years of trading were as follows:

	£000
yearto31December2016	240
yearto31December2017	260
yearto31December2018	290
	790

Ifthenewaccountingpolicyhadbeenappliedinpreviousyears,thetotaloperating expenses would have been:

	£000
yearto31December2016	390
yearto31December2017	310
yearto31December2018	230
	930

Furthermore,thecompany'sliabilitiesat31December2018wouldhavebeenhigherby £140,000(£930,000–£790,000).

Asummaryofthecompany'sstatementofcomprehensiveincomefortheyearto31 December2019(beforeadjustingcomparativefigurestoreflectthechangeinaccounti ng policy) shows the following:

	2019	2018
	£000	£000
Profitbeforeoperatingexpenses	1,510	1,450
Operatingexpenses	190	290
Profitbeforetaxation	1,320	1,160
Taxation	264	232
Profitaftertaxation	1,056	928

Retained earnings were originally reported to be £2,371,000 on 31 December 2018. No dividends have been paid in any year. It may be assumed that the company's tax expense is always equal to 20% of the profit before taxation.

Required:

(a) Rewritetheextractfrom thestatementofcomprehensiveincomesoastoreflectthe change in accounting policy, in accordance with the requirements of IAS8.

(b) Prepare an extract from the company's statement of changes in equity for the yearto 31 December 2019, showing changes to retained earnings.

4.6 Whilstpreparingitsfinancialstatementsfortheyearto30June2020,acompanydiscovers that (owing to an accounting error) the sales figure for the year to 30 June 2019 had been understated by £100,000. Trade receivables had been understated by the same amount. This error is regarded as material.

An extract from the company's draft statement of comprehensive income for the year to 30 June 2020, before correcting this error, is as follows:

	2020	2019
	£000	£000
Sales	1,660	1,740
Costofgoodssold	670	730
Grossprofit	990	1,010
Expenses	590	560
Profitbeforetaxation	400	450
Taxation	80	90
Profitaftertaxation	320	360

The additional trade receivables of £100,000 are still outstanding at 30 June 2020. The sales figure for the year to 30 June 2020 shows only the sales revenue for that year and doesnotincludethesalesof£100,000whichwereomittedfromthepreviousyear's financial statements.

Retained earnings at 30 June 2019 were originally reported as £1,220,000. No dividends were paid during the two years to 30 June 2020. It may be assumed that the company's tax expense is always equal to 20% of the profit before taxation.

Required:

(a) Revise the extract from the statement of comprehensive income for the year to 30 June 2020, showing restated comparative figures for the year to 30 June 2019.

(b) Prepare an extract from the company's statement of changes in equity for the yearto 30 June 2020, showing changes to retained earnings.

*4.7 J Ltd has been trading for many years, preparing financial statements to 31 March each year. As from 1 April 2019, the company decided to adopt a new accounting policy in relation to revenue recognition.

If this policy had been adopted in previous years, the company's revenue for the year to 31March2018wouldhavebeen£350,000higherthanpreviouslyreportedandtrade receivables at 31March2018 wouldalsohavebeen£350,000higher. Revenue for the year to 31 March 2019 would have been £600,000 higher than previously reported and tradereceivablesat31 March 2019 would havebeen £950,000 higher.Therewould have been no effect in any earlier year.

An extract from the company's draft statement of comprehensive income for the year to 31 March 2020 (with comparatives for 2019 as originally stated) is as follows:

	2020	2019
	£000	£000
Revenue	5,200	4,800
Operatingexpenses	4,100	3,900
Profitbeforetaxation	1,100	900
Taxation	220	180
Profitaftertaxation	880	720

The draft financial statements for the year to 31 March 2020 show only the revenue for thatyear(measuredinaccordancewiththenewaccountingpolicy)andhavenotbeen adjusted to include the additional revenue of £950,000 from previous years which now needs to be accounted for.

The company's taxation expense is always equal to 20% of its profit before taxation. No dividends were paid during the two years to 31 March 2020 and retained earnings at 31 March 2019 were originally reported to be £1,605,000.

Required:

(a) Explain the circumstances in which a company which complies with international standardsmaychangeanaccountingpolicy.Alsoexplainhowsuchachangeis accounted for in accordance with the requirements of IAS8.

(b) Revise the extract from the statement of comprehensive income for the year to 31 March 2020 (with comparatives for 2019).

(c) Prepare an extract from the company's statement of changes in equity for the yearto 31 March 2020, showing changes to retained earnings.

(d) Explain why the revised statement of comprehensive income is an improvement on the draft statement.

Part2

FINANCIALREPORTINGINPRACTICE

Chapter5

Property,plantandequipment

Introduction

The main purpose of this chapter is to explain the requirements of international standardIAS16*Property,PlantandEquipment*.Thisstandardprescribestheaccountingtreatment ofproperty,plantandequipmentanddealswiththefollowingprincipalissues:

(a) thecriteriawhichmustbesatisfiedinorderthatanitemofproperty,plantandequipment should be recognised as an asset

(b) thewayinwhichitemsofproperty,plantandequipmentshouldbemeasuredinthe financialstatements,bothatinitialrecognitionandlater

(c) thewayinwhichdepreciationchargesshouldbecalculatedandaccountedfor.

TheaccountingtreatmentprescribedbyIAS16appliestomostproperty,plantandequipment but does not apply if another standard requires or permits a different accountingtreatment. In particular, IAS16 does not apply to property, plant and equipment which is classifiedasheldforsale.ThisisdealtwithinaccordancewithIFRS5(seeChapter8).

This chapter of the book also considers four other international standards which may be relevantwhenaccountingforproperty,plantandequipment.Theseare:

(a) IFRS13*FairValueMeasurement*

(b) IAS23*BorrowingCosts*

(c) IAS20*AccountingforGovernmentGrantsandDisclosureofGovernmentAssistance*

(d) IAS40*InvestmentProperty*.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- definetheterm"property,plantandequipment"inaccordancewithIAS16
- statethecriteriawhichmustbesatisfiedforanitemofproperty,plantandequipment to be recognised as an asset

- determinethecostofanitemofproperty,plantandequipment
- distinguishbetweenthecostmodelandtherevaluationmodelforthemeasurementof property, plant and equipment after initial recognition
- calculateandaccountfordepreciationchargesinaccordancewithIAS16
- listthemaindisclosuresrequiredbyIAS16
- explain the requirements of IAS23 in relation to borrowing costs incurred for theacquisition,constructionorproductionofaqualifyingasset
- explaintherequirementsofIAS20inrelationtogovernmentgrants
- define the term"investment property" and explain the requirements of IAS40 inrelation to investment properties
- definetheterm"fairvalue"andoutlinetheguidanceprovidedbyIFRS13withregard to the measurement of fair value.

Definitionofproperty,plantandequipment

IAS16definesproperty,plantandequipmentas"*tangibleitemsthat:*

(a) areheldforuseintheproductionorsupplyofgoodsorservices,forrentaltoothers,orforadministrativepurposes;and

(b) areexpectedtobeusedduringmorethanoneperiod."

Thisdefinitioncoversthemajorityofthetangiblenon-currentassetsthatmightnormally be held by a business entity.

Definitionofcarryingamount

ThereareseveralotherdefinitionsinIAS16,mostofwhicharecoveredinlatersectionsof thischapter.Butonedefinitionwhichmustbeunderstoodfromtheoutsetisthedefinition of an asset's carrying amount. The term "carrying amount" is used throughout the international standards to refer to the amount at which an item is "carried" or shown in the financial statements. In the case of property, plant and equipment, IAS16 defines carrying amount as "*theamountatwhichanassetisrecognisedafterdeductinganyaccumulateddepreciationandaccumulatedimpairmentlosses*".Thisamountcouldalsobereferredto astheasset'swrittendownvalue,althoughthistermisnotusedbytheinternational standards.Impairmentlossesaredealtwithin Chapter 7 of this book.

Recognitionofproperty,plantandequipment

IAS16statesthatanitemofproperty,plantandequipmentshouldberecognisedasan asset if and only if:

(a) it is probable that future economic benefits associated with the itemwill flowto theentity concerned, and

(b) thecostoftheitemcanbemeasuredreliably†.

Assessingtheprobabilityoffutureeconomicbenefitswillrequiretheexerciseofjudgementbutmeasuringthecostofanitemwillusuallybestraightforward.IAS16alsomakes thefollowingpointswithregardtotherecognitionofproperty,plantandequipment:

(a) An "item" generally consists of an individual piece of property, plant and equipment. However, it may sometimes be appropriate to group relatively insignificant itemstogether(e.g.smalltools)andapplytherecognitioncriteriatothegroup.

(b) Sparepartsarerecognisedasproperty,plantandequipmentiftheymeetthedefinitiongivenearlierinthischapterandsatisfytherecognitioncriteria.However,small partsmaybetreatedasinventory(seeChapter10)andaccountedforasanexpense whentheyareusedintherepairandmaintenanceofproperty,plantandequipment.

(c) Itemsofproperty,plantandequipmentacquiredforsafetyorenvironmentalreasons arerecognisedasassetsbecausetheyenabletheentitytoderivefutureeconomic benefitsfromitsotherproperty,plantandequipment.Forinstance,amanufacturer might be obliged by law to instal certain safety equipment and would be unable tooperateanyproductionmachineryatallifthissafetyequipmentwerenotinstalled.

† *Thesecriteriaareinaccordancewiththerecognitioncriteriaforassetslaiddowninthe2010ConceptualFrameworkandhavenotyetbeenamendedtoreflecttherevisedrecognitioncriteriaestablishedinthe2018ConceptualFramework(seeChapter2).*

Subsequentcosts

Routineservicing,repairandmaintenancecostsincurredaftertheinitialrecognitionofan item of property, plant and equipment as an asset are not capital expenditure. These costs usuallyconsistoflabourcostsandthecostofsmallparts(seeabove)andareaccountedfor as an expense in the period to which they relate.

However, it may be necessary to replace major parts of some items of property, plant and equipmentatregularintervals(e.g.theinteriorfittingsofanaircraft).IAS16requiresthat thecostofmajorreplacementsshouldbetreatedascapitalexpenditureandrecognisedas anadditiontothecarryingamountoftheassetconcerned.Thecarryingamountofthepart thathasbeenreplacedshouldsimultaneouslybederecognised(seebelow).

Asimilarprocedureappliestothecostofmajorinspections.Ifanitemofproperty,plant andequipmentwhichhasbeenrecognisedasanassetneedsregularmajorinspections,the

cost of each inspection is added to the carrying amount of the asset when it occurs. Any remainingcarryingamountofthecostofthepreviousinspectionisderecognised.

Derecognition

Anitemofproperty,plantandequipmentpreviouslyrecognisedasanassetshouldbederecognised(i.e.removedfromthestatementoffinancialposition)when:

(a) itisdisposedof,or

(b) nofutureeconomicbenefitsareexpectedfromitsuseorfromitsdisposal.

IAS16 states that anygainor loss arisingonthe derecognitionof anitemof property, plant and equipment should be "included in profit or loss" when the item is derecognised. Thismeansthatthegainorlossshouldbeincludedinthecalculationoftheentity'sprofitor loss for the period in which derecognition occurs.

The gain or loss arising on derecognition is equal to the difference between the disposal proceeds(ifany)andtheasset'scarryingamountatthetimeofderecognition.

EXAMPLE1

(a) On1September2019,acompanypaid£80,000toreplacethewalllliningofoneofitsfurnaces. Thefurnacehadbeenacquiredseveralyearspreviouslyanditscarryingamounton1September2019(beforeaccountingforthereplacementofthelining)was£320,000.Ofthisamount, £10,000relatedtotheoriginalwalllining.

(b) On1September2019,acompanypaid£250,000foramajorinspectionofoneofitsaircraft.Itisalegalrequirementthatsuchaninspectioniscarriedoutatleastonceeverythreeyears.The previousinspectiontookplaceinMarch2017atacostof £210,000.Thecarryingamountoftheaircrafton1September2019(beforeaccounting forthenewinspection)was£1,200,000.Ofthisamount,£70,000relatedtothepreviousinspection.

ExplainhoweachofthesetransactionsshouldbeaccountedforinaccordancewiththerequirementsofIAS16.

Solution

(a) Thecostofthereplacementwalllliningshouldberecognisedasanassetandthecarryingamountoftheoriginallliningshouldbederecognised.Thecarryingamountofthefurnacebecomes£390,000(£320,000+£80,000–£10,000).Thegainorlossarisingonthedisposaloftheoldliningisincludedinthecalculationofthecompany'sprofitorlossfortheaccountingperiodinwhichderecognitionoccurs.Thisgainorlossiscalculatedasthedifferencebetweenthe£10,000carryingamountoftheoldliningandanyamountwhichisreceivedondisposal.

(b) Thecostofthenewinspectionshouldberecognisedasanassetandthecarryingamountoftheprevious inspectionshouldbederecognised.Thecarryingamountoftheaircraftbecomes £1,380,000(£1,200,000+£250,000–£70,000).The£70,000carryingamountoftheprevious inspectioniswrittenoffasanexpense.

Initialmeasurementofproperty,plantandequipment

Oninitialrecognition,IAS16requiresthatitemsofproperty,plantandequipmentshould bemeasuredatcost.Thecostofanitemofproperty,plantandequipmentcomprises:

(a) thepurchasepriceoftheitem,includingimportdutiesandnon-refundablepurchase taxes, less trade discounts or rebates

(b) coststhataredirectlyattributabletobringingtheitemtothelocationandcondition necessaryfor it tobeoperatedas intended, including:

  (i) labourcostsarisingdirectlyfromtheconstructionoracquisitionoftheitem

  (ii) sitepreparationcosts

  (iii) initialdeliveryandhandlingcosts

  (iv) installation,assemblyandtestingcosts

  (v) professionalfees

(c) theestimatedcostsofdismantlingandremovingtheitemandrestoringthesiteon whichtheitemislocated,aslongastheobligationtomeetthesecostsisincurred when the item is acquired or used (see Chapter 12).

Ingeneral,administrativecostsandothergeneraloverheadexpensesarenotpartofthe cost of an item of property, plant and equipment.

EXAMPLE2

On31July2019,acompanywhichpreparesfinancialstatementsto31Marcheachyearboughtam achinefor£648,000.Thisamountwasmadeupasfollows:

	£
Manufacturer'slistprice	500,000
Less:Tradediscount	30,000
	470,000
Deliverycharge	4,300
Installationandtestingcharges	24,500
Smallspareparts	5,200
Servicingcontractfortheyearto31July2020	36,000
	540,000
Valueaddedtaxat20%	108,000
	648,000

ThecompanyisVAT-registeredandreclaimsVATchargedtoitbyitssuppliers.Calculatethecostofthemachineinaccordancewiththerequirementsof IAS16.

Solution

Themachine'scostis£498,800(£470,000+£4,300+£24,500).Asregardstheotheramountsliste dabove:

(a) Thesmallsparepartswillprobablybetreatedasinventoryandshouldbeaccountedforasane xpensewhenused.

(b) Eight-twelfthsofthecostoftheservicingcontract(£24,000)shouldbeaccountedforasanexpense intheyearto31March2020.Theremainingfour-twelfths(£12,000)isaprepaymentofanexpensefortheyearto31March2021.

(c) VATcanbeignoredsinceitisrefundedtothecompany.

Self-constructedassets

Thecostofaself-constructedasset(e.g.anofficebuildingconstructedbyabuildingfirm for its own occupation) is determined in the same way as the cost of any other item ofproperty, plant and equipment. If the entity sells similar assets to customers in the normal course of trade, the cost of the self-constructed asset will usually be the same as the cost of constructing an asset for sale. This should exclude any profit element and is calculated in accordance with IAS2 *Inventories*(see Chapter 10).

Theaccountingtreatmentofinterestandotherborrowingcostsincurredinconnection with the acquisition, construction or production of an asset is prescribed by international standardIAS23*BorrowingCosts*(seelaterinthischapter).

Subsequentmeasurementofproperty,plantandequipment

IAS16allowstwodifferentwaysofmeasuringproperty,plantandequipmentsubsequent toitsinitialrecognitionasanasset.Thesearethe"costmodel"andthe"revaluation model". Abrief description of each model is as follows:

(a) **Thecostmodel**. After initial recognition, items of property, plant and equipment are carriedatcostlessanyaccumulateddepreciationandlessanyaccumulatedimpair-mentlosses.Impairmentlossesaredealtwithin Chapter7ofthisbook.

(b) **Therevaluationmodel**. After initial recognition, items of property, plant and equip-mentarecarriedatarevaluedamount.Therevaluedamountofanitemconsistsofits fairvalueatthedateofrevaluation,lessanysubsequentaccumulateddepreciation andlessanysubsequentaccumulatedimpairmentlosses.Notethat:

  (i) IAS16definesfairvalueas"*thepricethatwouldbereceivedtosellanassetorpaidtot ransferaliabilityinanorderlytransactionbetweenmarketparticipantsatthemeas urementdate*". This definition is derived from international standard IFRS13 *FairValueMeasurement*, which sets out a framework for measuring thefair value of an asset or liability. A brief summary of IFRS13 is provided in the appendix at the end of this chapter.

(ii) The revaluation model cannot be applied to an item of property, plant andequipmentunlessitsfairvaluecanbemeasuredreliably.

(iii) Iftherevaluationmodelisappliedtoanitemofproperty,plantandequipment, then it must be applied to the entire class to which the item belongs. A class of property, plant and equipment is a grouping of items of a similar nature. Typical classesmightincludeland,buildings,machinery,motorvehiclesetc.

(iv) Revaluationsshouldbemadewithsufficientregularitytoensurethatthecarryingamountofanitemisnotmateriallydifferentfromitsfairvalueattheendof the reporting period. All of the items within a class should be revalued simultaneously.Thisavoidsselectiverevaluationsandalsoavoidsthereporting ofamountsthatareamixtureofvaluationsmadeondifferentdates.

Accountingforrevaluationgainsandlosses

Ifthecarryingamountofanitemofproperty,plantandequipmentis*increased*asaresult ofarevaluation,theincreasemustnormallybecreditedtoarevaluationreserveandshown as "other comprehensive income" in the entity's statement of comprehensive income. This accountingtreatmentensuresthatunrealisedrevaluationgains(i.e.gainsthathavenot been turned into cash) are excluded from profit and so are not available for payment as a dividend.Ifthecarryingamountofanitemofproperty,plantandequipmentis*decreased*as a result of a revaluation, the decrease must normally be recognised as an expense when calculating the entity's profit or loss. But note that:

(a) arevaluationincreasemustberecognisedasincomewhencalculatingtheentity's profitorlosstotheextentthatitreversesanyrevaluationdecreaseinrespectofthe sameitemthat was previouslyrecognisedas anexpense

(b) a revaluation decrease must be debited to the revaluation reserve and shown (as anegative figure) in other comprehensive income to the extent of any credit balance previouslyexistingintherevaluationreserveinrespectofthatsameitem.

Disposalofarevalueditemofproperty,plantandequipment

Whenanitemofproperty,plantandequipmentisdisposedof,anyrevaluationgainwhich is included in the revaluation reserve in respect of that item may be transferred to retained earnings.Thistransfertakesaccountofthefactthatapreviouslyunrealisedgainhasnow beenrealised. Thetransferisrecordedinthestatementofchangesinequityanddoesnot affect the statement of comprehensive income.

Note that a revaluation gain is an example of an item of other comprehensive income thatwillnotbereclassifiedtoprofitorlossinasubsequentperiod(seeChapter3).Thefact that the transfer described above does not occur in the statement of comprehensive income means that the gain is excluded from profit both initially (when the asset is revalued) and subsequently (when it is disposed of).

EXAMPLE3

(a) CompanyXpreparesfinancialstatementsto31Mayeachyear.On31May2019,thecompany acquiredlandfor£400,000.Thislandwasrevaluedat£450,000on31May2020andat£375,0 00on31May2021.

(b) CompanyYpreparesfinancialstatementsto30Juneeachyear.On30June2019,thecompan yacquiredlandfor£600,000.Thislandwasrevaluedat£540,000on30June2020andat£620, 000on30June2021.

Assumingthatbothcompaniesusetherevaluationmodel,explainhoweachrevaluationshouldbe dealtwithinthefinancialstatements.Ignoredepreciation.

Solution

(a) The£50,000revaluationincreaseon31May2020shouldbecreditedtoarevaluationreserve andshownasothercomprehensiveincomeinthecompany'sstatementofcomprehensivein come.

£50,000ofthe£75,000decreaseon31May2021shouldbedebitedtorevaluationreserveand shown(asanegativefigure)inothercomprehensiveincomeinthestate-mentofcomprehensiveincome.Theremaining£25,000shouldberecognisedasanexpens ewhencalculatingthecompany'sprofitorlossfortheyear.

(b) The£60,000revaluationdecreaseon30June2020shouldberecognisedasanexpensewhe ncalculatingthecompany'sprofitorlossfortheyear.

£60,000ofthe£80,000increaseon30June2021shouldberecognisedasincomewhencalcu latingthecompany'sprofitorlossfortheyear.Theremaining£20,000shouldbecreditedtoar evaluationreserveandshownasothercomprehensiveincomeinthestatementofcomprehe nsiveincome.

Depreciation

IAS16definesdepreciationas"*thesystematicallocationofthedepreciableamountofanass etoveritsusefullife*". This definition makes it clear that the purpose of depreciation is simplytoallocateanexpensebetweenaccountingperiods.Thedepreciationprocessmakes noattempttoshowassetsattheircurrentvalues.Nordoesitguaranteethattherewillbe funds available to replace those assets when they come to the end of their useful lives. Depreciationchargesreduceprofitsbuthavenodirecteffectonanentity'scashresources anddonotensurethatcashis"savedup"tobuyreplacementassets.

IAS16 also defines a number of key terms which are used in the section of the standardwhich deals with depreciation. These are as follows:

(a) Depreciableamountis"*thecostofanasset,orotheramountsubstitutedforcost,lessitsr esidualvalue*".

(b) The residual value of an asset is "*theestimatedamountthatanentitywouldcurrentlyobtainfromdisposaloftheasset,afterdeductingtheestimatedcostsofdisposal,iftheassetwerealreadyoftheageandintheconditionexpectedattheendofitsusefullife*".

(c) Useful life is "*theperiodoverwhichanassetisexpectedtobeavailableforusebyanentity...orthenumberofproductionorsimilarunitsexpectedtobeobtainedfromtheassetbyanentity*".

Thedefinitionofdepreciableamountmakesitclearthatdepreciationdoesnotceaseifan asset is revalued. All that happens is that a valuation is substituted for the asset's carrying amount,resultinginarevaluationgainorloss.Depreciableamountisnowequaltothe amountofthevaluationlesstheasset'sresidualvalue.Subsequentdepreciationcharges willbebaseduponthisreviseddepreciableamountandwillcontinuefortheremainderof the asset's useful life.

If an item of property, plant and equipment is revalued upwards and a revaluation gain in relation to that item is credited to revaluation reserve, subsequent depreciation charges will exceeddepreciationbasedontheitem'soriginalcost.Inthesecircumstances,theamount ofexcessdepreciationineachaccountingperiodmaybetransferredfromrevaluation reservetoretainedearnings.Thistransfertakesplaceinthestatementofchangesinequity anddoesnotaffectthestatementofcomprehensiveincome.

IAS16requirementswithregardtodepreciation

IAS16 establishes a number of general requirements with regard to the depreciation ofproperty, plant and equipment and then deals with depreciation methods. The main general requirements are as follows:

(a) Each part of an item of property, plant and equipment with a cost that is significant in relation to the item's total cost should be depreciated separately. However, parts of anitemmaybegroupedfordepreciationpurposesiftheyhavethesameuseful lifeandif the same depreciation method is applicable to each part. An example of the need to depreciate the parts of an item separately arises in the case of an aircraft, where the airframeandtheenginesmayhaveverydifferentusefullives.

(b) Thedepreciationchargeforanaccountingperiodshouldnormallyberecognisedas an expense when calculating profit or loss. However, if an item of property, plant and equipment is used to produce other assets, then the depreciation of that item should be included in the cost of those other assets. For instance, the depreciation of factory machinesmaybeincludedinthecostofinventories(seeChapter10).

(c) Theresidualvalueandusefullifeofproperty,plantandequipmentshouldbere- viewed at least at the end of each financial year. If expectations differ from previous estimates, the revised estimates should be accounted for prospectively, as

required by IAS8(seeChapter4).Theasset'sremainingdepreciableamountshouldbeamended to reflect any change in residual value and then this amount should be allocated as depreciationovertheremainderoftheasset'sexpectedusefullife.

(d) Anumber offactors shouldbetakenintoaccount whenjudgingtheuseful lifeofan asset.Theseincludeexpectedusageoftheasset,expectedphysicalwearandtearand thelikelihoodoftechnicalorcommercialobsolescence.Usefullifeisdefinedinterms of the usefulness of the asset to the entity concerned and this may be shorter than the asset's full economic life.

(e) Iftheresidualvalueofanassetisgreaterthanorequaltoitscarryingamount,then theasset'sdepreciableamountiszero.Thismeansthatdepreciationchargeswillalso be zerountil suchtime as the asset's residual value becomes less thanits carrying amount. This may or may not happen.

(f) Depreciationshouldbeginwhenanassetisavailableforuseandthencontinueuntil the asset is derecognised or classified as held for sale (see Chapter 8). Depreciationshouldnotceasesimplybecauseanassethasbecomeidle.However,som emethods of depreciation (see below) are based on an asset's usage and would give a zero depreciationchargewhilst theasset is not beingused.

(g) Land and buildings should be dealt with separately from one another for depreciation purposes.Inmostcases,landhasanunlimitedusefullifeandisnotdepreciatedfor that reason. But an exception arises in the case of quarries, mines etc. which generally have finite useful lives and so should be depreciated.

Depreciationmethods

IAS16 states that a variety of depreciation methods may be used to allocate the depreciable amountofanitemofproperty,plantandequipmentoveritsusefullife.Theseinclude(but arenot limitedto) thefollowingwell-knownmethods:

(a) **Straight-linemethod**. The asset's depreciable amount is spread evenly over its usefullife,sogivingaconstantdepreciationchargeineachaccountingperiod.

(b) **Diminishingbalance(orreducingbalance)method**. The depreciation charge for an accountingperiodiscalculatedbyapplyingaconstantpercentagetothecarrying amount of the asset brought forward from the previous period. This method gives a decreasingdepreciationchargeineachsuccessive period.

(c) **Unitsofproductionmethod**. This method is typically applied to machines used in a factory.Theusefullifeoftheassetismeasuredinunitsofproductionratherthan years and the depreciation charge for an accounting period is calculated in accordance withthenumberofunitsofproductionachievedinthatperiod.

Thisisverysimilartothemachinehoursmethod,whereTheusefullifeofamachine is measured in working hours and the depreciation charge for an accounting period is calculatedinaccordancewiththenumberofhoursforwhichthemachinehasbeen used during the period.

In principle, the chosen method should be the one which most closely matches the usagepatternoftheassetconcerned.ThisiswhatIAS16requires.

The depreciation method applied to an asset should be reviewed at least at the end of each financialyearandchangediftherehasbeenachangeinusagepattern.Suchachange should be accounted for as a change in an accounting estimate in accordance with the
requirementsofIAS8(seeChapter4).Thisstandardrequiresthenewdepreciationmethod tobeappliedprospectivelyovertheremainderoftheasset'susefullife.

EXAMPLE4

On1January2019,acompanywhichpreparesfinancialstatementsto31Decembereachyearbuy samachineatacostof£46,300.Themachine'susefullifeisestimatedatfouryearswitharesidualv alueof£6,000.Themachineisexpectedtoachieve50,000unitsofproductionoveritsusefullife,asf ollows:

	2019	*2020*	*2021*	*2022*
Numberofunits	10,000	20,000	15,000	5,000

Calculatedepreciationchargesforeachofthesefouryearsusing:

(a) thestraight-linemethod

(b) thediminishingbalancemethod(atarateof40%)

(c) theunitsofproductionmethod.

Solution

(a) Themachine'sdepreciableamountis£40,300.Allocatingthisevenlyoverthefouryearsgives anannualdepreciationchargeof£10,075.

(b)

Year	*Carryingamount b/f*	*Depreciation at40%*	*Carryingamount c/f*
	£	£	£
2019	46,300	18,520	27,780
2020	27,780	11,112	16,668
2021	16,668	6,667	10,001
2022	10,001	4,001	6,000
		40,300	

(c) Depreciationperunitis80.6p(£40,300÷50,000).Depreciationchargesare:

Year	*Unitsof production*	*Depreciation at80.6p*
	£	£
2019	10,000	8,060
2020	20,000	16,120
2021	15,000	12,090
2022	5,000	4,030
		40,300

Disclosurerequirements

ThedisclosurerequirementsofIAS16areveryextensive.Themaindisclosuresrequired are as follows:

(a) foreachclassofproperty,plantandequipment:

  (i) themeasurementbasesused

  (ii) thedepreciationmethodsused

  (iii) theusefullivesordepreciationratesused

  (iv) thegrosscarryingamountandaccumulateddepreciationatthebeginningand end of the accounting period

  (v) a reconciliation of the carrying amount at the beginning and end of the period, showing additions, disposals, revaluation increases and decreases, depreciation, impairment losses and any other movements

(b) theamountofanyproperty,plantandequipmentpledgedassecurityforliabilities

(c) theamountofanycontractualcommitmentsfortheacquisitionofproperty,plantand equipment

(d) foritemsofproperty,plantandequipmentstatedatrevaluedamounts(inadditionto thedisclosuresrequiredbyIFRS13*FairValueMeasurement*):

  (i) thedateoftherevaluation

  (ii) whetherornotanindependentvaluerwasinvolved

  (iii) foreachrevaluedclassofproperty,plantandequipment,thecarryingamount thatwouldhavebeenrecognisedifthecostmodelhadbeenused.

IAS16alsoencourages(butdoesnotrequire)entitiestodiscloseadditionalinformation whichmayberelevanttotheneedsofusers.Thisadditionalinformationmightinclude:

(e) thecarryingamountoftemporarilyidleproperty,plantandequipment

(f) thegrosscarryingamountofanyfully-depreciatedproperty,plantandequipmentthat is still in use

(g) thefairvalueofproperty,plantandequipmenttowhichthecostmodelhasbeenapplied,if thisismateriallydifferentfromthecarryingamount.

Borrowingcosts

TheobjectiveofIAS23*BorrowingCosts*istoprescribetheaccountingtreatmentof interestandotherborrowingcosts,especiallythosewhichareincurredinconnectionwith theacquisitionofassetssuchasproperty,plantandequipment.

The "core principle" of IAS23 is that borrowing costs that are directly attributable to the acquisition,constructionorproductionofa"qualifyingasset"shouldbecapitalisedaspart of the cost of that asset. Other borrowing costs should be recognised as an expense. The standard provides the following definitions:

(a) Borrowingcostsare"*interestandothercoststhatanentityincursinconnectionwiththeborrowingoffunds*". Borrowing costs include:

  (i) costsaccountedforbythe"effectiveinterestmethod"(seeChapter11)suchas:
    – interestonbankoverdraftsandonshort-termandlong-termborrowings
    – discountsandpremiumsrelatedtoborrowings
    – transactioncostsincurredinconnectionwiththearrangementofborrowings
  (ii) interestarisinginrespectofleaseliabilities(seeChapter9).

(b) Aqualifyingassetis"*anassetthatnecessarilytakesasubstantialperiodoftimetogetreadyforitsintendeduseorsale*". Depending on the circumstances, any of the following may be qualifying assets:
  – inventories
  – manufacturingplantsandpowergenerationfacilities
  – intangibleassets
  – investmentproperties.

  Inventoriesproducedoverashortperiodoftimearenotqualifyingassets.Norare assetswhicharereadyfortheirintendeduseorsaleassoonastheyareacquired.

Borrowingcostseligibleforcapitalisation

Theborrowingcoststhataredirectlyattributabletotheacquisition,constructionor productionofaqualifyingassetarethoseborrowingcostswhichwouldhavebeenavoided iftheexpenditureontheassethadnotoccurred.Identifyingthesecostsisstraightforward iffundsareborrowedspecificallyforthispurpose.Inthesecircumstances,theborrowing costseligibleforcapitalisationaretheactualborrowingcostsincurredontheborrowed fundsduringthe "periodof capitalisation" (seebelow).

Ifaqualifyingassetisfundedoutofapoolofgeneralborrowings,theborrowingcosts thatmaybecapitalisedarecalculatedbyapplyinga"capitalisationrate"totheexpenditure on the asset. The capitalisation rate is the weighted average of the borrowing costs that are applicabletothegeneralborrowingsoutstandingduringtheperiodofcapitalisation.

Periodofcapitalisation

Thecapitalisationofborrowingcostsincurredinrelationtoaqualifyingassetshouldbegin as soonas*all*of thefollowingconditions aresatisfied:

(a) expenditureisbeingincurredontheasset,and

(b) borrowingcostsarebeingincurred,and

(c) activitiesareinprogressthatarenecessarytoprepare theassetforitsintendeduse.

Capitalisationofborrowingcostsceaseswhensubstantiallyalloftheactivitiesnecessary to prepare the asset for its intended use are complete.

Disclosurerequirements

Anentityisrequiredtodisclose:

(a) theamountofborrowingcostscapitalisedduringtheaccountingperiod

(b) thecapitalisationrateusedtocalculatetheamountofgeneralborrowingcoststhatare eligible for capitalisation.

EXAMPLE5

Acompanywhichpreparesfinancialstatementsto30Juneeachyearhasthefollowinggeneralborrowi ngsoutstandingthroughouttheyearto30June2020:

	£000
7.5%Bankloan	800
9%Bankloan	500
8.5%Loanstock	1,200
	2,500

On1October2019,thecompanybeganconstructionofaqualifyingassetandincurredexpenditure of£300,000.Afurther£240,000wasspenton1February2020.Bothoftheseamountswerefinance doutofgeneralborrowings.Constructionoftheassetwasstillunderwayat30June2020.

Calculatetheamountofborrowingcoststhatshouldbecapitalisedaspartofthecostofthequalif yingassetduringtheyearto30June2020.

Solution

Thetotalborrowingcostsincurredinrelationtogeneralborrowingsduringtheyearto30June2020 were(£800,000x7.5%)+(£500,000x9%)+(£1,200,000x8.5%)=£207,000.

Ontotalborrowingsof£2.5million,thisrepresentsaweightedaveragerateof8.28%.Theborrowin gcostswhichshouldbecapitalisedaretherefore(£300,000x8.28%x9/12)+(£240,000x8.28%x5/ 12)=£26,910.

Governmentgrants

ThemainobjectiveofinternationalstandardIAS20*AccountingforGovernmentGrantsandDisclosureofGovernmentAssistance*is to prescribe the accounting treatment of government grants. IAS20 defines government grants as "*assistancebygovernmentintheformoftransfersofresourcestoanentityinreturnforpastorfuturecompliancewithcertainconditionsrelatingtotheoperatingactivitiesoftheentity*".Government grantsare of two main types:

(a) **Grantsrelatedtoassets**.Thesearegovernmentgrantswhicharemadeoncondition thattheentityshouldpurchase,constructorotherwiseacquirelong-termassetssuch asproperty,plantandequipment.Thepurposeofsuchagrantistohelptheentityto pay for the asset or assets concerned.

(b) **Grantsrelatedtoincome**. These are government grants other than grants related to assets.Theusualpurposeofagrantrelatedtoincomeistohelptheentitytopaysome of its operating expenses.

The first requirement of IAS20 is that government grants should not be recognised in the financial statements until there is reasonable assurance that the entity will comply with the relevant conditions and the grant will in fact be received. Once this assurance exists, government grants should be "*recognisedinprofitorlossonasystematicbasisovertheperiodsinwhichtheentityrecognisesasexpensestherelatedcostsforwhichthegrantsareintendedtocompensate*".

Thismeansthatagrantfortheacquisitionofanassetshouldberecognisedasincome whencalculatingtheentity'sprofitorlossfortheaccountingperiodsinwhichdepreciation is charged on that asset. In each period, the proportion of the grant which is recognised as income should be the same as the proportion of the asset's depreciable amount which ischargedasdepreciationinthatperiod.IAS20permitstwowaysofachievingthiseffect:

(a) The grant may be credited to a deferred income account and then systematically trans- ferredtothestatementofcomprehensiveincomeovertheusefullifeoftheasset.

(b) The grant may be deducted from the carrying amount of the asset. This will result in reduced depreciation charges over the asset's useful life.

The two methods are equivalent but give a different presentation in the statement of comprehensiveincomeandinthestatementoffinancialposition.

EXAMPLE6

On1April2019,acompanywhichpreparesfinancialstatementsto31Marchacquiresanitemofproperty,plantandequipmentandreceivesagovernmentgrantof40%towardstheitem'scost.Theitemcosts£250,000andhasausefullifeoffouryears.Itsresidualvalueis£60,000.

(a) Calculatetheamountofthegrantthatshouldberecognisedasincomeforeachofthefouryea rsto31March2023iftheassetisdepreciated:

(i) onthestraight-linebasis

(ii) onthediminishingbalancebasis(atarateof30%).

(b) Assumingthatthestraight-linebasisisused,explainhowthegrantwillbedealtwithinthefinancialstatementsif:

(i) thegrantistreatedasdeferredincome

(ii) thegrantisdeductedfromthecostoftheasset.

Solution

(a) Thegrantis£100,000andtheasset'sdepreciableamountis£190,000.Theamountofthegra ntthatshouldberecognisedasincomeeachyeariscalculatedasfollows:

(i) **Straight-linebasis**

	Depreciation charge	*Grantrecognised asincome*
	£	£
yearto31March2020	47,500	25,000
yearto31March2021	47,500	25,000
yearto31March2022	47,500	25,000
yearto31March2023	47,500	25,000
	190,000	100,000

Sincetheassetisdepreciatedonthestraight-linebasis,thegrantisrecognisedasincomeonthestraight-linebasis.

(ii) **Diminishingbalancebasis**

	Carrying amountb/f	*Depreciation charge*	*Grantrecognised asincome*
	£	£	£
yearto31March2020	250,000	75,000	39,474
yearto31March2021	175,000	52,500	27,632
yearto31March2022	122,500	36,750	19,342
yearto31March2023	85,750	25,750	13,552
		190,000	100,000

Eachyear'sdepreciationchargeis30%ofthecarryingamountbroughtforward,exceptt hatthechargefor2023hasbeenroundedtoensurethatthesumofthedepreciationchar gesisexactlyequaltothedepreciableamount.

In2020,thedepreciationchargeof£75,000isapproximately39.474%ofthedepreciabl eamountof£190,000,so39.474%ofthegrantisrecognisedasincomeinthatyear.Asim ilarcalculationisusedintheremainingthreeyearstocalculatetheamountofthegrantre cognisedasincome.

(b) (i)Thegrantof£100,000iscreditedtoadeferredincomeaccountandtransferredinequalinstalmentstothestatementofcomprehensiveincome.Thefiguresappearinginthestatementofcomprehensiveincomeandinthestatementoffinancialpositionareasfollows:

	2020	*2021*	*2022*	*2023*
	£	£	£	£
Statementofcomprehensive income:				
Depreciationcharge	47,500	47,500	47,500	47,500
Grantincome	25,000	25,000	25,000	25,000
Statementoffinancialposition:				
Assetcarryingamount	202,500	155,000	107,500	60,000
Deferredincomea/c	75,000	50,000	25,000	0

(ii)Inthiscase,thecostoftheasset(netofthegrant)is£150,000.Residualvalueis£60,000,sodepreciableamountis£90,000.Thisiswrittenoffasanexpenseonthestraight-linebasisoverthefouryears,asfollows:

	2020	*2021*	*2022*	*2023*
	£	£	£	£
Statementofcomprehensiveinc ome:				
Depreciationcharge**Statement offinancialposition**:	22,500	22,500	22,500	22,500
Assetcarryingamount	127,500	105,000	82,500	60,000

DisclosurerequirementsofIAS20

IAS20requiresthatentitiesshoulddisclose:

(a) theaccountingpolicyadoptedinrelationtogovernmentgrants,includingthemethod of presentation adopted in the financial statements

(b) thenatureandextentofgovernmentgrantsrecognisedinthefinancialstatements.

(c) anyunfulfilledconditionsattachingtogovernmentgrantsthathavebeenrecognised.

Investmentproperty

ThereisapresumptioninIAS16thatproperty,plantandequipmentisacquiredforusein anentity'soperationsandisgenerallyusedupor"consumed"overtheperiodofitsuseful life.Depreciationchargesaremadesoastomatchthecostofconsuminganassetagainst therevenueswhichithelpstogenerate.Butpropertywhichisacquiredasaninvestment ratherthanforuseisnotconsumedintheentity'soperationsanddoesnothaveauseful life.Thismeansthattheaccountingtreatmentrequiredby IAS16isgenerallyinappropriate for such property. The objective of IAS40 *InvestmentProperty* is to offer a more suitable accounting treatment for property held as an investment.

Definitionofinvestmentproperty

IAS40definesinvestmentpropertyas"*property(landorabuilding-orpartofabuilding -orboth)held...toearnrentalsorforcapitalappreciationorboth,ratherthanfor:*

(a) useintheproductionorsupplyofgoodsorservicesorforadministrativepurposes;or

(b) saleintheordinarycourseofbusiness".

ExamplesofinvestmentpropertygiveninIAS40includethefollowing:

(a) landheldforlong-termcapitalappreciation

(b) landheldforacurrentlyundeterminedfutureuse

(c) abuildingthatisleasedoutunderoneormoreoperatingleases(seeChapter9)

(d) abuildingthatisvacantbutisheldtobeleasedoutunderoperatingleases

(e) propertythatisbeingconstructedordevelopedforfutureuseasinvestmentproperty.

Thestandardalsoprovidesexamplesofitemsthatare*not*investmentpropertyandarenot within the scope of IAS40. These include:

(a) propertyintendedforsaleintheordinarycourseofbusiness;theapplicablestandard is IAS2 *Inventories*(see Chapter 10)

(b) owner-occupiedproperty(includingpropertyheldforfutureuseasowner-occupied property);theapplicablestandardisIAS16*Property,PlantandEquipment*

(c) propertyleasedtoanotherentityunderafinancelease;theapplicablestandardis IFRS16 *Leases*(see Chapter 9).

Measurementofinvestmentproperty

Investmentpropertyshouldbemeasuredinitiallyatcost.Thisincludestransactioncosts such as legal fees and property transfer taxes. As regards the measurement of investment propertysubsequenttoitsinitialrecognition,IAS40requiresanentitytochoosebetween twomodels.Whichevermodelisadoptedastheentity'saccountingpolicymustnormally beappliedtoalloftheentity'sinvestmentproperty.Thetwomodelsareasfollows.

(a) **Thefairvaluemodel**. Investment propertyis measuredat its fair value at theendof eachreportingperiod.Asstatedearlierinthischapter,IFRS13definesfairvalueas "*thepricethatwouldbereceivedtosellanassetorpaidtotransferaliabilityinanorderlytransactionbetweenmarketparticipantsatthemeasurementdate*". Againorlossarisingfromachangeinthefairvalueofinvestmentpropertymust berecognisedinthecalculationofprofitorlossfortheperiodinwhichitarises.This is different from the IAS16 treatment of revaluation gains and losses, since IAS16requiresrevaluationgainstobeexcludedfromprofit(seeearlierinthischapter).

(b) **Thecostmodel**. This is the cost model as defined in IAS16. Investment property is measured at cost, less any accumulated depreciation and less any accumulated impair- mentlosses.The*BasisforConclusions*forIAS40suggeststhatthismodelmightbe usedincountrieswithless-developedpropertymarketsandvaluationprofessions.

Anentitywhichgenerallyadoptsthefairvaluemodelinrelationtoinvestmentproperty mustnonethelessapplythecostmodeltoaspecific investmentpropertyifthefairvalueof that property cannot be determined reliably.

Disclosurerequirements

The general disclosure requirements of IAS40 (which are in addition to the disclosuresrequired by IFRS16 *Leases*) are as follows:

(a) whethertheentityhasadoptedthefairvaluemodelorthecostmodel

(b) theextenttowhichfairvalueshavebeendeterminedbyanindependentvaluerwho holdsarecognisedandrelevantprofessionalqualification

(c) the amounts of any rental income from investment property and related expenses thathavebeenrecognisedwhencalculatingtheentity'sprofitorlossfortheperiod.

If the fair value model is adopted, the entity must also provide a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing additions,disposals,gainsorlossesfromfairvalueadjustmentsandanyothermovements. Ifthecostmodelisadopted,theentitymustdisclosesimilarinformationtothatrequired byIAS16forproperty,plantandequipmentmeasuredusingthecostmodel.Theentity mustalsodisclosethefairvalueofitsinvestmentproperty(unlessthiscannotbe determinedreliably).Thismeansthatfairvalueswillnormallyhavetobedetermined whetherornottheentityhasactuallyadoptedthefairvaluemodel.

Summary

- Property,plantandequipmentconsistsoftangiblenon-currentassetsthatareheldfor use in the production or supply of goods or services, or for rental to others or for administrative purposes.
- Property, plant and equipment is recognised as an asset when it is probable that it will yield future economic benefits and its cost can be measured reliably. It should be derecognisedondisposalorwhennofutureeconomicbenefitsareexpectedfromit.
- Property,plantandequipmentismeasuredinitiallyatcost.Subsequently,anentity mayapplyeither thecost model or therevaluation model.
- Ingeneral,revaluationgainsarecreditedtoarevaluationreserveandrecognisedas other comprehensive income in the statement of comprehensive income. Revaluation lossesarerecognisedasanexpensewhencalculatingprofitorlossfortheperiod.
- The purpose of depreciation is to allocate the depreciable amount of an asset over its useful life. Residual values and lengths of useful lives should be reviewed at regular intervals.Adepreciationmethodshouldbechosenthatbestmatchestheusagepattern of the asset concerned.
- Borrowing costs that are directly attributable to the acquisition, construction orproductionofaqualifyingassetmustbecapitalisedaspartofthecostofthatasset. Otherborrowingcostsmustberecognisedasanexpense.
- Governmentgrantsrelatingtotheacquisitionofanassetarerecognisedasincome overtheusefullifeofthatasset.Thegrantmaybecreditedtoadeferredincome accountandthensystematicallytransferredtothestatementofcomprehensive income.Alternatively,thegrantmaybedeductedfromthecarryingamountofthe asset,resultinginreduceddepreciationchargesovertheasset'susefullife.
- Investmentpropertyconsistsoflandorbuildingsheldforthepurposeofearning rental income or for capital appreciation or both.
- Investment property is measured initially at cost. Subsequently, an entity may applyeither the fair value model or the cost model.

Appendix

IFRS13*FairValueMeasurement*

TheobjectivesofIFRS13aretodefine"fairvalue",tosetoutaframeworkformeasuring fairvalue,andtospecifytherequireddisclosuresaboutfairvaluemeasurements.

Definitionoffairvalue

IFRS13 defines fair value as "*thepricethatwouldbereceivedtosellanassetorpaidtotransferaliabilityinanorderlytransactionbetweenmarketparticipantsatthemeasurementdate*". This definition makes it clear that fair value is an "exit price" from the perspectiveoftheentitythatholdstheassetorhastheliability.

Measurementoffairvalue

IFRS13 states that the fair values of assets and liabilities should be determined by using appropriatevaluationtechniques.ThreetechniquesidentifiedinIFRS13are:

(a) the "market approach", which uses prices generated by market transactions involving identicalorcomparableassets(e.g.quotedpricesoflistedshares)

(b) the"costapproach",whichisbaseduponcurrentreplacementcosts

(c) the "income approach", which converts future amounts (e.g. cash flows) into a single current discounted amount (e.g. present value).

IFRS13alsoestablishesafairvaluehierarchywhichcategorisesintothreelevelstheinputs tothetechniquesusedtomeasurefairvalue.Theselevelsareasfollows:

(a) "Level1inputs"arequotedpricesinactivemarketsforidenticalassetsorliabilities.

(b) "Level2inputs"areinputs(otherthanLevel1inputs)thatareobservablefortheasset orliability,eitherdirectlyorindirectly.Examplesofsuchinputsincludequoted pricesforsimilarassetsorliabilitiesinactivemarketsandinputsotherthanquoted pricesthatareobservablefortheassetorliability,suchasinterestrates.

(c) "Level 3 inputs" are unobservable inputs for the asset or liability (i.e. inputs for which market data is not available). Such inputs use the best information available about the assumptionsthatmarketparticipantswouldmakewhenpricingtheassetorliability.

IFRS13 gives the highest priority to Level 1 inputs and gives the lowest priority to Level 3 inputs.Entitiesarerequiredtomaximisetheuseofobservableinputsandminimisetheuse ofunobservableinputswhenmakingfairvaluemeasurements.

Fairvaluedisclosures

Entitiesarerequiredtodiscloseinformationwhichhelpsuserstoassess:

(a) for assets and liabilities measured at fair value in the entity's financial statements, the valuationtechniquesandinputsusedtodeterminethosemeasurements

(b) for fair value measurements made using Level 3 inputs, the effect of those measure-

mentsontheentity'sprofitorlossorothercomprehensiveincomefortheperiod.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

5.1 (a) Definetheterm"property,plantandequipment".

(b) Whenshouldanitemofproperty,plantandequipmentberecognisedasanasseta nd when should it be derecognised?

(c) Which of the following costs should be included in the cost of an item of property, plant and equipment at initial recognition?

- thepurchasepriceoftheitem
- importdutiesincurredinrelationtotheitem
- deliverycharges
- smallsparepartsfortheitem
- thecostofamaintenancecontract
- non-refundablepurchasetaxesrelatingtothepurchasepriceoftheitem.

5.2 (a)Distinguishbetweenthecostmodelandtherevaluationmodelforthemeasurement of property, plant and equipment subsequent to its initial recognition.

(b) If the revaluation model is used, explain how revaluation gains and losses shouldbe accounted for.

(c) A company which uses the revaluation model and prepares financial statements to 31 December each year acquired an item of property on 1 February 2019 at a costof£5 million. On 31 December 2019, this property was revalued at £5.2 million. On 31 December 2020, it was revalued at £4.7 million.

Explain how these revaluations should be accounted for. Also explain what would have happened if the valuations at 31 December 2019 and 2020 had been reversed.

5.3 (a)Inrelationtoproperty,plantandequipment,definetheterms"depreciation", "depreciable amount", "useful life" and "residual value".

(b) On1July2019,acompanywhichpreparesfinancialstatementsto30Juneeach year acquires an itemof equipment at a cost of £59,500. The item's useful life is expected to be five years with a residual value of £10,000. Calculate depreciation charges for each of the five years of the item's useful life, using:

- thestraight-linemethod
- thediminishingbalancemethod(atarateof30%)

Howshouldthecompanychoosebetweenthesemethods?

5.4 (a) Definetheterm"borrowingcosts"andexplaintheaccountingtreatmentofsuch costs which is required by international standard IAS23.

(b) During the year to 31 December 2019, a company started work on the construction of a manufacturing plant and incurred expenditure as follows:

	£000
1April2019	1,500
1August2019	2,400
1December2019	1,800

Allofthesepaymentsweremadeoutofgeneralborrowings.Constructionworkw as still underway at 31 December 2019. The company had the following general borrowings outstanding throughout the year 2019:

	Amountofloa n	*Interestfortheyear*
	£000	*£000*
LoanA	10,000	1,150
LoanB	8,000	720
LoanC	5,000	430

Calculatetheamountofborrowingcoststhatshouldbecapitalisedinrelationtoth e construction of the manufacturing plant during the year.

5.5 (a)Definetheterm"investmentproperty"andexplainthetwomodelspermittedby international standard IAS40 for the measurement of investment property after its initial recognition.

(b)Howdo these two models differ fromthe two models permitted by IAS16 inrelation to the measurement of property, plant and equipment?

5.6 Elite Leisure is a private limited liability company that operates a single cruise ship. The ship was acquired on 1 October 2011. Details of the cost of the ship's components and their estimated useful lives are:

component	originalcost (£million)	depreciationbasis
ship'sfabric(hull,decksetc.)	300	25yearsstraight-line
cabinsandentertainmentareafittings	150	12yearsstraight-line
propulsionsystem	100	usefullifeof40,000hours

At30September2019nofurthercapitalexpenditurehadbeenincurredontheship.

Intheyearended30September2019theshiphadexperiencedahighlevelofengine trouble which had costthe company considerable lost revenue and compensation costs. The measured expired life of the propulsionsystemat 30 September 2019 was 30,000 hours.Duetotheunreliabilityoftheengines,adecisionwastaken inearlyOctober2019 toreplacethewholeofthepropulsionsystem atacostof£140million.Theexpectedlife ofthenewpropulsionsystemwas50,000hoursandintheyearended30September202 0 the ship had used its engines for 5,000 hours.

Atthesametimeasthepropulsionsystemreplacement,thecompanytookthe opportunity to do a limitedupgrade to the cabin and entertainment facilities at a cost of
£60 million and repaintthe ship's fabric ata cost of £20 million.Afterthe upgrade of the cabin and entertainment area fittings it was estimated that their remaininglife was five years (from the date of the upgrade). For the purpose of calculating depreciation, all the workontheshipcanbeassumedtohave beencompletedon1October2019.Allresidual values can be taken as nil.

Required:

CalculatethecarryingamountofEliteLeisure'scruiseshipat30September 2020andtherelatedamountswhichshouldberecognisedasexpensesfortheyearend ed30 September 2020. Your answer should explain the treatment of each item.

(ACCA)

***5.7** AccountingstandardIAS16*Property,PlantandEquipment*makesanumberof recognition,measurementanddisclosurerequirementswithregardtotangiblenon-currentassets.Theterm "non-currentasset"isdefined in accounting standard IAS1 *PresentationofFinancialStatements*.Theinformationgivenbelowrelatestotwo companies, both of which prepare accounts to 31 December.

AlphaLtd

Alpha Ltd bought a factory machine on 30 June 2019 and paid a total of £420,000. The supplier's invoice showed that this sum was made up of the following items:

	£
Manufacturer'slistprice	380,000
Less:Tradediscount	38,000
	342,000
Deliverycharge	6,800
Installationcosts	29,600
Maintenancechargeforyearto30June2020	27,000
Smallspareparts	14,600
	420,000

BetaLtd

On1January2009,BetaLtdboughtfreeholdpropertyfor£800,000.Thisfigurewas made up of land £300,000 and buildings £500,000. The land was non-depreciable but it was decided to depreciate the buildings on the straight-line basis, assuming a useful life of 40 years and a residual value of £nil.

On 1 January 2019, the land was revalued at £400,000 and the buildings were revaluedat £450,000. The company decided to incorporate these valuations into its accounts. The previous estimates of the buildings' useful life and residual value remain unchanged.

Required:

(a) Distinguish between current assets and non-current assets, giving TWO examplesof each type of asset.

(b) Explain,with appropriate examples,the differencebetween capitalexpenditure and revenue expenditure.

(c) Ifacompanyincorrectlyclassifiedanitemofcapitalexpenditureasrevenue expenditure, what effect would this have on the company's accounts in the year of the expenditure and in subsequent years?

(d) InaccordancewiththerulesofIAS16,calculatethecostfigureatwhichthe machineboughtbyAlphaLtdshouldinitiallybemeasured.Alsoexplainthecorrect accounting treatment of any component of the £420,000 expenditure which cannot be treated as part of the machine's cost.

(e) WritejournalentriesfortherevaluationofBetaLtd'sfreeholdpropertyon1 January 2019. Also calculate the amount of depreciation which should be chargedin relation to the buildings for the year to 31 December 2019.

(CIPFA)

*5.8 (a)Define the term "investment property". Explain why it is not generally appropriateto charge depreciation in relation to such a property.

(b) Givethreeexamplesofproperties(landorbuildings)thatshouldbeclassifiedas investment properties.

(c) Explain the "fair value model" which is permitted by IAS40 for the measurementof investment property.

(d) A company's investment property at 31 December 2019 is shown in the statementoffinancialpositionatitsfairvalueof£23m.Explaintheaccountingtre atment whichshouldbeappliedinthefinancialstatementsfortheyearto31December 2020iftheppropertyhasriseninvalueby10%duringtheyear.Alsoexplainthe accounting treatment if the property has fallen in value by 10% during the year.

Chapter6

Intangibleassets

Introduction

The main purpose of this chapter is to explain the requirements of international standardIAS38 *IntangibleAssets*. Basically, intangible assets are those without physical substance,suchaspatentsandtrademarks.IAS38appliestoallintangibleassetsexceptfort hose which fall within the scope of another international standard. The main exceptions and the applicable standards are:

(a) intangibleassetsheldforsaleintheordinarycourseoftrade(IAS2*Inventories*)
(b) deferredtaxassets(IAS12*IncomeTaxes*)
(c) leases(IFRS16*Leases*)
(d) assetsarisingfromemployeebenefits(IAS19*EmployeeBenefits*)
(e) financialassets(IAS32*FinancialInstruments:Presentation*)
(f) goodwillacquiredinabusinesscombination(IFRS3*BusinessCombinations*)
(g) non-currentintangibleassetsheldforsale(IFRS5*Non-currentAssetsHeldforSaleandDiscontinuedOperations*)
(h) customercontractassets(IFRS15*RevenuefromContractswithCustomers*).

TherequirementsofIFRS3withregardtogoodwillareexplainedlaterinthischapter.All oftheotherstandardsmentionedabovearedealtwithinlaterchaptersofthisbook.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- definetheterm"intangibleasset"inaccordancewithIAS38
- stateandexplaintherecognitioncriteriaforanintangibleasset
- determinethecostofanintangibleasset
- distinguishbetweenthecostmodelandtherevaluationmodelforthemeasurementof intangible assets after initial recognition

- explaintherequirementsofIAS38withregardtotheamortisationofintangibleassets
- listthemaindisclosurerequirementsofIAS38
- explaintherequirementsofIFRS3inrelationtogoodwill.

Definitionofanintangibleasset

IAS38definesanintangibleassetas"*anidentifiable,non-monetaryassetwithoutphysicalsubstance*".Themainfeaturesofthisdefinitionareasfollows:

(a) **Asset**. An item cannot be an intangible asset unless it is an asset first of all. IAS38definesanasset†as"*aresourcecontrolledbytheentityasaresultofpasteventsand fromwhichfutureeconomicbenefitsareexpectedtoflowtotheentity*". The standard makes the point that expenditure on intangible resources (e.g. research) does not necessarilymeanthatanintangibleassethasbeenacquired.Thiscanonlybethecase if the expenditure results in the acquisition of an item which qualifies as an asset. The criteria which may be difficult to satisfy are:

(i) **Futureeconomicbenefits**. There must be an expectation of future economic benefits,suchasrevenuefromthesaleofgoodsorservices,orcostsavings.

(ii) **Control**. The entity must have the power to obtain the future economic benefits flowingfromtheresource.Thispowerwillusually(butnotnecessarily)stem from legally enforceable rights. In the absence of such rights, it is much more difficulttodemonstratecontrolandthereforemuchmoredifficulttoprovethat an asset exists. For example:

– Technical knowledge which gives rise to future economic benefits may be protectedbyapatentorcopyright.Thiswoulddemonstratethattheentityhas thepowertoobtainthefuturebenefitsassociatedwiththatknowledge.

– Expenditure on staff training may result in improved staff skills which are expectedtogeneratefutureeconomicbenefits.However,theentityincurring thisexpendituremayhavelittleornocontroloverthestaff,whocoulddecide to move to a different employer and take their skills with them. It would be difficultinsuchacasetodemonstratethattheentityhasthepowertoobtain the future benefits associated with the training.

† *Thisdefinitioniscopiedfromthe2010ConceptualFrameworkandhasnotyetbeenrevisedtoreflectthemodifieddefinitionofanassetgiveninthe2018ConceptualFramework(seeChapter2).However,IAS38willpresumablyberevisedinduecourse.*

(b) **Withoutphysicalsubstance**.Intangibleassetsaredistinguishedfromproperty,plant and equipment by the fact that they are without physical substance. IAS38 givesexamplesofitemsthathavenophysicalsubstanceandwhichwouldthereforequalify as intangible assets if all of the other necessary conditions were met. These examples

includecomputersoftware,patentsandcopyrights,importquotas,franchisesetc.

(c) **Non-monetary**.Monetaryassetsaredefinedas"*moneyheldandassetstobereceivedinfixedordeterminableamountsofmoney*". Intangible assets must be non-monetary. Therefore, items such as cash, bank deposits and trade receivables are not intangible assets.Suchitemsareinfactfinancialassets(seeChapter11).

(d) **Identifiable**.IAS38statesthatanassetisidentifiablewhenitarisesfromcontractual or other legal rights or when it is "separable". An asset is separable if it "*iscapableofbeingseparatedordividedfromtheentityandsold,transferred,licensed,rentedorexchanged*".Thedefinitionofanintangibleassetrequirestheassettobeidentifiable so as to distinguish it from goodwill, which is outside the scope of IAS38. Goodwillarises from factors such as an entity's good reputation and, by definition, is notidentifiable (see later in this chapter).

Initialrecognitionandmeasurementofintangibleassets

Anitemshouldberecognisedasanintangibleassetinthefinancialstatementsifitmeets thedefinitiongivenaboveandsatisfiesthefollowingrecognition†criteria:

(a) itisprobablethattheexpectedfutureeconomicbenefitsthatareattributabletothe asset will flow to the entity, and

(b) thecostoftheassetcanbemeasuredreliably.

Theprobabilityofexpectedfutureeconomicbenefitsshouldbeassessedusingreasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist during the asset's useful life.

IAS38statesthatintangibleassetsshouldbemeasuredinitiallyattheircost.Thecostof anintangibleassetisthecostincurredtoacquireitorinternallygenerateit(seebelow).

† *Thesecriteriaareinaccordancewiththerecognitioncriteriaforassetslaiddowninthe2010ConceptualFrameworkandhavenotyetbeenamendedtoreflecttherevisedrecognitioncriteriaestablishedinthe2018ConceptualFramework(seeChapter2).*

Separatelyacquiredintangibleassets

Ifanintangibleassetisacquiredinaseparatetransaction,thefactthatapricehasbeen paidfortheassetisareflectionoftheexpectationthatfutureeconomicbenefitswillflow totheentity.Furthermore,theasset'scostcanusuallybemeasuredreliably.Thereforeboth of the recognition criteria listed above will usually be satisfied in the case of separatelyacquiredintangibleassets.Thecostofsuchanassetincludes:

(a) the purchase price of the asset, including import duties and non-refundable purchasetaxes, after deducting trade discounts and rebates, and

(b) any directly attributable costs of preparing the asset for its intended use, including employeecosts,professionalfeesandtestingcosts(butexcludingadvertisingcosts,

stafftrainingcostsandadministrativeorothergeneraloverheadcosts).

Onceanintangibleassetisinworkingcondition,anyfurthercostsincurredinrelationto that asset are not recognised as part of its cost. Therefore, costs incurred in using orredeployinganintangibleassetshouldberecognisedasanexpense.

Intangibleassetsacquiredaspartofabusinesscombination

Anintangibleassetmaybeacquiredinabusinesscombination.Internationalstandard IFRS3*BusinessCombinations*definesabusinesscombinationas"*atransactionorothereventinwhichanacquirerobtainscontrolofoneormorebusinesses*".

Ifanintangibleassetisacquiredinabusinesscombination,thecostofthatassetis specified by IAS38 (in accordance with IFRS3) to be the asset's fair value on the date of

acquisition.Fairvalueisdefinedbyinternationalstandard IFRS13as"*thepricethatwouldbereceivedtosellanassetorpaidtotransferaliabilityinanorderlytransactionbetweenmarketparticipantsatthemeasurementdate*"(seeChapter5).

The fact that a price has been paid for an intangible asset which is acquired in a business

combinationisacceptedasevidencethatfutureeconomicbenefitsareexpectedtoflowto the entity. Furthermore, sufficient information will always exist to measure the asset's fairvalue reliably. Therefore both of the required recognition criteria will be satisfied for an intangible asset acquired in a business combination.

Internallygeneratedintangibleassets

Internallygeneratedintangibleassetsarethosewhichhavebeendevelopedbytheentity itselfratherthanpurchasedfromanotherentity.Thefirstpointmadeby IAS38inrelation tointernallygeneratedassetsisthat"*internallygeneratedgoodwillshallnotberecognisedasanasset*".Goodwillwhichispurchasedwhenonebusinessentityacquiresanotheris dealt withbyIFRS3*BusinessCombinations*(seebelow).

IAS38thenstatesthatitmaybedifficulttoassesswhetheraninternallygenerated intangible asset qualifies for recognition because of:

(a) the problem of establishing whether or not there is an identifiable asset which will generate future economic benefits, and

(b) theproblemofdeterminingthecostoftheassetreliably.

Toresolvetheseproblems,IAS38requiresthattheinternalgenerationofanintangible asset should be classified into a "research phase" and a "development phase". The standardthenprovidesguidancewithregardtotheaccountingtreatmentofeachphase.

Theresearchphase

Research is defined as "*originalandplannedinvestigationundertakenwiththeprospectofgainingnewscientificortechnicalknowledgeandunderstanding*". Examples of research activities include:

(a) activitiesaimedatgainingnewknowledge

(b) thesearchforapplicationsofresearchfindings

(c) thesearchforalternativesformaterials,products,processesetc.

(d) the formulation, design, evaluation and selection of possible alternatives for new or improved materials, products, processes etc.

IAS38 takes the view that, in the research phase of an internal project, it is not possible to demonstrate that an asset exists which will probably generate future economic benefits. In consequence, entities are not allowed to recognise an intangible asset arising from research work.Allresearchexpendituremustbewrittenoffasanexpensewhenitisincurred.

Thedevelopmentphase

Developmentisdefinedas"*theapplicationofresearchfindingsorotherknowledgetoaplanor designfortheproductionofneworsubstantiallyimprovedmaterials,devices,products,proc esses,systemsorservicesbeforethestartofcommercialproductionoruse*". Examples of development activities include:

(a) thedesign,constructionandtestingofpre-productionprototypesandmodels

(b) thedesignoftools,jigs,mouldsanddiesinvolvingnewtechnology

(c) thedesign,constructionandoperationofapilotplant

(d) thedesign,constructionandtestingofachosenalternativeforneworimproved materials, products, processes etc.

Sincethedevelopmentphaseofaninternalprojectisfurtheradvancedthantheresearch phase, it may be possible to identify an intangible asset arising from this phase and to demonstratethatthisassetwillprobablygeneratefutureeconomicbenefits.

IAS38 requires that an intangible asset arising from the development phase of an internal project*must*berecognisedifallofthefollowingcanbedemonstrated:

(a) thetechnicalfeasibilityofcompletingtheassetsothatitwillbereadyforuseorsale

(b) theentity'sintentiontocompletetheassetanduseorsellit

(c) theentity'sabilitytouseorselltheasset

(d) thefactthattheassetwillprobablygeneratefutureeconomicbenefits

(e) theavailabilityofadequatetechnical,financialandotherresourcestocompletethe development work and use or sell the asset

(f) theentity'sabilitytomeasurereliablytheexpenditureattributabletotheassetduring its development.

If any of these cannot be demonstrated, the development expenditure concerned must bewritten off as an expense when it is incurred. Past development expenditure which was previously written off an expense (because one or more of the above matters could not be demonstratedatthattime)cannotbecapitalisedatalaterdate.

Expenditureoninternallygeneratedbrands,mastheads,publishingtitles,customerlists and similar items must always be written off.

Costofaninternallygeneratedintangibleasset

Thecostofaninternallygeneratedintangibleassetisthesumofthedirectlyattributable costs incurred in relation to the asset as from the date when it first meets the recognitioncriterialistedabove.Examplesofdirectlyattributablecostsinclude:

(a) costsofmaterialsandservicesusedorconsumedingeneratingtheasset
(b) labourcostsarisingfromthegenerationoftheasset
(c) feestoregisterlegalrights
(d) amortisationofpatentsandlicensesusedtogeneratetheasset(seebelow).

Selling, administrative and other general overhead costs are usually excluded, as are staff training costs.

EXAMPLE1

Duringtheyearto31March2020,acompanyincurredthefollowingexpenditurewithregardtothedevelopmentofanewproductionprocess:

	£000
1April2019to31October2019	230
1November2019to31March2020	410

Thecriteriafortherecognitionofaninternallygeneratedintangibleassetweresatisfiedasfrom1November2019.Explaintheaccountingtreatmentofthedevelopmentcosts.

Solution

The£230,000mustbewrittenoffasanexpenseinthestatementofcomprehensiveincomefortheyearto31March2020.The£410,000mustbecapitalisedandrecognisedasanintangibleassetinthestatementoffinancialposition.The£230,000cannotbereinstatedascapitalexpenditure.

Recognitionofanexpense

IAS38providesanumberofexamplesofexpenditureonintangibleresourcesthatmustbe recognisedasanexpensewhentheexpenditureisincurred.Theseexamplesinclude:

(a) start-upcosts
(b) trainingexpenditure
(c) expenditureonadvertisingandpromotionalactivities
(d) expenditureonrelocatingorreorganisingpartorallofanentity.

Suchexpenditurecannotbetreatedasgivingrisetotheacquisitionofanintangibleasset.

Subsequentmeasurementofintangibleassets

IAS38allowsentitiestochoosebetweenthe"costmodel"andthe"revaluationmodel"for themeasurementofintangibleassetssubsequenttoinitialrecognition.Thesetwomodels are very similar to those which are permitted by IAS16 in relation to property, plant and equipment(seeChapter5).Abriefdescriptionofeachmodelisasfollows:

(a) **Thecostmodel**. After initial recognition, intangible assets are carried at cost less any accumulatedamortisationandaccumulatedimpairmentlosses(seeChapter7).Note thattheallocationofthedepreciableamountofanintangibleassetoveritsusefullife isnormallyreferredtoas"amortisation"ratherthan"depreciation".

(b) **Therevaluationmodel**. After initial recognition, intangible assets are carried at a revaluedamount.Therevaluedamountofanintangibleassetconsistsofitsfairvalue at the date of revaluation, less any subsequent accumulated amortisation and less any subsequent accumulatedimpairment losses. Notethat:

   (i) Forthispurpose,thefairvalueofanintangibleassetmustalwaysbedetermined byreferencetoanactivemarketinthattypeofasset.Therevaluationmodel cannotbeappliedtoanintangibleassetifthereisnoactivemarket.However,it isunusualforsuchamarkettoexist,sincemanyintangibleassetsareunique.

   (ii) If the revaluation model is applied to an intangible asset, the same model should normallybeappliedtoalloftheotherassetsinitsclass.Aclassofintangible assets is a grouping of assets of a similar nature and use. However, if there is no active market for a specific intangible asset which belongs to a class of revalued intangibleassets,thisparticularassetshouldbemeasuredusingthecostmodel.

   (iii) Revaluationsshouldbemadewithsufficientregularitytoensurethatthecarryingamountofanintangibleassetdoesnotdiffermaterially from fair value. The itemswithinaclassofintangibleassetsshouldallberevaluedsimultaneously. Thisavoidsselectiverevaluationsandalsoavoidsthereportingofamountsthat are a mixture of valuations made on different dates.

Accountingforrevaluationgainsandlosses

If the carrying amount of an intangible asset is *increased*as a result of a revaluation, the increase must normally be credited to a revaluation reserve and recognised as "other comprehensive income" in the statement of comprehensive income. This treatment ensuresthatunrealisedrevaluationgainsareexcludedfromprofitandsoarenotavailablefor paymentasadividend.Ifthecarryingamountofanintangibleassetis*decreased*asa result of a revaluation, the decrease must normally be recognised as an expense when calculating the entity's profit or loss. But note that:

(a) arevaluationincreasemustberecognisedasincomewhencalculatingtheentity's

profitorlosstotheextentthatitreversesanyrevaluationdecreaseinrespectofthe sameasset that was previouslyrecognisedas anexpense

(b) a revaluation decrease must be debited to the revaluation reserve and shown (as anegative figure) in other comprehensive income to the extent of any credit balance previouslyexistingintherevaluationreserveinrespectofthatsameasset.

These rules are of course identical to the corresponding rules in IAS16 with regard to the revaluationofproperty,plantandequipment(seeChapter5).

Disposalofarevaluedintangibleasset

Whenanintangibleassetisdisposedof,anyrevaluationgainincludedintherevaluation reserveinrespectofthatassetmaybetransferredtoretainedearnings.Thisrecognisesthe factthatapreviouslyunrealisedgainhasnowbeenrealised.Thetransferisrecordedinthe statementofchangesinequityanddoesnotaffectthestatementofcomprehensiveincome. Notethatrevaluationgainsrecognisedinitiallyinothercomprehensiveincomecannotbe reclassifiedtoprofitorlossinasubsequentperiod(seeChapter3).

EXAMPLE2

(a) CompanyRpreparesfinancialstatementsto31Mayeachyear.On31May2019,thecompany acquiredanintangibleassetfor£50,000.Thisassetwasrevaluedat £60,000on31May2020andat£35,000on31May2021.

(b) CompanySpreparesfinancialstatementsto31Marcheachyear.On31March2019,thecom panyacquiredanintangibleassetfor£70,000.Theassetwasrevaluedat £55,000on31March2020andat£75,000on31March2021.

(c) CompanyTpreparesfinancialstatementsto30Aprileachyear.On30April2020,thecompan ydisposedofanintangibleassetthathadbeenacquiredsomeyearsagoandwhichhadbeenr evaluedsinceacquisition.Thecompany'srevaluationreserveat30April2020includeda£10 0,000revaluationgaininrelationtothisasset.

Assumingthatallthreecompaniesusetherevaluationmodel,explainhoweachoftheabovetrans actionsshouldbedealtwithinthefinancialstatements.Ignoreamortisation.

Solution

(a) The£10,000revaluationincreaseon31May2020shouldbecreditedtoarevaluationreserve andrecognisedasothercomprehensiveincome.

£10,000ofthe£25,000decreaseon31May2021shouldbedebitedtorevaluationreserveand recognised(asanegativefigure)inothercomprehensiveincome.Theremaining£15,000sh ouldberecognisedasanexpense.

(b) The£15,000decreaseon31March2020shouldberecognisedasanexpense.

£15,000ofthe£20,000increaseon31March2021shouldberecognisedasincome.Therem aining£5,000shouldbecreditedtoarevaluationreserveandrecognisedasothercomprehen siveincome.

(c) £100,000maybetransferredfromrevaluationreservetoretainedearnings.Thistransfersho uldbeshowninthestatementofchangesinequity.

Amortisationofintangibleassets

Theaccountingtreatmentofanintangibleassetisdependentuponthelengthofitsuseful life.Intangibleassetswithfiniteusefullivesareamortised(i.e.depreciated).Intangible assetswithindefiniteusefullivesarenot.Thereforeitisimportanttobeabletodetermine theusefullifeofanintangibleassetandIAS38listsanumberoffactorswhichshouldbe taken into account when doing this. These include:

(a) theexpectedusageoftheassetbytheentityconcerned

(b) publicinformationonestimatesofusefullivesofsimilarassetsusedinsimilarways

(c) technological,commercialorothertypesofobsolescence

(d) thestabilityoftheindustryinwhichtheassetisbeingused

(e) expectedactionsbycompetitors

(f) thelevelofmaintenanceexpenditurerequiredsoastoensurethattheassetgenerates the expected economic benefits (and whether the entity has the ability and intention to fund that level of expenditure)

(g) theperiodofcontrolovertheassetandanylegal(orsimilar)limitsonthelengthof time for which it can be used.

Ifanintangibleassetarisesfromcontractualorotherlegalrights,theusefullifeofthe assetcannotexceedtheperiodofthoserights,butmaybeshorterthanthisiftheentity intends to use the asset for a shorter period.

Anintangibleassetshouldberegardedashavinganindefiniteusefullifeonlyifthereis noforeseeablelimittotheperiodoverwhichtheassetisexpectedtogeneratenetcash inflows for the entity.

Intangibleassetswithfiniteusefullives

IAS38 requires that the depreciable amount of an intangible asset with a finite useful lifeshouldbeamortisedonasystematicbasisoveritsusefullife.Anintangibleasset's depreciable amount is defined as "*thecostofanasset,orotheramountsubstitutedforcost,lessitsresidualvalue*". Note the following points:

(a) Amortisationofanintangibleassetshouldbeginwhentheassetisavailableforuse andshouldthencontinueuntiltheassetisderecognisedorclassifiedasheldforsale (seeChapter8).Variousamortisationmethodsareavailable,includingthestraight-lineand diminishing balancemethods. Thechosen method should reflect theasset's usagepatternandshouldbeappliedconsistentlyunlessthereisachangeinthat pattern.Iftheasset'susagepatterncannotbeestimatedreliably,thestraight-line method should be used.

(b) Amortisationshouldnormallyberecognisedasanexpense.Butifanintangibleasset is used in the production of other assets (e.g. inventories), the amortisation of that intangibleassetshouldbeincludedinthecostofthoseassets.

(c) As with property, plant and equipment, amortisation does not stop simply because an intangible asset is revalued. In these circumstances, the asset's depreciable amount isresettotheamountofthevaluation(lessresidualvalue)andamortisationchargesfor therestoftheasset'susefullifearebaseduponthisreviseddepreciableamount.

(d) Ifanintangibleassetisrevaluedupwardsandarevaluationgaininrelationtothat asset is credited to revaluation reserve, subsequent amortisation charges will exceed amortisation based on the asset's original cost. In these circumstances, the amount of excess amortisation in each accounting period may be transferred from revaluationreserve to retained earnings. This transfer takes place in the statement of changes inequityanddoesnotaffectthestatementofcomprehensiveincome.

Residualvalue

The residual value of an intangible asset with a finite useful life is normally assumed to bezero. However, this will not be the case if:

(a) athirdpartyiscommittedtobuytheassetattheendofitsusefullife,or

(b) residual value can be determined by reference to an active market for the type of asset concernedandthatmarketwillprobablystillexistattheendoftheasset'susefullife.

The residual value of an intangible asset should be reviewed at least at the end of eachfinancial year. Any change in residual value is accounted for as a change in an accounting estimateinaccordancewiththerequirementsofIAS8(seeChapter4).

If the residual value of an intangible asset becomes greater than or equal to its carrying amount, the asset's depreciable amount is zero. Amortisation charges will then also be zerountilsuchtimeastheasset'sresidualvaluebecomeslessthanitscarryingamount.

Reviewofusefullifeandamortisationmethod

Theusefullifeofanintangibleassetandtheamortisationmethodusedforthatasset shouldbereviewedatleastattheendofeachfinancialyear.Iftheasset'sexpecteduseful lifehaschanged,theamortisationperiodshouldbechangedaccordingly.Iftheexpected usage pattern of the asset has changed, the amortisation method should be changedaccordingly. These changes should be accounted for as changes in accounting estimates in accordancewiththerequirements of IAS8(seeChapter 4).

Intangibleassetswithindefiniteusefullives

Intangible assets with indefinite useful lives are not amortised. However, the useful life ofsuchanassetshouldbereviewedineveryaccountingperiod.Ifcircumstancesnow indicatethattheasset'susefullifehasbecomefinite,itshouldbeamortisedoverthe remainderofthatlife.Thischangeisaccountedforasachangeinanaccountingestimate inaccordancewiththerequirementsofIAS8(seeChapter4).

International standard IAS36 *ImpairmentofAssets*explicitly states that intangible assetswithindefiniteusefullivesshouldbereviewedforimpairmenteveryyear(seeChapter7) .

Derecognition

Anitempreviouslyrecognisedasanintangibleassetshouldbederecognised(i.e.removed from the statement of financial position) when:

(a) itisdisposedof,or

(b) nofutureeconomicbenefitsareexpectedfromitsuseorfromitsdisposal.

IAS38statesthatanygainorlossarisingonthederecognitionofanintangibleassetshould be"recognisedinprofitorloss"whentheassetisderecognised.Thismeansthatthegain orlossshouldbeincludedinthecalculationoftheentity'sprofitorlossfortheperiodin which derecognition occurs.

The gain or loss arising on derecognition is equal to the difference between the disposal proceeds(ifany)andtheasset'scarryingamountatthetimeofderecognition.

Disclosurerequirements

ThemaindisclosuresrequiredbyIAS38areasfollows:

(a) foreachclassofintangibleasset,distinguishingbetweeninternallygenerated intangible assets and other intangible assets:
    (i) whether the useful lives are indefinite or finite and, if finite, the useful lives or amortisation rates used
    (ii) theamortisationmethodsused
    (iii) thegrosscarryingamountandaccumulatedamortisationatthebeginningand end of the accounting period
    (iv) thelineitem(s)inthestatementofcomprehensiveincomeinwhichamortisation of intangible assets is included
    (v) a reconciliation of the carrying amount at the beginning and end of the period, showing additions, disposals, revaluation increases and decreases, amortisation, impairment losses and any other movements

(b) thecarryingamountofeachintangibleassetwhichisassessedashavinganindefinite useful life and the reasons for that assessment

(c) thedescription,carryingamountandremainingamortisationperiodofanyindividual intangibleassetwhichismaterialtotheentity'sfinancialstatements

(d) thecarryingamountsofanyintangibleassetspledgedassecurityforliabilities

(e) theamountofanycontractualcommitmentsfortheacquisitionofintangibleassets

(f) forintangibleassetsstatedatrevaluedamounts:

(i) for each revalued class, the date of the revaluation, the carrying amount of the revaluedassetsandthecarryingamountthatwouldhavebeenrecognisedifthe cost model had been used

(ii) theamountoftherevaluationsurplusatthebeginningandendoftheperiod

(g) theamountofresearchanddevelopmentexpenditurerecognisedasanexpenseduring the accounting period.

IAS38alsoencourages(butdoesnotrequire)entitiestodiscloseadditionalinformation whichmayberelevanttotheneedsofusers.Thisadditionalinformationmightinclude:

(h) adescriptionofanyfully-amortisedintangibleassetthatisstillinuse

(i) abriefdescriptionofanysignificantintangibleassetswhichwerenotrecognisedas assetsbecausetheydidnotmeettheIAS38recognitioncriteria.

Goodwill

As stated earlier in this chapter, goodwill arises from factors such as an entity's goodreputation and strong customer relationships. Goodwill is a very significant asset to many entitiesbutisnot"identifiable"(seeabove)andsodoesnotqualifyasanintangibleasset forthepurposesofinternationalstandardIAS38.Inaddition,accountingforgoodwill raises the following difficulties:

(a) It is generally impossible to determine the cost (or the value) of internally generated goodwill. Because of this very high level of "measurement uncertainty", internally generated goodwill does not meet the recognition criteria set out in the *ConceptualFramework*(see Chapter 2).

However,thisdifficultydoesnotarisetothesameextentifgoodwillispurchased when an entity acquires an established business, since the cost of the goodwill can be measured reliably in these circumstances.

(b) Goodwillisaveryvulnerableassetandmayeasilybedamagedordestroyed.

BecauseofthefirstofthesedifficultiesIAS38doesnotallowinternallygeneratedgood-willtoberecognisedasanasset(seeabove).However,purchasedgoodwillisrecognised as an asset in accordance with IFRS3 *BusinessCombinations*. The requirements of thisstandardinsofarastheyrelatetogoodwillareexplainedbelow.

IFRS3*BusinessCombinations*

In general, entities are required to apply the requirements of IFRS3 when accounting for "businesscombinations".Asmentionedearlierinthischapter,abusinesscombination occurswhenanentityacquirescontrolofabusiness.Thismayhappenwhen:

(a) theacquirerbuysnetassetswhichtogetherformabusiness,or

(b) the acquirer buys the shares of another entity and so establishes a parent-subsidiary relationship (see Chapter 18).

Ineachcase,itisnecessarytomeasuretheamountofanygoodwillacquiredasaresultof the business combination. IFRS3 defines goodwill as "*anassetrepresentingthefutureeconomicbenefitsarisingfrom...assetsacquiredinabusinesscombinationthatarenotindividuallyidentifiedandseparatelyrecognised*" and requires that goodwill acquired in a business combination should be recognised as an asset. In case (a) above, this goodwill is recognisedasanassetinthefinancialstatementsoftheacquirer.Incase(b),thegoodwill isrecognisedintheacquirer'sconsolidatedfinancialstatements(seeChapter18).

IFRS3 also prescribes the way in which such goodwill should be measured at initial recognition. This measurement can involve a number of factors (see Chapter 18). But in a straightforwardcasetheamountofthegoodwilltoberecognisedistheexcessof:

(a) thepricepaidbytheacquirerinthebusinesscombination,over

(b) the acquirer's interest in the net fair value of the acquiree's identifiable assets andliabilities at the acquisition date.

Therefore the measurement of goodwill acquired in a business combination depends upon ascertaining the net fair value of the identifiable assets and liabilities acquired and then comparingthiswiththepricepaidbytheacquirer.IFRS3repeatstheIFRS13definitionof fairvalueas"*thepricethatwouldbereceivedtosellanassetorpaidtotransferaliabilityinanorderlytransactionbetweenmarketparticipantsatthemeasurementdate*".

Negativegoodwill

Iftheprice(or"consideration")paidbytheacquirerinabusinesscombinationis*less*than thenetfairvalueoftheidentifiableassetsandliabilitiesacquired,itwouldappearthat thereis"negativegoodwill"(thoughthistermisnotusedinIFRS3).Thissituationcould arise for two main reasons:

(a) Errorsmighthavebeenmadewhendeterminingthefairvalueoftheconsiderationorthefairvaluesoftheidentifiableassetsandliabilitiesacquired.

(b) Theacquirermayhavemadea"bargainpurchase".

Accordingly,thefirstrequirementofIFRS3ifnegativegoodwillarisesisthatthereshould beareassessmentofthefairvalueoftheconsiderationandthefairvaluesofthe identifiable assets and liabilities acquired. Any negative goodwill which remains after this

reassessmentshouldbetreatedasincomeandincludedintheacquirer'sprofitorloss.

Subsequentmeasurementofgoodwill

Afterinitialrecognition,goodwillacquiredinabusinesscombinationshouldnotbe amortised. Instead, IFRS3 requires that such goodwill should be measured at the amount initially recognised less any accumulated "impairment losses". In very general terms, an impairmentlossariseswhenanasset'svaluefallsbelowitscarryingamount.

IAS36*ImpairmentofAssets*prescribestheaccountingtreatmentofimpairmentlosses. This standard states that goodwill acquired in a business combination should be tested for impairment every year (see Chapter 7).

DisclosurerequirementsofIFRS3

ThemaindisclosurerequirementsofIFRS3inrelationtogoodwillareasfollows:

(a) areconciliationofthecarryingamountofgoodwillatthebeginningandendofthe accounting period, showing:
   (i) thegrossamountofgoodwillandanyaccumulatedimpairmentlossesatthebegin ning of the period
   (ii) additionalgoodwillrecognisedintheperiod
   (iii) goodwillnowderecognisedbecauseithasbeendisposedoforbecauseitis includedinadisposalgroupclassifiedasheldforsale(seeChapter8)
   (iv) impairmentlossesfortheperiod
   (v) anyothermovements
   (vi) thegrossamountofgoodwillandanyaccumulatedimpairmentlossesattheend of the period

(b) inthecaseofabargainpurchase:
   (i) theamountofanygainwhichhasbeenincludedintheentity'sprofitorlossfor theperiodandthelineiteminthestatementofcomprehensiveincomeinwhich this gain is included, and
   (ii) anexplanationofthereasonsthatcausedthisgaintooccur.

Summary

- IAS38 defines intangible assets as identifiable, non-monetary assets without physical substance. An asset is identifiable if it arises from legal rights or is capable of being separatedfromtheentityandsold,transferred,licensed,rentedorexchanged.
- GoodwillisnotidentifiableandisthereforeoutsidethescopeofIAS38.
- The cost of a separately acquired intangible asset includes its purchase price and any directlyattributablecostsofpreparingtheassetforuse.Generaladministrativeor otheroverheadcostsareexcluded.Thecostofanintangibleassetacquiredina businesscombinationisitsfairvalueonthedateofacquisition.
- All research expenditure is written off an expense when it is incurred. Development expenditure incurred in relation to an internally generated intangible asset must be recognisedas anasset if certainconditions aresatisfied.
- Entities may choose between the cost model and the revaluation model for measuring intangible assets after initial recognition. But the revaluation method cannot be used unless thereis anactivemarket for theassetsconcerned.
- Iftherevaluationmodelisused,itmustbeappliedtoentireclassesofintangible assets and regular revaluations must be made.
- Ingeneral,revaluationgainsarecreditedtoarevaluationreserveandrecognisedas other comprehensive income in the statement of comprehensive income. Revaluation lossesarerecognisedasanexpensewhencalculatingprofitorlossfortheperiod.
- Intangibleassetswithfiniteusefullivesshouldbesystematicallyamortisedover thoselives.Intangibleassetswithindefiniteusefullivesarenotamortisedbutare subject to annual impairment reviews.
- Internallygeneratedgoodwillcannotberecognisedasanasset.
- Goodwill acquired in a business combination is recognised as an asset and measured initiallyattheexcessofthepricepaidbytheacquireroverthenetfairvalueofthe assetsandliabilitiesacquired.Negativegoodwillistreatedasincomeandisincluded in the acquirer's profit or loss.
- Subsequent to its initial recognition, goodwill acquired in a business combination is measured at the amount at which it was initially recognised less any accumulated impairmentlosses.Goodwillmustbetestedforimpairmenteveryyear.
- Intangible assets are derecognised on disposal or if they are expected to yield no more economic benefits.
- IAS38 and IFRS3 make disclosure requirements with regard to intangible assets and goodwill respectively.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

6.1 (a) Definetheterm"intangibleasset"andexplainthemainfeaturesofthisdefinition.

(b) Explain how an intangible asset should be measured at its initial recognition if it is acquired in a separate transaction.

(c) Explain how an intangible asset should be measured at its initial recognition if it is acquired in a business combination.

6.2 (a)Distinguishbetweenresearchexpenditureanddevelopmentexpenditure.

(b) ExplaintheaccountingtreatmentrequiredbyIAS38inrelationtoeachofthese types of expenditure.

(c) Duringtheyearto31July2020,apharmaceuticalscompanyspentatotalof £830,000 on research and development. Of this amount, £370,000 was spent on an unsuccessful attempt to find a cure for the common cold. The remaining £460,000 wasspentonthedevelopmentofanewrangeofcosmeticproducts.Howshould this expenditure be accounted for in the company's financial statements?

6.3 Acompanyhaspurchasedthefollowingintangibleassetsinseparatetransactions:

(a) apatentwhichexpiresaftertenyears;thecompanyexpectstomakeuseofthis patent for six years and then dispose of it

(b) a copyright which expires after 40 years; the company intends to use this copyright for 30 years, after which it is expected to be of no further value

(c) a trademark relating to a product; this trademark has an unlimited legal life but the company expects to cease manufacture of the product within three years.

Determine the useful life of each of these assets. Assuming that the company does notusetherevaluationmodel,explainhoweachassetshouldbetreatedinthecompany's financial statements.

6.4 Distinguishbetweenthecost model andtherevaluationmodel for themeasurement ofintangible assets subsequent to their initial recognition.

6.5 (a) Define the term "goodwill" and distinguish between internally generated goodwill and goodwill acquired in a business combination.

(b) Identifythemainfeaturesofgoodwillwhichdistinguishitfromotherintangibleassets and which warrant a special accounting treatment.

(c) Whyisnotlogicaltoamortisepurchasedgoodwill?

6.6 On1January2020,ALtdboughtalloftheassetsandliabilitiesofBLtdforapriceof £500,000. B Ltd then went into liquidation. The statements of financial position of thetwo companies just beforethis purchase were as follows:

	ALtd		BLtd	
	£000	£000	£000	£000
Assets				
Non-currentassets				
Property,plantandequipment		4,320		460
Currentassets				
Inventories	1,210		220	
Tradereceivables	940		90	
Cashatbank	1,650	3,800	-	310
		8,120		770
Equity				
Ordinarysharecapital		1,000		200
Retainedearnings		3,650		390
		4,650		590
Liabilities				
Non-currentliabilities		2,500		-
Currentliabilities		970		180
		8,120		770

The fair values of the assets and liabilities of B Ltd as at 1 January 2020 were agreed to be as follows:

	£000
Property,plantandequipment	390
Inventories	160
Tradereceivables	80
Currentliabilities	180

Required:

(a) CalculatetheamountpaidbyALtdforthegoodwillofBLtd.

(b) Prepare a statement of financial positionfor A Ltd as it would be immediately after the purchase of the net assets of B Ltd, assuming that A Ltd paid for this purchase out of its bank account.

6.7 (a) Distinguish between *research* and *development* within the context of IAS38 *Intangible Assets*.

(b) State, with reasons, how the following expenditure would be dealt with in the financial statements of Prebnez plc to conform with IAS38:

(i) Money spent on a joint project with a university investigating the potential use of carbon nanotubes for the storage of digital data.

(ii) Expenditure on developing a new high speed hard disk which, in the opinion of Prebnez plc, has an assured and profitable market. Work has been suspended pending the development of a new glue suitable for the construction of the disk drives. *(CIPFA)*

***6.8** The following information relates to three companies that use the revaluation model in relation to intangible assets and prepare annual financial statements to 31 December:

(a) Company W acquired an intangible asset for £250,000 on 31 December 2018. This asset was revalued at £225,000 on 31 December 2019 and at £270,000 on 31 December 2020.

(b) Company X disposed of an intangible asset on 31 December 2020. This asset had been acquired some years previously at a cost of £100,000 and had a carrying amount of £160,000 on the date of disposal. Disposal proceeds were £195,000.

(c) Company Y acquired an intangible asset for £80,000 on 31 December 2018. This asset was revalued at £90,000 on 31 December 2019 and at £65,000 on 31 December 2020.

Describe the circumstances in which the revaluation model may be used (in accordance with the requirements of IAS38) and explain how each of the above matters should be dealt with in the financial statements of the company concerned.

***6.9** There are two international standards which deal with goodwill. IAS38 does not allow internally generated goodwill to be recognised as an asset. Goodwill acquired in a business combination is dealt with by IFRS3.

(a) Define the term "goodwill" and explain why internally generated goodwill may not be recognised as an asset.

(b) Explain how goodwill acquired in a business combination should be measured at initial recognition and in subsequent accounting periods.

(c) Explain the accounting treatment which should be applied if goodwill acquired in a business combination appears to have a negative value.

(d) List the main disclosures required by IFRS3 in relation to goodwill.

Chapter7

Impairmentofassets

Introduction

ThischapterexplainsthemainrequirementsofinternationalstandardIAS36*ImpairmentofAssets*.Theobjectiveofthisstandardistoensurethatassetsarenotcarriedinthe financial statements at more than their recoverable amounts. The recoverable amount of an assetistheamountthatcanbeobtainedbyeitherusingitorsellingitandanassetissaid tobe"impaired"ifitsrecoverableamountfallsbeneathitscarryingamount.IAS36applies to all assets other than those for which other standards prescribe the required accounting treatment.Themainexceptionsandtheapplicablestandardsare:

(a) inventories(IAS2*Inventories*)
(b) contractswithcustomers(IFRS15*RevenuefromContractswithCustomers*)
(c) deferredtaxassets(IAS12*IncomeTaxes*)
(d) assetsarisingfromemployeebenefits(IAS19*EmployeeBenefits*)
(e) mostfinancialassets(IFRS9*FinancialInstruments*)
(f) investmentpropertymeasuredatfairvalue(IAS40*InvestmentProperty*)
(g) non-currentassetsclassifiedasheldforsale(IFRS5*Non-currentAssetsHeldforSaleandDiscontinuedOperations*).

Allofthestandardsonthislistaredealtwithinotherchaptersofthisbook.

In principle, IAS36 applies to assets in general, not just non-current assets. However, the exclusionofinventoriesandmostfinancialassets(includingreceivablesandcash)means that,inpractice,thestandardismainlyapplicabletonon-currentassets.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- definetheterm"impairmentloss"
- listthemainfactorswhichmayindicatethatanassetisimpaired
- calculatetherecoverableamountofanassetandtheamountofanyimpairmentloss
- explaintheaccountingtreatmentofimpairmentlosses

- definetheterm"cash-generatingunit"andexplainhowsuchunitsareidentified
- allocateanimpairmentlossamongsttheassetsofacash-generatingunit
- accountforthereversalofanimpairmentloss
- listthemaindisclosurerequirementsofIAS36.

Indicationsofimpairment

IAS36definesanimpairmentlossas"*theamountbywhichthecarryingamountofanassetora cash-generatingunitexceedsitsrecoverableamount*".Acash-generatingunitis agroupofassetswhicharejudgedforimpairmentcollectively(seelaterinthischapter).

Thisdefinitionsuggeststhatitmightbenecessarytodeterminetherecoverableamount ofeveryasseteverytimethatfinancialstatementsareprepared,soastodiscoverwhich assetshavesufferedimpairmentlosses.However,thiswouldinvolveagreatdealofeffort and much of that effort would be wasted, since in normal circumstances it is unlikely thatmany of an entity's assets will actually be impaired. In general, therefore, IAS36 requires
entitiestodeterminetherecoverableamountofanassetonlyifthereissomeindication thattheassetmightbeimpaired.ExamplesofsuchindicationslistedbyIAS36include:

(a) **ExternalsourcesofinformationExternalsourcesofinformation**:

(i) thereareobservableindicationsthatanasset'svaluehasdeclinedduringthe period by significantly more than expected

(ii) significantandadversechangeshaveoccurred(orwilloccurinthenearfuture) in the technological, market, economic or legal environment in which the entity operates or inthemarket towhich anasset is dedicated

(iii) interestrateincreaseshaveoccurredwhicharelikelytoincreasethediscount rateusedincalculatinganasset'svalueinuse(seelaterinthischapter)andso causeamaterial decreaseintheasset's recoverableamount

(iv) thecarryingamountoftheentity'snetassetsexceedsitsmarketcapitalisation (i.e.themarketvalueofitsentiresharecapital,inthecaseofacompany).

(b) **InternalsourcesofinformationInternalsourcesofinformation**:

(i) thereisevidenceofobsolescenceofanassetorphysicaldamagetoanasset

(ii) significantandadversechangeshaveoccurred(orareexpectedtooccurinthe nearfuture)intheextenttowhichanassetisusedorthemannerinwhichitis used; such changes include:

- theassetbecomingidle
- planstodiscontinuetheoperationinwhichtheassetisused
- planstodisposeoftheassetearlierthanexpected
- reassessingtheasset'susefullifeasfiniteratherthanindefinite

(iii) thereisevidencethattheeconomicperformanceofanassetis(orwillbe)worse than expected.

Ifanyoftheseindicationsarepresent,theassetconcernedmustbetestedforimpairment bycomparingitsrecoverableamountwithitscarryingamount.IAS36stressesthatthe above list is not exhaustive and there could be other indications that an asset might beimpaired.Theseindicationswouldalsorequiretheentitytodeterminetherecoverable amount of the asset concerned.

IAS36 also points out that if there are indications that an asset might be impaired, these indicationsmayalsosuggestthattheentityshouldreviewtheasset'susefullifeand residualvalueandthedepreciationoramortisationmethodbeingused,inaccordancewith therequirementsofstandardsIAS16(seeChapter5)andIAS38(seeChapter6).

Intangibleassetsandgoodwill

Asstatedabove,therecoverableamountofmostassetsneednotbedeterminedunless thereissomeindicationthatimpairmentmighthaveoccurred.However,therearetwo typesofassetforwhichtherecoverableamountmustbedeterminedeveryyear,regardless ofwhetherornottherearеanyindicationsofimpairment.Theseare:

(a) intangible assets which have an indefinite useful life or which are not yet available foruse (see Chapter 6)

(b) goodwillacquiredinabusinesscombination(seeChapter6).

Recoverableamount

IAS36definestherecoverableamountofanasset(orcash-generatingunit)as"*thehigherofitsfairvaluelesscostsofdisposalanditsvalueinuse*".Thisde finitiondependsupon threefurther definitionsalsogiveninIAS36. Theseare:

(a) Fairvalue(asdefinedbyIFRS13)is"*thepricethatwouldbereceivedtosellanassetorpaid totransferaliabilityinanorderlytransactionbetweenmarketparticipantsatthemeasur ementdate*".

(b) Costsofdisposalare"*incrementalcostsdirectlyattributabletothedisposalofanasseto rcash-generatingunit,excludingfinancecostsandincometaxexpense*".

(c) Valueinuseis"*thepresentvalueofthefuturecashflowsexpectedtobederivedfromana ssetorcash-generatingunit*".

If an asset's fair value cannot be determined, its value in use may be used as its recoverable
amount.Conversely,ifthereisnoreasontosupposethatvalueinuseismateriallyhigher thanfairvaluelesscostsofdisposal(asmaybethecaseifanassetisheldfordisposal) thentheasset'sfairvaluelesscostsofdisposalmaybeusedasitsrecoverableamount.

Inanycase,itisnotalwaysnecessarytodeterminebothfairvaluelesscostsofdisposal andvalueinuseforanasset.Ifeitherofthesetwoamountscanbeshowntobegreater thantheasset'scarryingamount,itfollowsthattheassetcannotbeimpairedandsothereis no need to determine the other of the two amounts.

EXAMPLE1

Acompanyhassevenassets(labelledAtoG)forwhichthereareindicationsofpossibleimpairment.Thecarryingamount,fairvaluelesscostsofdisposalandvalueinuseforeachassetareasshownbelow.Determinetheamountofanyimpairmentlossarisinginrelationtoeachasset.

	Carrying amount	*Fairvalueless costsofdisposal*	*Valuein use*
	£	£	£
AssetA	10,000	12,000	18,000
AssetB	11,000	9,000	13,000
AssetC	7,000	11,500	n/d
AssetD	8,500	6,500	7,000
AssetE	12,750	n/d	16,800
AssetF	10,000	14,000	12,000
AssetG	21,000	15,000	10,000

Note:n/d=notdetermined

Solution

	Carrying amount	*Recoverable amount*	*Impairment loss*
	£	£	£
AssetA	10,000	18,000	0
AssetB	11,000	13,000	0
AssetC	7,000	11,500(atleast)	0
AssetD	8,500	7,000	1,500
AssetE	12,750	16,800(atleast)	0
AssetF	10,000	14,000	0
AssetG	21,000	15,000	6,000

Notes:

(i) Ineachcase,recoverableamountisthehigheroffairvaluelesscostsofdisposalandvalueinuse.ForassetsCandE,oneofthesefigureshasnotbeendetermined,sorecoverableamountcannotbecalculated.However,recoverableamountmustbeatleastequaltotheonefigurewhichisknown(andmaybehigher).

(ii) Formostoftheassets,carryingamountislessthanrecoverableamount,sothereisnoimpairmentloss.However,assetsDandGareimpaired.

(iii) AlthoughvalueinusehasnotbeendeterminedforassetCandfairvaluelesscostsofdisposalhasnotbeendeterminedforassetE,itisstillclearthattheseassetsarenotimpaired.Therefore,itisnotnecessarytoexpendfurtheraccountingeffortintryingtodeterminethemissingfigures.

Fairvaluelesscostsofdisposal

Anasset'sfairvalueshouldbedeterminedinaccordancewiththerequirementsofIFRS13 (seeChapter5).Ifthetypeofassetinquestionistradedinanactivemarketinvolving identicalassets,thenthe"marketapproach"canbeusedandthequotedpriceinthat market will provide a Level 1 input. Otherwise, the fair value of the asset will have to be determinedbyusingoneoftheothervaluationtechniqueslistedinIFRS13.Notethat:

(a) An asset's fair value normally differs from its value in use because value in use mayreflect factors that are specific to the entity concerned and not applicable to market participants in general.

(b) The costs of disposal which are deducted when calculating fair value less costs ofdisposal include items such as legal costs, stamp duty, costs of removing the asset and directcoststhatwouldbeincurredtobringtheassetintoaconditionsuitableforsale.

Valueinuse

As stated above, an asset's value in use is calculated by discounting† the future cash flows whichtheassetisexpectedtogenerate.Thesefuturecashflowsshouldinclude:

(a) projectionsoffuturecashinflowsfromtheuseoftheasset

(b) projectionsoffuturecashoutflowsthatwillbenecessarilyincurredsoastogenerate cashinflowsfromtheuseoftheasset(e.g.servicingandmaintenancecosts)

(c) net cash flows (if any) to be received or paid on disposal of the asset at the end of its useful life.

Futurecashflowsshouldbeestimatedfortheassetinitscurrentconditionandshouldnot takeintoaccountanycashflowsthatareexpectedtoarisefromimprovingorenhancing theasset'sperformance.Furthermore,estimatesoffuturecashflowsshould*not*include:

(a) cashinflowsoroutflowsfromfinancingactivities(e.g.interestpayable)

(b) taxreceiptsorpayments.

It is clear that the calculation of value in use will involve making estimates of future cashflows. IAS36 states that these estimates should be based on reasonable and supportable assumptions and that greater weight should be given to external evidence than to internal evidence.IAS36alsostatesthatcashflowprojectionsshouldbebasedonmanagement's most recent financial budgets or forecasts. Short-term budgets may be extrapolated into the futureusingasteadyordeclininggrowthrate(unlessanincreasingratecanbejustified).

Thediscountrateusedincalculatinganasset'svalueinuseshouldbeapre-taxinterest ratewhichreflectscurrentmarketassessmentsofthetimevalueofmoney.

† *Theconceptsofdiscountingandpresentvalueareexplainedintheappendixgivenattheendof Chapter2ofthisbook.*

EXAMPLE2

Acompanyestimatesthatanassetisexpectedtogeneratethefollowingcashflowsoveritsusefull ifeoffouryears:

	Inflows	*Outflows*
	£000	£000
Year1	75	6
Year2	100	7
Year3	90	7
Year4	60	6

Allcashflowswilloccurattheendoftheyearconcerned.Attheendofthefour-yearperiod,theassetisexpectedtobesoldfor£50,000.Assumingadiscountrateof12%andworking tothenearest£000,calculatetheasset'svalueinuse.

Solution

	Inflows	*Outflows*	*Netcash flow*	*Discount factor*	*Present value*
	£000	£000	£000		£000
Year1	75	6	69	0.893	62
Year2	100	7	93	0.797	74
Year3	90	7	83	0.712	59
Year4	110	6	104	0.636	66
Valueinuse					261

Notes:

(i) Thecashinflowforyear4includesthe£50,000disposalproceedsoftheasset.

(ii) Thediscountfactorforthefirstyearis1/1.12=0.893.Thediscountfactorforthesecondyear is $1/(1.12)^2$andsoforth(seeChapter2).

(iii) Theasset'svalueisuseis£261,000.

Recognitionandmeasurementofanimpairmentloss

Iftherecoverableamountofanassetislessthanitscarryingamount,IAS36requiresthat theasset'scarryingamountshouldbereducedtoitsrecoverableamount.Thisreductionis an impairment loss. In general, an impairment loss should be recognised as an expense. However,iftheassetiscarriedatarevaluedamount,theimpairmentlossisaccountedfor inthesamewayasarevaluationdecrease.Thismeansthat:

(a) theimpairmentlossisdebitedtotherevaluationreserveandshown(asanegative figure) in other comprehensive income to the extent of any credit balance previously existingintherevaluationreserveinrespectofthatsameasset

(b) anyexcessisthenrecognisedasanexpense.

Afteranimpairmentlosshasbeenrecognised,subsequentdepreciationoramortisation charges should allocate the asset's revised carrying amount (less residual value) over the remainder of its useful life on a systematic basis.

Cash-generatingunits

Ifthereis any indication that an asset might be impaired, the asset's recoverable amountshouldbedeterminedandcomparedwithitscarryingamount.Butaproblemarisesifi tis notpossibletodetermineanindividualasset'srecoverableamount.Thiswouldoccurif:

(a) theassetdoesnotgeneratecashinflowsthatarelargelyindependentofthosefrom other assets, sovalueinusecannot bedetermined, and

(b) fairvaluelesscostsofdisposalcannotbeusedastheasset'srecoverableamountsince itsvalueinusemightbemateriallymorethanitsfairvaluelesscostsofdisposal.

In these circumstances, IAS36 requires that impairment testing should be performed at thecash-generating unit (CGU) level. IAS36 defines a cash-generating unit as "*thesmallestidentifiablegroupofassetsthatgeneratescashinflowsthatarelargelyindependentofthecashinflowsfromotherassetsorgroupsofassets*". An entity's CGUs should be identified consistentlyfromperiodtoperiodunlessachangecanbejustified.

If the recoverable amount of an individual asset which might be impaired cannot be determined, the recoverable amount of the CGU to which the asset belongs should be determined instead and an impairment loss should be recognised if the CGU's recoverable amountislessthanitscarryingamount.ACGUshouldalsobetestedforimpairmentif thereisanyindicationthattheCGUasawholeisimpaired.

EXAMPLE3

Thisexampleisbaseduponone providedinIAS36.

Aminingcompanyownsaprivaterailwaytosupportitsminingactivities.Thisrailwaycouldbesold onlyforscrapvalueanddoesnotgeneratecashinflowsthatarelargelyindependentofthecashinfl owsfromtheotherassetsofthemine.Woulditbepossibletodeterminetherecoverableamountof therailway?

Solution

Therailway'svalueinusecannotbeestimatedandisprobablymateriallymorethanitsscrapvalue. Thereforetherecoverableamountoftherailwaycannotbedetermined.Ifthereisanyindicationofi mpairment,thecompanyshoulddeterminetherecoverableamountoftheCGUtowhichtherailwa ybelongs(i.e.themineasawhole).

RecoverableamountandcarryingamountofaCGU

TherecoverableamountofaCGUisthehigherofitsfairvaluelesscostsofdisposaland its value in use. The carrying amount of a CGU should be determined on a basis that is consistentwiththewayinwhichitsrecoverableamounthasbeendetermined.Thismeans that a CGU's carrying amount:

(a) includes the carrying amount of only those assets that can be attributed directly to the CGU (or can be allocated to it on a reasonable and consistent basis) and which will generatethefuturecashinflowsusedindeterminingtheCGU'svalueinuse

(b) excludes the carrying amount of the CGU's liabilities, unless the CGU's recoverable amountcannotbedeterminedwithouttakingtheseliabilitiesintoaccount.

Assets which are not within the scope of IAS36 (e.g. inventories) should be excluded when determiningaCGU'scarryingamountandrecoverableamount.

EXAMPLE4

Oneofacompany'scash-generatingunitsisbeingtestedforimpairment.ThecarryingamountoftheCGU'sassetsonthedateofthetestis£25million.Thecarryingamountofitsliabilitiesonthatdateis£8million.

IthasbeenestablishedthattheCGUcouldbesoldtoabuyerfor£15million,inwhichcasethebuyerwouldtakeoveralloftheCGU'sassetsandliabilities.Disposalcostswouldbeimmaterial.ThevalueinuseoftheCGUisestimatedtobe£24million.Thisfigureignoresfuturecashoutflowsrelatingtopaymentoftheexistingliabilities.

CalculatetheCGU'srecoverableamountandcarryingamount.Alsocalculatetheamountofanyimpairmentloss.

Solution

Normally,existingliabilitiesareignoredwhendeterminingthecarryingamountandvalueinuseofaCGU.However,thefigurewhichisgivenforfairvaluelesscostsofdisposaltakesintoaccounttheCGU'sliabilitiesaswellasitsassets.Therefore,toensurethatmeaningfulcomparisonsaremade,theseliabilitiesmustalsobetakenintoaccountwhendeterminingtheCGU'scarryingamountanditsvalueinuse.Thecalculationsareasfollows:

(i) Fairvaluelesscostsofdisposalisstatedtobe£15million.Valueinuse(subtractingtheexistingliabilities)is£16million.Thereforerecoverableamountis£16million.

(ii) Carryingamount(againsubtractingtheexistingliabilities)is£17million.Thisexceedsrecoverableamountby£1millionandsothereisanimpairmentlossof£1million.

Goodwill

As mentioned earlier in this chapter, goodwill acquired in a business combination must be tested for impairment every year, regardless of whether or not there are any indications of impairment. However, goodwill does not generate cash flows independently of other assetsandsomustbeallocatedbetweenCGUsforimpairmenttestingpurposes.Ifgoodwill cannot be allocated between individual CGUs, it is allocated between groups of CGUs towhichthegoodwillrelates.Impairmenttestingthenproceedsasfollows:

(a) AnindividualCGUtowhichgoodwillhasbeenallocatedshouldbetestedannually for impairment by comparing its carrying amount (including goodwill) with its recoverable amount.

(b) A group of CGUs to which goodwill has been allocated should be tested annually for impairmentbycomparingthecarryingamountofthegroup(includinggoodwill)with the group's recoverable amount.

(c) An individual CGU to which no goodwill has been allocated should be tested only ifthere are indications of impairment. This applies whether or not the CGU belongs to a groupofCGUstowhichgoodwillhasbeenallocated.Theimpairmenttestcompares theCGU'scarryingamount(excludinggoodwill)withitsrecoverableamount.

Corporateassets

IAS36definescorporateassetsas"*assetsotherthangoodwillthatcontributetothefutureca shflowsofboththecash-generatingunitunderreviewandothercash-generatingunits*". Corporate assets include items such as a headquarters building or research centre. Like goodwill,corporateassetsdonotgeneratecashinflowsindependentlyofotherassetsand so must be allocated between CGUs (or groups of CGUs) for impairment testing purposes.Thisallocationmustbedoneonareasonableandconsistentbasis.Ifitbecomesne cessary totestaCGU(orgroupofCGUs)forimpairment,thetestingprocedureisasfollows:

(a) AnindividualCGUtowhichaportionofcorporateassetshasbeenallocatedshould betestedforimpairmentbycomparingitscarryingamount(includingtheallocation of corporate assets) with its recoverable amount.

(b) A group of CGUs to which a portion of corporate assets has been allocated should be tested for impairment by comparing the carrying amount of the group (including the allocationofcorporateassets)withthegroup'srecoverableamount.

(c) AnindividualCGUtowhichnoportionofcorporateassetshasbeenallocatedshould betestedbycomparingtheCGU'scarryingamount(excludingcorporateassets)with its recoverable amount, in the usual way.

AllocationofanimpairmentlossforaCGU

An impairment loss must be recognised if the recoverable amount of a CGU (or group of CGUs) is less than its carrying amount. This loss is recognised by reducing the carryingamountoftheCGU'sassets.Animpairmentlossisallocatedbetweenassetsasfollows:

(a) first,toanygoodwillwhichhasbeenallocatedtotheCGU

(b) next,totheotherassetsoftheCGU,inproportiontotheircarryingamounts.

Theseallocationsarethentreatedasiftheywereimpairmentlossesonindividualassets (seeearlierinthischapter).Whenallocatinganimpairmentlossbetweentheassetsofa CGU,thecarryingamountofanassetshouldnotbereducedbelowthehighestof:

(a) theasset'sfairvaluelesscostsofdisposal(ifmeasurable)

(b) theasset'svalueinuse(ifthiscanbedetermined)

(c) zero.

Ifanyoftheserestrictionsapply,theamountoftheimpairmentlossthatwouldotherwise have been allocated to the asset concerned should be allocated pro rata between the otherassets of the CGU.

EXAMPLE5

Thecarryingamountsoftheassetsofacashgeneratingunitareasfollows:

	£000
Goodwillacquiredinabusinesscombination	200
Developmentcosts	300
Property,plantandequipment	600
	1,100

TherecoverableamountofthisCGUisonly£780,000.Thefairvaluelesscostsofdisposaloftheproperty,plantandequipmentis£500,000.

(a) CalculatetheamountoftheimpairmentlossandshowhowthisshouldbeallocatedbetweentheassetsoftheCGU.

(b) Explainhowtheallocationoftheimpairmentlosswouldchangeifthefairvaluelesscostsofdisposaloftheproperty,plantandequipmentwere£550,000.

Solution

(a)Theimpairmentlossis£320,000(£1,100,000–£780,000).Ofthisloss,£200,000isusedtoeliminatethegoodwill.Theremaining£120,000issplitbetweentheothertwoassetsintheratio300:600.Developmentcostsarereducedby£40,000andproperty,plantandequipmentisreducedby£80,000.

Thecarryingamountsoftheassetsin theCGUarenow£260,000fordevelopmentcostsand£520,000forproperty,plantandequipment(atotalof£780,000).

(b)Thecarryingamountoftheproperty,plantandequipmentcannotbereducedtolessthan£550,000.So£30,000oftheimpairmentlossthatwouldhavebeenallocatedtothisassetmustbeallocatedinsteadtothedevelopmentcosts(theonlyremainingassetoftheCGU).

Thecarryingamountsoftheassetsin theCGUarenow£230,000fordevelopmentcostsand£550,000forproperty,plantandequipment(atotalof£780,000).

Reversalofimpairmentlosses

Ifimpairmentlosseshavebeenrecognisedinpreviousaccountingperiods,IAS36requires theentitytoassess(attheendofeachreportingperiod)whethertherearean yindications that these impairment losses have now decreased or no longer exist. Examples of such indications listed by IAS36 include:

(a) **Externalsourcesofinformation**:

(i) there are observable indications that an asset's value has increased significantly during the period

(ii) significantandfavourablechangeshaveoccurred(orwilloccurinthenear future) in the technological, market, economic or legal environment in which the entityoperatesorinthemarkettowhichanasset isdedicated

(iii) interest rate decreases have occurred which are likely to reduce the discount rateused in calculating an asset's value in use and so cause a material increase in the asset's recoverable amount.

(b) **Internalsourcesofinformation**:

(i) significantandfavourablechangeshaveoccurred(orareexpectedtooccurin thenearfuture)intheextenttowhichorthemannerinwhichanassetisused

(ii) there is evidence that the economic performance of an asset is (or will be) betterthan expected.

Ifanyoftheseindicationsexist,therecoverableamountoftheassetorCGUconcerned must be determined again, with a view to reversing all or part of the previously recognised impairment loss. However, there is one exception to this general rule. IAS36 states that

"*animpairmentlossrecognisedforgoodwillshallnotbereversedinasubsequentperiod*".

Thefollowingpointsshouldbenotedwithregardtothereversalofimpairmentlosses:

(a) A previously recognised impairment loss cannot be reversed unless there has been a changeintheestimatesusedwhentheimpairmentlosswasrecognised.Ifthisisthe caseandtherecoverableamountoftheassetorCGUconcernedisnowgreaterthan itscarryingamount,thenthecarryingamountofthatassetorCGUshouldgenerally beincreasedtoitsrecoverableamount.However,thisissubjectto(c)below.

(b) ThereversalofanimpairmentlossforaCGUshouldbeallocatedbetweentheassets oftheCGU(otherthangoodwill)proratatothecarryingamountsofthoseassets.

(c) Whenanimpairmentlossinrelationtoanassetisreversed,theasset'sincreased carryingamountshouldnotexceedthecarryingamountthatwouldhaveappliedif there had been no impairment loss in the first place. Any further increase beyond that amountisarevaluationandshouldbedealtwithinaccordancewiththerelevant standard(IAS16*Property,PlantandEquipment*orIAS38*IntangibleAssets*).

(d) Thereversalofapreviouslyrecognisedimpairmentlossisusuallyrecognisedas income.Butiftheassetiscarriedatarevaluedamount,thereversalisaccountedfor in the same way as a revaluation gain.

(e) Afterthereversalofanimpairmentloss,subsequentdepreciationoramortisation chargesshouldallocatetheasset'srevisedcarryingamount(lessresidualvalue)over theremainderofitsusefullife.Itmayalsobenecessarytoreviewtheasset'suseful lifeandresidualvalueandthedepreciationoramortisationmethodbeingused.

Disclosurerequirements

ThedisclosurerequirementsofIAS36areextremelyextensive.Asummaryofthemain disclosures that are required is as follows:

(a) Foreachclassofassets,theentityshoulddisclose:

  (i) theamountofimpairmentlossesrecognisedasexpensesduringtheperiodand the line items in the statement of comprehensive income in which these impair-ment losses are included

  (ii) the amount of reversals of impairment losses recognised as income during theperiodandthelineitemsinthestatementofcomprehensiveincomeinwhich these reversals are included

  (iii) the amount of impairment losses (and reversals) on revalued assets recognised in other comprehensive income during the period.

(b) For each impairment loss or reversal that has been recognised during the period, theentity should disclose:

  (i) theeventsthatledtotherecognitionoftheimpairmentlossorreversal

(ii) theamountoftheimpairmentlossorreversal

(iii) thenatureoftheimpairedassetoradescriptionoftheimpairedCGU

(iv) the recoverable amount of the asset or CGU and whether this is its fair value less costs of disposal or its value in use

(v) ifrecoverableamountisfairvaluelesscostsofdisposal,thelevelofthefair valueinputs(seeChapter5)whichhavebeenusedtodeterminethefairvalueof the asset or CGU

(vi) if recoverable amount is value in use, the discount rate used when calculating the value in use figure.

Summary

- An impairment loss is the amount by which the carrying amount of an asset or cash-generatingunitexceedsitsrecoverableamount.Impairmenttestingmustbecarried out annually for goodwill and for intangible assets with indefinite useful lives. Other assetsshouldbetestediftherearеindicationsofimpairment.
- The recoverable amount of an asset or CGU is the higher of its fair value less costs of disposal and its value in use. Value in use is calculated by discounting the future cash flows which the asset or CGUis expected to generate.
- Impairment losses are usually recognised as an expense. But if an asset is carried at a revaluedamount,impairmentlossesaretreatedinthesamewayasrevaluationlosses.
- A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.Goodwillandcorporateassetsareallocatedbetween CGUsforimpairment testing purposes.
- AnimpairmentlossforaCGUfirstreduces(oreliminates)anygoodwillwhichhas beenallocatedtotheCGU.AnyremainingpartofthelossthenreducestheCGU's other assets.
- Impairmentlossesarereversed(partlyorwholly)iftherecoverableamountofthe assetorCGUconcernedisnowgreaterthanitscarryingamount.Butimpairment losses recognised for goodwill cannot be reversed.
- IAS36makesextensivedisclosurerequirements.Therequireddisclosuresprovide users with information about the impairment losses recognised or reversed during the accounting period.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

7.1 (a) Definetheterm"impairmentloss".

(b) Listthemainindicationswhichwouldsuggestthatanassetmightbeimpaired.

(c) Identify the two types of asset which must always be tested for impairment, even if there are no indications that impairment has occurred.

(d) Explainhowtherecoverableamountofanassetisdetermined.

7.2 Determinetherecoverableamountofeachofthefollowingfourassetsandstatethe amount of any impairment loss which should be recognised in each case:

	Carrying amount	*Fairvalueless costsofdisposal*	*Valuein use*
	£	£	£
Asset1	25,000	22,500	27,500
Asset2	6,500	3,750	4,800
Asset3	18,250	17,500	15,000
Asset4	11,400	13,400	12,750

7.3 An asset (which has never been revalued) has a carrying amount of £100,000. The assetis being depreciated on the straight-line basis, with a remaining useful life of three years and a residual value of £10,000.

The asset is expected to generate net cash inflows of £20,000 per year for the next three years and then to be sold for £10,000. Disposal costs are expected to be negligible.

Atpresent,theassetcouldbesoldfor£50,000.Disposalcostswouldbe£2,000.

Required:

(a) Assumingadiscountrateof10%andthatallcashflowsoccurattheendoftheyear concerned, determine the asset's value in use.

(b) Calculate the amount of the impairment loss which has occurred and explain how this should be accounted for.

(c) Calculate the amount of depreciation that should be charged in relation to the asset foreachofthenextthreeyears,assumingthatthestraight-linemethodwillcontinue to be used.

7.4 (a) Definetheterm"cash-generatingunit"(CGU).

(b) ExplainthecircumstancesinwhichaCGUshouldbetestedforimpairment.

7.5 Thecarryingamountsoftheassetsofacash-generatingunitareasfollows:

	£m
Goodwill	25
Patentsandcopyrights	50
Property,plantandequipment	200
	275

There are indications that this CGU is impaired and therefore its recoverable amount has been determined.The CGU's recoverable amountis £195 million.Value is use cannotbe ascertained for any of the assets, but fair value less costs of disposal is £20 million forthe patents and copyrights and £160 million for the property, plant and equipment.

Calculatetheamountoftheimpairmentlossandshowhowthisshouldbeallocated between the assets of the CGU.

7.6 IAS36 *ImpairmentofAssets*was issued in June 1998 and subsequently revised in March 2004andJanuary2008.Itsmainobjectiveistoprescribetheproceduresthatshould ensurethatanentity'sassetsarecarriedatnomorethantheirrecoverableamounts. Where an asset is carried at an amount in excess of its recoverableamount, it is said tobe impaired and IAS36 requires an impairment loss to be recognised.

Wilderness owns and operates an item of plant that cost £640,000 and had accumulated depreciationof £400,000 at1 October2019.Itisbeing depreciated at12.5% on cost.On 1 April 2020 (exactly half way through the year) the plant was damaged when a factory vehicle collided into it. Due to the unavailability ofreplacement parts, it is not possibleto repair the plant, but it still operates, albeit at a reduced capacity. Alsoit is expected that as a result of the damage the remaining life of the plant from the date of the damage will be only two years.

Basedonitsreducedcapacity,theestimatedpresentvalueoftheplantinuseis £150,000.Theplanthasacurrentdisposalvalueof£20,000(whichwillbenilintwo years'time),butWildernesshasbeenofferedatrade-invalueof£180,000againsta replacement machine which has a costof £1 million (there would be no disposal costsfor the replaced plant). Wilderness is reluctant to replace theplant as it is worried about the long-term demand for the product produced by the plant. The trade-in valueis only available if the plant is replaced.

Required:

(a) Defineanimpairmentloss,explainingtherelevanceofanasset'sfairvalueless costs of disposal and its value in use. State how frequently assets should be tested for impairment.

(b) Explainhowanimpairmentlossisaccountedforafterithasbeencalculated.

(c) Prepare extracts from the financial statements of Wilderness in respect of the plant fortheyearended30September2020. Youranswershouldexplainhowyou arrivedatyourfigures. *(ACCA)*

*7.7 An asset which cost £200,000 on 1 January 2018 is being depreciated on the straight line basis over a five year period with an estimated residual value of £40,000. The company whichownstheassethasconductedanimpairmentreviewat31December2019and estimates that the asset will generate the following cash flows over the remainder of its useful life:

Year	*Inflows*	*Outflows*
	£00	£000
	0	
2020	45	5
2021	35	5
2022	60	5

Thecashinflowfor2022includestheestimatedresidualvalueof£40,000.Theasset could be sold on 31 December 2019 for £110,000. Disposal costs would be £6,000.

(a) Determine the asset's value in use, assuming that all cash flows occur at the end of the year concerned and using a discount rate of 8%.

(b) Determinetheasset'srecoverableamount.

(c) Calculate the amount of the impairment loss that has occurred and explain how this should be accounted for.

(d) Calculate the amount of depreciation that should be charged in relation to the asset for each of the remaining years of its useful life.

*7.8 Stenberg plc is preparing its financial statements for the year ended 30 November 2020. On 1 May 2020, the company purchased a factory for the manufacture of optical disks, paying £24,000,000. The factory will be depreciated over its estimated life of 10 years using the straight line method on a full year basis with no residual value.

The asking price for the factory had been £30,000,000. However, Stenberg plc estimated the net present value of the factory's future expected net cash flows at £28,500,000 and the price eventually agreed with the vendor was £24,000,000.

During October 2020 a rival company announced that it had patented a new technology whichhasbeenenthusiasticallygreetedbythemajorplayersintheindustry.Stenbergpl cnowfeelsthatitmaybenecessarytorevisedownwardsitsexpectationsforthe factory.Itnowbelievesthatthenetpresentvalueoftheexpectednetcashflowsfrom the factory as at 30 November 2020 was £20,500,000. The net realisable value of the factory was estimated at £14,000,000 as at 30 November 2020.

Required:

DiscusswhetherornotthereisevidenceofimpairmentanddescribehowthefactoryDiscusswhetherornotthereisevidenceofimpairmentanddescribehowthefactory should be treated in the financial statements for the year ended 30 November 2020.

(CIPFA)

Chapter8

Non-currentassetsheldforsaleanddiscontinuedoperations

Introduction

Non-current assets such as property, plant and equipment are generally held for use, ratherthanforsale.Inotherwords,anentitywhichholdsnon-currentassetsnormallyintendsto usetheminitsbusinessoperations.Inthesecircumstances,itisappropriatetospreadthe cost (or revalued amount) of the assets over their useful lives in the form of depreciation charges which are then matched against the revenue which use of the assets has helped to generate.Importantly,therealisablevalueofsuchassets(i.e.theamountforwhichthey could be sold) is usually of no interest.

However,ifanon-currentassetisheldforsaleratherthanuse,thenotionof"usefullife" is inapplicable and it is no longer appropriate to make depreciation charges or to carry theasset at its cost (or revalued amount) less depreciation to date. A more suitable accounting treatment for such assets is prescribed by IFRS5 *Non-currentAssetsHeldforSaleandDiscontinuedOperations*and the first purpose of this chapter is to explain that accounting treatment.

A non-current asset held for sale may originally have been acquired for use in a business operationthathasnowbeendiscontinued.Itislogical,therefore,thatIFRS5shoulddeal with discontinued operations as well as with non-current assets held for sale. The standard establishes certain presentation and disclosure requirements with regard to discontinued operationsandthesecondpurposeofthischapteristoexplainthoserequirements.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- correctly classify non-current assets as either held for use or held for sale, inaccordance with the requirements of IFRS5

- explaintheconceptofa"disposalgroup"
- correctlymeasurenon-currentassets(ordisposalgroups)heldforsale

- definetheterm"discontinuedoperation"
- statethemainpresentationanddisclosurerequirements of IFRS5withregardtonon-current assetsheldfor saleanddiscontinuedoperations.

Classificationofnon-currentassetsasheldforsale

IFRS5statesthatanon-currentassetshouldbeclassifiedasheldforsaleifitscarrying amount (the amount at which it is "carried" in the financial statements) "*willberecoveredprincipallythroughasaletransactionratherthanthroughcontinuinguse*".F orthistobe thecase,theassetmustbeavailableforimmediatesaleinitspresentcondition,subject only to terms that are usual and customary for sales of such assets. The sale must also behighlyprobable.Asaleisusuallyregardedas"highlyprobable"if:

(a) managementiscommittedtoaplantoselltheassetandanactiveprogrammehas beeninitiatedtolocateabuyerandcompletetheplan;and

(b) the asset is being actively marketed at a sale price that is reasonable in relation to its current fair value; and

(c) acompletedsaleisexpectedwithinoneyearfromthedateofclassification(although thisperiodmaybeextendedifanydelayiscausedbycircumstancesbeyondthe entity's control); and

(d) itisunlikelythattherewillbeanysignificantchangestotheplanorthattheplanwill be withdrawn.

If these criteria are not satisfied at the end of the reporting period, the asset should not be classifiedasheldforsale.Ifthecriteriaaresatisfiedafterthereportingperiodbutbefore thefinancialstatementsareauthorisedforissue,thefactthattheassetisnowclassifiedas heldforsaleshouldbedisclosedinthenotestothefinancialstatements.

Disposalgroups

IFRS5 also applies if an entity disposes of a group of assets (possibly with some directly associatedliabilities)inasingletransaction.Suchagroupisknownasa"disposalgroup" andmayconsistofanumberofcash-generatingunits,asinglecash-generatingunitorpart ofacash-generatingunit.Acash-generatingunitisdefinedas"*thesmallestidentifiablegroupofassetsthatgeneratescashinflowsthatarelargelyindependentofthecashinflowsfromotherassetsorgroupsofassets*"(se eChapter7).

Aswithindividualnon-currentassets,adisposalgroupshouldbeclassifiedasheldfor saleifitscarryingamountwillberecoveredprincipallythroughasaletransactionrather than through continuing use. The criteria which are used to determine whether or not adisposalgroupisheldforsalearethesameasthosewhichapplyinthecaseofindividual non-

current assets (see above).

EXAMPLE1

Thisexampleisbaseduponimplementationguidanceprovidedwith IFRS5.

(a) CompanyAiscommittedtoaplantosellitsheadquartersbuildingandhasinitiatedaanactive programmetofindabuyerandcompletetheplan.Thebuildingisbeingmarketedatareasona blepriceandacompletedsaleisexpectedwithin12months.Itisunlikelythatthisplanwillcha ngesignificantly.Thecompanywillnotactuallyvacatethebuildinguntilabuyerisfoundbutth enthetimetakentovacatethebuildingwillnotexceedwhatisregardedasusualandcustomar yforsuchbuildings.

(b) CompanyBisalsocommittedtoaplantosellitsheadquartersbuildingandisinpreciselythes amesituationasCompanyAexceptthatitwillnotvacatethebuildingandtransferittoabuyeru ntilanewheadquartersbuildinghasbeenconstructed.

(c) CompanyCiscommittedtoaplantosellafactoryandhasinitiatedactionstofindabuyer.How ever,thereiscurrentlyabacklogofuncompletedordersandthecompanydoesnotintendtotr ansferthefactorytoabuyeruntilithasdealtwiththisbacklog.

(d) CompanyDisalsocommittedtoaplantosellafactoryandisinpreciselythesamesituationas CompanyCexceptthatthebacklogoforderswillbetransferredtothebuyerofthebuildingalo ngwiththebuildingitself.Thereforetheexistenceofthisbacklogwillnotdelaythesale.

(e) CompanyEiscommittedtoaplantoselladisposalgroup.Allofthecriteriawhichmustnormall ybemetinorderforadisposalgrouptobeclassifiedasheldforsalearesatisfiedexceptthatth esaleisnotexpectedtotakeplacewithinoneyear.Itishighlyprobablethatabuyerwillbefound withinthattimebutthesalewillthenrequireGovernmentapproval.Theapprovalprocessisal engthyoneandcannotbeginuntilabuyerhasbeenfound.Thereforecompletionofthesaleis unlikelytooccurwithin12months.

Ineachcase,determinewhetherornottheassetordisposalgroupinquestionshouldbeclassified asheldforsale.

Solution

(a) Strictlyspeaking,thebuildingisnotimmediatelyavailablesinceitwilltaketimeforthecompa nytomoveoutonceabuyerisfound.However,thetimetakenwillbe"usualandcustomary".Fu rthermore,alloftheothercriteriaforclassificationasheldforsalearesatisfied.Thereforethis buildingshouldbeclassifiedasheldforsale.

(b) Thebuildingisnotavailableforimmediatesalesincethesalecannotbecompleteduntilanew HQbuildinghasbeenconstructed.Thisbuildingshouldnotbeclassifiedasheldforsale.

(c) Thefactoryisnotavailableforimmediatesalesincethesalecannotbecompleteduntiltheba cklogofordershasbeendealtwith.Thisisasimilarsituationto(b)aboveandthefactoryshoul dnotbeclassifiedasheldforsale.

(d) Thefactoryisimmediatelyavailableandshouldbeclassifiedasheldforsalesolongasallofth eotherclassificationcriteriaspecifiedinIFRS5aresatisfied.

(e) Saleofthedisposalgroupisnotexpectedtobecompletedwithinoneyear.However,abuyeris expectedtobefoundwithinthattimeandanydelayincompletionwillbecausedbycircumsta ncesoutsidethecompany'scontrol.Thedisposalgroupshouldbeclassifiedasheldforsale.

Measurementofnon-currentassetsheldforsale

IFRS5 requires that a non-current asset or a disposal group which is held for sale should be measuredatthelowerofitscarryingamountwhenitwasinitiallyclassifiedasheldfor sale and its "fair value less costs to sell", where:

(a) fairvalue(asdefinedbyIFRS13)is"*thepricethatwouldbereceivedtosellanassetorpaidt otransferaliabilityinanorderlytransactionbetweenmarketparticipantsatthemeasure mentdate*", and

(b) costs to sell are "*...costsdirectlyattributabletothedisposalofanasset(ordisposalgroup),excludingfin ancecostsandincometaxexpense*".

When an asset or disposal group is initially classified as held for sale, an impairment loss shouldberecognised(seeChapter7)ifthefairvaluelesscoststosellofthe assetorgroup atthattimeislowerthanitscarryingamount.Subsequently,afurtherimpairmentloss shouldberecognisedifthereisadecreaseinfairvaluelesscoststosellandagainshould be recognised if there is an increase in fair value less costs to sell. However, gains whichexceedthecumulativeimpairmentlossesthathavealreadybeenrecognisedinrelatio nto the asset or disposal group (if any) are not recognised.

In the case of a disposal group, impairment losses and any subsequent gains are generally allocated between the non-current assets in the group in the order set out in international standard IAS36 *ImpairmentofAssets*(see Chapter 7). However, no allocation is made toassetsthatareoutsidethescopeofthemeasurementrequirementsofIFRS5(seebelow).

Itisimportanttoappreciatethatdepreciationshouldceasewithregardtonon-current assets or disposal groups which are held for sale and that such assets should instead be measured as described above.

EXAMPLE2

(a) On1July2019,acompanywhichpreparesfinancialstatementsto31Decemberclassifiesan on-currentassetasheldforsale.Theasset'scarryingamountonthatdateis£10,000anditsfairva luelesscoststosellis£9,500.TheassetissoldinMay2020for£9,400(netofcosts).Calculate anyimpairmentlosses(orgains)thatshouldberecognisediftheasset'sfairvaluelesscostst osellat31December2019is:

(i)£9,200 (ii)£9,700 (iii)£10,100

Ineachcase,alsocalculatethegainorlossthatshouldberecognisedonthedisposaloftheas

set.

(b) On1October2019,acompanywhichpreparesfinancialstatementsto31Decemberclassifiesanon-currentassetasheldforsale.Theasset'scarryingamountonthatdateis£50,000anditsfairvaluelesscoststosellis£55,000.TheassetissoldinJune2020for£53,000(net).Calculateanyimpairmentlosses(orgains)thatshouldberecognisediftheasset'sfairvaluelesscoststosellat31December2019is:

(i)£52,500 (ii)£49,000

Ineachcase,alsocalculatethegainorlossthatshouldberecognisedonthedisposaloftheasset.

Solution

(a) Animpairmentlossof£500shouldberecognisedon1July2019,writingtheassetdowntoitsfairvalue(lesscoststosell)of£9,500.On31December2019:

(i) theassetisremeasuredat£9,200andanimpairmentlossof£300isrecognised

(ii) theassetisremeasuredat£9,700andagainof£200isrecognised

(iii) theassetisremeasuredat£10,000andagainof£500isrecognised(thegaincannotbe£600sincethiswouldexceedthepreviouslyrecognisedimpairmentlossesinrelationtotheasset).

ThegainorlossonthesaleinMay2020(recognisedinthefinancialstatementsfortheyearto31December2020)is:

(i) gain£200(£9,400–£9,200)(ii)

loss£300(£9,400–£9,700)(iii)loss£

600(£9,400–£10,000).

(b) Thereisnoimpairmentlosson1October2019,sincetheasset'sfairvaluelesscoststosellexceedsitscarryingamount.Theassetcontinuestobemeasuredat£50,000.On31December2019:

(i) theassetisstillmeasuredat£50,000andnogainisrecognised(sincetherewerenopreviousimpairmentlossesinrelationtothisasset)

(ii) theassetisremeasuredat£49,000andanimpairmentlossof£1,000isrecognised.

ThegainorlossonthesaleinJune2020(recognisedinthefinancialstatementsfortheyearto31December2020)is:

(i) gain£3,000(£53,000–£50,000)(ii)

gain£4,000(£53,000–£49,000).

ScopeofthemeasurementrequirementsofIFRS5

ThemeasurementrequirementsofIFRS5applyonlytonon-currentassetsanddonotapply atalltothefollowingtypesofasset,whetherthesearetobesoldindividuallyoraspartof a disposal group:

	Chapterofthisbook
(a)deferredtaxassets(IAS12*IncomeTaxes*)	15
(b)employeebenefitsassets(IAS19*EmployeeBenefits*)	14
(c)financialassets(IFRS9*FinancialInstruments*)	11
(d)investmentpropertiesatfairvalue(IAS40*InvestmentProperty*)	5

If an asset on this list is classified as held for sale, it should continue to be measured in accordance with the applicable standard. But the asset should be presented in the financial statementsasanassetheldforsale(seelaterinthischapter).

Inthecaseofadisposalgroupheldforsale,thecarryingamountofallassetsnotwithin the scope of IFRS5 (and the carrying amount of any liabilities) should be remeasured in accordance with the applicable standard on each occasion that the carrying amount of the disposalgroupiscomparedwithitsfairvaluelesscoststosell.

EXAMPLE3

On1September2019,acompanywhichpreparesfinancialstatementsto31Decembereachyearc lassifiesadisposalgroupasheldforsale.Thisdisposalgroupisstillunsoldat31December2019.T hecarryingamountsofthedisposalgroup'sassetsandliabilitiesat1September2019areshownb elow,alongwiththecarryingamountsatwhichtheseassetsandliabilitieswouldhavebeenmeasur edat31December2019(inaccordancewithapplicablestandards)ifthegrouphadnotbeenclassif iedasheldforsale.

	1September2019	31December2019
	£000	£000
Goodwill	2,000	1,900
Property,plantandequipment(PPE)	4,300	3,900
Inventories	850	800
Financialassets	1,500	1,750
Liabilities	(900)	(900)

Thefairvalue(lesscoststosell)ofthedisposalgroupis£8millionat1September2019and£7.5mill ionat31December2019.Calculatetheamountofanyimpairmentlosses(orgains)thatshouldber ecognisedat:

(a) 1September2019

(b) 31December2019.

Alsoshowhowtheseimpairmentlossesorgainsshouldbeallocatedamongsttheassetsandliabil itiesinthegroup.

Solution

(a) On1September2019,thetotalcarryingamountofalltheassetsandliabilitiesinthedisposalgroupis£7.75m.Thisislessthanfairvaluelesscoststosell(£8m).Sothegroupismeasuredatitscarryingamount.Therearenoimpairmentlosses.

(b) ThemeasurementrequirementsofIFRS5donotapplytotheinventories,thefinancialassetsortheliabilities.Thereforethecarryingamountsofthesethreeitemsmustberemeasuredon31December2019inaccordancewiththeapplicablestandards.Thecarryingamountofthedisposalgroupbecomes£7.95m,asfollows:

	£000
Goodwill	2,000
Property,plantandequipment	4,300
Inventories	800
Financialassets	1,750
Liabilities	(900)
	7,950

Thisexceedsfairvaluelesscoststosell(£7.5m)sothereisanimpairmentlossof£450,000.Thislossisallocatedtonon-currentassetstowhichthemeasurementrequirementsofIFRS5apply(goodwillandPPE).IAS36requiresthelosstobesetfirstagainstthegoodwill,reducingthatassetfrom£2millionto£1.55million.Thisabsorbsthewholeofthelosssothereisnothingleft tosetagainstthePPE.Theassetsandliabilitiesinthedisposalgrouparenowmeasuredasfollows:

	£000
Goodwill	1,550
Property,plantandequipment	4,300
Inventories	800
Financialassets	1,750
Liabilities	(900)
	7,500

Thegainonremeasurementof£200,000(£7.95m–£7.75m)andtheimpairmentlossof£450,000arerecognisedinthecompany'sstatementofcomprehensiveincomefortheyearto31December2019.

Measurementofassetsnolongerclassifiedasheldforsale

If an asset or disposal group has been classified as held for sale but then the criteria for this classification are no longer met, the asset or disposal group should cease to be classified asheldforsale.Non-currentassetthatceasestobeclassifiedasheldforsale(orceasestobepartofadisposalgroupclassifiedassuch)shouldbemeasuredatthe*lower*of:

(a) its carrying amount before being classified as held for sale, less any depreciation that wouldhavebeenchargedinthemeantimeifithadnotbeenheldforsale,and

(b) itsrecoverableamountatthedateofthedecisionnottosell,whichisthe*higher*of:
  (i) theasset'sfairvaluelesscoststosell
  (ii) the asset's value in use, which is defined as "*thepresentvalueofestimatedfuturecashflowsexpectedtoarisefromthecontinuinguseofanassetandfromitsdisposalattheendofitsusefullife*".

Theeffectofthismeasurementruleisthatanimpairmentreviewisrequiredwheneveran assetceasestobeclassifiedasheldforsale(seeChapter7).

Presentationofnon-currentassetsheldforsale

Non-current assets held for sale and the assets of a disposal group held for sale should be presented separately from other assets in the statement of financial position. Similarly, the liabilities of a disposal group should be presented separately from other liabilities. It is not permissible to offset these assets and liabilities. The major classes of assets and liabilities classifiedasheldforsaleshouldbedisclosedeitherinthestatementoffinancialposition or in the notes.

Additionaldisclosures

Intheaccountingperiodinwhichanon-currentassetoradisposalgroupisclassifiedas heldforsale(orissold)thefollowingadditionaldisclosuresshouldbemadeinthenotesto the financial statements:

(a) adescriptionoftheassetordisposalgroup
(b) adescriptionofthefactsandcircumstancesoftheexpecteddisposal(orthesale)and the expected manner and timing of that disposal
(c) anyimpairmentlossrecognisedwhentheassetordisposalgroupwasclassifiedas heldforsaleandanyfurtherlossorgainrecognisedsubsequently
(d) ifapplicable,thereportablesegmentinwhichtheassetordisposalgroupispresented (see Chapter 24).

Ifanassetordisposalgroupwhichwaspreviouslyclassifiedasheldforsaleisnolonger heldforsale,thefactsandcircumstancesofthisdecisionshouldalsobedisclosed.

ILLUSTRATION

ThisillustrationisbaseduponimplementationguidanceprovidedwithIFRS5.

Acompanywhichpreparesfinancialstatementsto31Decembereachyearhasclassifiedadisposalgroupasheldforsale.At31December2019,thisgroup'sassetsconsistofnon-currentassetswithacarryingamountof£8millionandliabilitieswithacarryingamountof£3.3million.Theseassetsandliabilitiescouldbepresentedinthestatementoffinancialpositionat31December2019asfollows:

Statementoffinancialpositionasat31December2019

	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment		xxx
Currentassets		
Inventories	xxx	
Tradereceivables	xxx	
Cashatbank	xxx	
	xxx	
Non-currentassetsheldforsale	8,000	xxx
		xxx
Equity		
Sharecapital		xxx
Retainedearnings		xxx
		xxx
Liabilities		
Non-currentliabilities		
Long-termloans		xxx
Currentliabilities		
Tradepayables	xxx	
Liabilitiesdirectlyassociatedwith non-currentassetsheldforsale	3,300	xxx
		xxx

Discontinuedoperations

IFRS5requiresthatentitiesshouldpresentanddiscloseinformationthatenablesusersof thefinancialstatementstoevaluatetheeffectsofdiscontinuedoperations.Twodefinitions are important here:

(a) Adiscontinuedoperationis"*acomponentofanentitythateitherhasbeendisposedofori sclassifiedasheldforsale...*".

(b) A component of an entity comprises "*operationsandcashflowsthatcanbeclearlydistinguished...fromtherestoftheentity*". Whilstheldforuse,acomponentwill usuallybeasinglecash-generatingunitoragroupofsuchunits(seeChapter7).

In general, a discontinued operation will represent "*aseparatemajorlineofbusinessorgeographicalareaofoperations*".Thepresentationandd isclosurerequirementsofIFRS5 in relation to discontinued operations are outlined below.

Presentationanddisclosureofdiscontinuedoperations

Withregardtodiscontinuedoperations,anentityshoulddisclose:

(a) asingleamountinthestatementofcomprehensiveincome,comprisingthetotalof:
  (i) thepost-taxprofitorlossofdiscontinuedoperations,and
  (ii) thepost-taxgainorlossrecognisedonthemeasurementtofairvaluelesscosts tosell(oronthedisposal)oftheassetsconstitutingthediscontinuedoperation

(b) ananalysisofthissingleamount,eitherinthestatementofcomprehensiveincomeor in the notes to the financial statements, into:
  (i) therevenue,expensesandpre-taxprofitorlossofdiscontinuedoperations
  (ii) thetaxexpensearisinginrelationtothisprofitorloss
  (iii) thegainorlossrecognisedonthemeasurementtofairvaluelesscoststosell(or onthedisposal)oftheassetsconstitutingthediscontinuedoperation
  (iv) thetaxexpensearisinginrelationtothisgainorloss.

(c) thenetcashflowsattributabletotheoperating,investingandfinancingactivitiesof discontinuedoperations(eitherinthestatementofcashflowsorinthenotes).

ILLUSTRATION

Thisillustrationisbaseduponimplementationguidanceprovidedwith IFRS5.

Acompanydiscontinuedanoperationduringtheyearto31March2020andsoldthecorresponding disposalgroup.Therevenueandexpensesofthediscontinuedoperationfortheyearto31March2 020wereasfollows:

	£000
Revenue	432
Expenses	295
Pre-taxprofit	137
Taxexpense	26
Post-taxprofit	111

Thefairvalueofthedisposalgroupwhenitwasinitiallyclassifiedasheldforsalewasinexcessofits carryingamount,sotherewasnoimpairmentlossatthattime.Apre-taxgainof£20,000arosewhenthedisposalgroupwassold(taxexpense£4,000).Thereforethetot alprofitfromdiscontinuedoperationsis£127,000(£111,000+£20,000–£4,000).

Thisinformationcouldbepresentedinthestatementofcomprehensiveincomefortheyearto31M arch2020inthefollowingmanner:

Statementofcomprehensiveincomefortheyearto31March2020

	£000
Continuingoperations	
Revenue	xxx
Costofsales	(xxx)
Grossprofit	xxx
Otherincome	xxx
Distributioncosts	(xxx)
Administrativeexpenses	(xxx)
Financecosts	(xxx)
Profitbeforetax	xxx
Taxation	(xxx)
Profitfortheyearfromcontinuingoperations	xxx
Discontinuedoperations	
Profitfortheperiodfromdiscontinuedoperations	127*
Profitfortheyear	xxx
Othercomprehensiveincomefortheyear	xxx
Totalcomprehensiveincomefortheyear	xxx

*Ananalysisofthisfigurewouldbegiveninthenotes.

Summary

- Non-currentassetsordisposalgroupsshouldbeclassifiedasheldforsaleiftheir value will be recovered principally through sale rather than through use. The asset or groupmustbeavailableforimmediatesaleandthesalemustbehighlyprobable.
- Adisposalgroupisagroupofassets(togetherwithanyassociatedliabilities)which are to be disposed of in a single transaction.
- Non-currentassetsanddisposalgroupsheldforsaleshouldbemeasuredatthelower oftheircarryingamountwheninitiallyclassifiedasheldforsaleandtheirfairvalue less costs to sell. Depreciation should cease.
- The measurement requirements of IFRS5 do not apply to deferred tax assets, assetsarisingfromemployeebenefits,financialassetsorinvestmentproperties.
- Non-current assets held for sale should be presented separately in the statement of financialposition.Theliabilitiesofadisposalgroupshouldalsobepresented separately.

- Adiscontinuedoperationisacomponentofanentitythathasbeendisposedoforis heldforsale.Acomponentcomprisesanoperationthatcanbeclearlydistinguished from the rest of the entity.
- Theresultsofdiscontinuedoperationsshouldbepresentedseparatelyinthestatement ofcomprehensiveincomeandinthestatementofcashflows.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

8.1 (a) Explainwhatismeantbyanon-currentasset"heldforsale"andlistthecriteria which must be satisfied in order for an asset to be classified as held for sale.

(b) Explain why it is not appropriate to measure non-current assets held for sale in the same way as non-current assets held for use.

(c) Explainhownon-currentassetsheldforsaleshouldbemeasured.

8.2 Wilbern Ltd prepares financial statements to 30 June each year. On 1 March 2019, the companyclassifiesanon-currentassetasheldforsale.Theassetiseventuallysoldin July 2019. Calculate:

(i) anyimpairmentlosses(orgains)thatshouldberecognisedinthefinancial statements for the year to 30 June 2019, and

(ii) any gain or loss on disposal that should be recognised in the financial statementsfor the year to 30 June 2020

if the carrying amount of the asset at 1 March 2019, its fair value (less costs to sell) on that date and on 30 June 2019 and its disposal proceeds are as follows::

	Carryingamount at1March2019	*Fairvalueat 1March2019*	*Fairvalueat 30June2019*	*Disposal proceeds*
	£	£	£	£
(a)	6,000	5,400	5,200	5,140
(b)	6,000	6,800	6,750	6,630
(c)	6,000	5,900	5,950	5,920
(d)	6,000	5,900	6,050	6,080

8.3 (a) Explainwhatismeantbya"discontinuedoperation".

(b)Explain why IFRS5 requires the results of discontinued operations to be presented separately in the financial statements.

8.4 Varnay Ltd is a manufacturing company which prepares annual financial statements to31 December. In November 2019, the company announced a plan to close down one of itsmanufacturingoperationsandtosellofftheassetsofthatoperation.Theoperation will be closed down over a period of approximately nine months and closure is expected to be complete by the end of July 2020. Sale of the operation's assets is expected to take place in September 2020.

Explainhowthisclosureandsaleshouldbedealtwithinthefinancialstatementsof Varnay Ltd for the year to 31 December 2019 and for the year to 31 December 2020.

8.5 YengandSons Ltdprepares financial statements to31Mayeachyear. On25January 2020,thecompanyclassifiesadisposalgroupasheldforsale.Thisdisposalgroupis eventually sold in August 2020. The carrying amounts of the assets and liabilities in the disposal group at 25 January 2020 and the carrying amounts at which these assets and liabilities would have been measured at 31 May 2020 if the group had not been held for sale are as follows:

	25January2020	*31May2020*
	£000	£000
Goodwill	200	150
Property,plantandequipment	2,100	1,900
Investmentproperties	700	760
Inventories	420	380
Liabilities	(360)	(360)

The fair value (less costs to sell) of the disposal group is £3 million at 25 January 2020 and £2.85 million at 31 May 2020. The group is sold in August 2020 for £2.8 million.

(a) Calculate the amount of any impairment losses (or gains) that should be recognised at 25 January 2020 and at 31 May 2020.

(b) Calculatethegainorlossarisingonthesaleofthedisposalgroup.

8.6 AnextractfromthedraftstatementofcomprehensiveincomeofAndissonLtdforthe year to 30 April 2020 is as follows:

	£000	£000
Salesrevenue		558
Costofsales		184
Grossprofit		374
Otherincome		12
		386
Distributioncosts	59	
Administrativeexpenses	148	207
Profitbeforetax		179

Taxation	35
Profitfortheyear	144

InJanuary2020,thecompanysoldoneofitsbusinessoperations,incurringalossof £17,000 on the sale. This loss is included in administrative expenses. The associated tax relief of £3,000 has been deducted when computing the tax expense shown in the draft statement of comprehensive income.

The operation sold in January 2020 yielded sales revenue of £103,000 during the year to 30April2020.Relatedcostswerecostofsales£38,000,distributioncosts£2,000and administrativeexpenses£20,000.Thetaxexpenseshowninthedraftstatementof comprehensive income includes £9,000 in relation to the profit made by this operation.

Re-draft the extract from the statement of comprehensive income in accordance with the requirementsofIFRS5anddraftasuitablenoterelatingtodiscontinuedoperationswhi ch could appear in the notes to the financial statements.

*8.7 Bakewall Ltd prepares annual financial statements to 31 December. On 1 August 2019 thecompanycloseddownoneofitsoperationsandclassifiedthecorrespondingcash-generatingunit(CGU)asheldforsale.AlloftheassetsinthisCGUwerewithinthe scope of the measurement requirements of IFRS5. There were no associated liabilities.

The carrying amount of the CGU on 1 August 2019 was £3m and its fair value on that datewasestimatedtobe£2.7m.Estimateddisposalcostswere£100,000.TheCGU remained unsold on 31 December 2019. On this date, its estimated fair value had fallento £2.5m and estimated disposal costs had risen to £150,000.

The operation which was closed down generated sales revenue of £400,000between1 January2019and1August2019.Costsoftheoperationduringthisperiodtotalled £520,000.Thistotalcomprisedcostofsales£360,000,distributioncosts£70,000and administrative expenses £90,000.

(a) Explain what is meant by a "disposal group" and explain why the CGU referred to above qualifies as a disposal group. Also list the criteria which determine whether or not a disposal group may be classified as held for sale.

(b) Explainwhatismeantbya"discontinuedoperation"andexplainwhytheoperation referred to above qualifies as a discontinued operation.

(c) Explain how the transactions referred to above will affect the financial statementsof Bakewall Ltd for the year to 31 December 2019. (Ignore taxation).

Chapter9

Leases

Introduction

The IASB *ConceptualFramework*(see Chapter 2) states that financial information cannot
faithfullyrepresenttransactionsunlessitrepresentstheirunderlyingeconomicsubstance rather than just their legal form. This principle is embodied in IFRS16 *Leases*, which dealswiththeaccountingtreatmentofleaseditemssuchasproperty,plantandequipment.

The legal form of a lease is that ownership of the leased item remains with the *lessor*(the
supplier)andisnottransferredtothe*lessee*(theuser).However,thesubstanceofmost leasesisthat(ineffect)thelesseeacquiresanassetandincursacorrespondingliabilityto the lessor. In such cases, IFRS16 requires that a "right-of-use" asset and the liability to the lessorshouldberecognisedinthelessee'sfinancialstatements.

ThepurposeofthischapteristooutlinethemainrequirementsofIFRS16andtoexplain thewayinwhichaleaseshouldbeaccountedforinthefinancialstatementsofthelessee and in the financial statements of the lessor.

WithdrawalofIAS17

IFRS16wasissuedin2016andmustbeappliedforaccountingperiodsbeginningonor after 1 January 2019 (though earlier application is permitted). IFRS16 was developed inajointprojectwiththeUSFASBandsupersedesIAS17*Leases*.

IAS17 is no longer dealt with in this chapter. The reader who still requires information regardingIAS17isreferredtopreviouseditionsofthisbook.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- definetheterms"lease","inceptiondate","commencementdate"and"leaseterm"
- account for a lease in the financial statements of the lessee in accordance with therequirements of IFRS16 *Leases*
- measure a lessee's right-of-use asset and lease liability, both at the

commencementdate of a lease and in subsequent periods

- distinguishbetweenafinanceleaseandanoperatinglease
- account for finance leases and operating leases in the financial statements of thelessor in accordance with the requirements of IFRS16
- outlinetherequirementsofIFRS16withregardtosaleandleasebacktransactions.

Definitionofalease

IFRS16definesaleaseas"*acontract,orpartofacontract,thatconveystherighttouseanasset(theunderlyingasset)foraperiodoftimeinexchangeforconsideration*". Twofurther definitions given in IFRS16 are as follows:

(a) Theinceptiondateofaleaseis"*theearlierofthedateofaleaseagreementandthedateofcommitmentbythepartiestotheprincipaltermsandconditionsofthelease*".

(b) Thecommencementdateofaleaseis"*thedateonwhichalessormakesanunderlyingassetavailableforusebyalessee*".

At the inception of a contract, an entity should assess whether or not the contract meets the definition of a lease. If so, the requirements of IFRS16 must be applied. For a contract to qualify as a lease, it must convey the right to controlthe use of the underlying asset for aperiod of time. Throughout the "period of use" specified in the contract, the customer musthave both of the following:

(a) therighttoobtainsubstantiallyalloftheeconomicbenefitsfromuseoftheunder- lying asset (e.g. by having exclusive use of it), and

(b) therighttodirecttheuseofthatasset.

If these conditions are satisfied for only part of the term of a contract, then the contract is a leaseforonlythatpartoftheterm.Inotherwords,thecontract"contains"alease.

A customer has the right to direct the use of an asset if the customer controls the way in whichtheassetisusedandthepurpose(s)forwhichitisused(withinthescopeofitsright of use defined in the contract).

EXAMPLE1

Thisexampleisbaseduponimplementationguidanceprovidedwith IFRS16.

On1January2020,aretailerentersintoafive-yearcontractfortheexclusiveuseofaretailunit.Theunitissituatedinashoppingcentreandthecontractspecifiesthatitcanbeusedtosellgoodsonlyduringthecentre'sopeninghours.Theretailerwillcontrolphysicalaccesstotheretailunitthroughoutthefive-yearperiodandisatlibertytodecideonthemixofgoodssold,thepricesthatarechargedandthequantitiesofinventorythatareheld.However,theunitcannotbeusedforanypurposeotherthanthesaleofgoods.

Theretailerisrequiredtopay£10,000permonthfortheuseoftheretailunit.Shouldthiscontractbetreatedasalease?

Solution

Theretailerhasexclusiveuseoftheunitthroughoutthefive-yearperiodandsohastherighttoobtainsubstantiallyalloftheeconomicbenefitsfromitsuse.Furthermore,duringtheperiodofuse,alldecisionsregardingthewayinwhichtheunitisusedaremadebytheretailer.Thefactthattheunitmaybeusedonlyforthesaleofgoods(andthenonlyduringtheopeninghoursoftheshoppingcentre)determinesthescopeofthecontractbutdoesnotrestricttheretailer'srighttodirecttheuseoftheunitwithinthatscope.

Thecontractconveystherighttocontroltheuseoftheretailunitforaperiodoftimeinexchangeforconsideration(i.e.payment).Thereforethecontractisaleaseandshouldbeaccountingforinaccordancewith IFRS16.

Leaseterm

IFRS16definesthelengthofalease(the"leaseterm")as"*thenon-cancellableperiodofthelease,togetherwithboth:*

(a) periodscoveredbyanoptiontoextendtheleaseifthelesseeisreasonablycertaintoexercisethatoption;and

(b) periodscoveredbyanoptiontoterminatetheleaseifthelesseeisreasonablycertainnottoexercisethatoption."

Itisimportanttodeterminetheleasetermsothattheliabilitytothelessorandtheright-of-useasset(seebelow)maybemeasuredcorrectlyatthecommencementdateofalease.

Leaseaccountingbylessees

IFRS16requiresthat,atthecommencementofalease,thelesseeshouldrecognisearight- of-useassetandacorrespondingleaseliability.Aright-of-useassetisdefinedas"*anassetthatrepresentsalessee'srighttouseanunderlyingassetfortheleaseterm*".

Therequirementtorecognisearight-of-useassetandaleaseliabilitygenerallyappliestoallleases.However,anentitymayelectnottoapplythisaccountingtreatmentto:

(a) short-termleases(i.e.leasesof12monthsorless),and

(b) leasesforwhichtheunderlyingassetisoflowvalue(seebelow).

Ifsuchanelectionismade,theleasepaymentsfortheleasesconcernedarerecognisedasanexpenseandspreadovertheleaseterm(usuallyonastraight-linebasis).Thereisno right-of-useassetorleaseliability.Theelectionforshort-termleasesshouldbemadebyclassofunderlyingasset,wherea"class"isagroupingofassetsofasimilarnatureanduse.Theelectionforleasesoflow-valueassetsshouldbemadeonalease-by-leasebasis.

Theterm"lowvalue"isnotdefinedinIFRS16,buttheapplicationguidancewhichforms part of the standard makes it clear that the assessment of whether an asset is of low valueshouldbecarriedoutonanabsolutebasis,notamaterialitybasis.Thereforelesseeswit h verydifferentmaterialitythresholdsshouldreachthesameconclusionaboutwhetheror not any given asset is of low value. Examples given in the application guidance include personalcomputersandsmallitemsofofficefurniture.The*BasisforConclusions*for IFRS16 (which is not actually part of the standard) suggests that assets with a value not exceedingfivethousandUSdollarsmightberegardedaslow-valueassets.

Initialmeasurementoftheright-of-useassetandtheleaseliability

Theright-of-useassetwhichisrecognisedatthecommencementofalease(unlesseither oftheaboveexemptionsapply)ismeasuredinitiallyatcost.Thecostoftheright-of-use assetisobtainedbyaddingtogetherthefollowingelements:

(a) theamountoftheinitialmeasurementoftheleaseliability(seebelow)

(b) anyleasepaymentsmadeatorbeforethecommencementdate(e.g.deposits)

(c) anyinitialdirectcostsincurredbythelessee

(d) an estimate of any costs to be incurred by the lessee in dismantling or removing the underlyingassetattheendoftheleaseterm,restoringthesiteonwhichitislocated orrestoringtheassetasrequiredbythetermsofthelease(seeChapter12).

Notethatthereisnoreferenceheretothefairvalueoftheunderlyingasset.Inthisregard, the*BasisforConclusions*forIFRS16statesthatinitialmeasurementatcostisconsistent with the measurement of many other assets (e.g. property, plant and equipment) and is less complexandcostlyforentitiesthanmeasurementatfairvalue,especiallyinthecaseof assets for which there is no active market.

Theleaseliabilitywhichisrecognisedatthecommencementdateismeasuredinitiallyat thepresentvalueoftheleasepaymentswhichfalldueafterthatdate.Thesepayments shouldbediscountedattheinterestrateimplicitinthelease(ifthisisknown)oratthe lessee'sincrementalborrowingrateotherwise.Theseratesareasfollows:

(a) The "interest rate implicit in the lease" is equal to the rate of interest which causes the present value of:

  (i) theleasepaymentsmadebythelesseeduringtheleaseterm,and
  (ii) theestimatedresidualvalueoftheunderlyingassetforthelessor(ifany)atthe end of the lease term

  toequalthefairvalueoftheunderlyingassetatthecommencementdateplusany initial direct costs borne by the lessor.

(b) Alessee's"incrementalborrowingrate"istherateofinterestthatthelesseewould have to pay over a similar term to borrow the funds necessary to acquire an asset of a similar value to the leased asset.

Subsequentmeasurement

In most cases, the right-of-use asset established at the commencement of a lease should be measured subsequently at cost less any accumulated depreciation and accumulated impair-ment losses (the "cost model"). The asset should be depreciated in accordance with IAS16 *Property,PlantandEquipment*(seeChapter5)andimpairmentlossesshouldbeaccounted forinaccordancewithIAS36*ImpairmentofAssets*(seeChapter7).Notethat:

(a) If the lease transfers ownership of the underlying asset to the lessee by the end of thelease term(or if the lessee is expected to exercise a purchase option) the right-of-useassetshouldbedepreciateduptotheendoftheusefullifeoftheunderlyingasset.

(b) Otherwise,theright-of-useassetshouldbedepreciateduptothe*earlier*oftheendof theleasetermandtheendoftheusefullifeoftheright-to-useasset.

However,iftheright-of-useassetrelatestoaclassofproperty,plantandequipmentto whichthelesseeappliestherevaluationmodel(seeChapter5)thentherevaluationmodel may also be applied to the right-of-use asset. Similarly, if the lessee applies the fair valuemodeltoinvestmentproperty(seeChapter5)thenthefairvaluemodelshouldalsobe appliedtoright-of-useassetswhichmeetthedefinitionofinvestmentproperty.

Asregardstheliabilitytothelessor,eachleasepaymentisapportionedbetweenthe interest(orfinancecharge)element(whichisrecognisedasanexpense)andtheamount whichreducestheoutstandingliability.IFRS16requiresthatinterestontheliabilityshould be calculated in such a way as to produce "*aconstantperiodicrateofinterestontheremainingbalanceoftheleaseliability*".Theinterest rateappliedshouldbethediscount ratewhichwasusedwheninitiallymeasuringtheleaseliability.

EXAMPLE2

On1January2019,acompanywhichpreparesaccountsto31Decemberentersintoafive-yearleaseofabuildingfromapropertydeveloper.Leasepaymentsare£40,000perannum,payabl einadvanceon1Januaryineachyear.Therateofinterestimplicitintheleaseis8%perannum.Explai nhowthisleaseshouldbeaccountedforbythecompanyinaccordancewiththerequirementsofIF RS16.

Solution

Thecompanyshouldrecognisealeaseliability,measuredinitiallyatthepresentvalueofthefourlea sepaymentsfallingdueafterthecommencementdate.

Withadiscountrateof8%,discountfactorsforone,two,threeandfouryearsare0.926(1/1.08),0.85 7($1/1.08^2$),0.794($1/1.08^3$)and0.735($1/1.08^4$)respectively(seeChapter2).Thesumofthesefact orsis3.312.Therefore thepresentvalueof£40,000tobepaidon1Januaryeachyearfrom2020to2 023inclusiveis£132,480(3.312×£40,000).

Theinterestexpenseforeachyearoftheleaseandtheoutstandingliabilityattheendofeachyearar

ecalculatedasfollows:

Year	*Liability b/f*		*Lease payment*		*Balance*		*Interestexpense @8%*		*Liability c/f*
	£		£		£		£		£
2019	132,480	–	(0)	=	132,480	+	10,598	=	143,078
2020	143,078	–	(40,000)	=	103,078	+	8,246	=	111,324
2021	111,324	–	(40,000)	=	71,324	+	5,706	=	77,030
2022	77,020	–	(40,000)	=	37,030	+	2,970	=	40,000
2023	40,000	–	(40,000)	=	0	+	0	=	0

Notes:

(i) Theinterestexpensefor2022hasbeenroundedupslightlytoensurethattheliabilityreducestoexactlyzeroafterthefinalleasepaymentismade.Thisisnecessarybecausethediscountfactorswereroundedtothreedecimalplaces.

(ii) Theliabilityattheendofeachyearshouldbesplitintoacurrentliabilityandanon-currentliability.Forinstance,theliabilityattheendof2019issplitintoacurrentliabilityof£40,000andanon-currentliabilityof£103,078.

On1January2019,thecompanyshouldalsorecognisearight-of-useasset.Thisassetismeasuredinitiallyat£172,480(£132,480plusthe£40,000paidonthecommencementdate).Assumingthattheleasedoesnottransferownershipofthebuildingtothecompanybytheendoftheleaseterm,theassetshouldbedepreciatedbetween1January2019andthe*earlier*oftheendoftheleaseterm(31December2023)andtheendoftheusefullifeoftheright-of-useasset.

Presentationanddisclosurerequirementsforlessees

IFRS16 requires that lessees should either present right-of-use assets separately from other assets in the statement of financial position or disclose the line items in which right-of-use assets are included. Similarly, lessees should either present lease liabilities separately from otherliabilitiesinthestatementoffinancialpositionordisclosethelineitemsinwhich lease liabilities are included. The interest on lease liabilities should be included in financecosts in the statement of comprehensive income.

TheIFRS16disclosurerequirementsforlesseesareveryextensive.Amongstother things,alesseeshoulddisclosethefollowingamountsforthereportingperiod:

(a) thedepreciationchargeforright-of-useassets,analysedbyclassofunderlyingasset

(b) theinterestexpenseonleaseliabilities

(c) the expenses relating to leases of short term assets and leases of low-value items forwhichthelesseehaselectednottorecognisearight-of-useassetandaleaseliability

(d) thecarryingamountofright-of-useassetsattheendofthereportingperiod,analysed by class of underlying asset.

A lessee should also provide a maturity analysis of lease liabilities and should disclose any further information necessary to ensure that users of the financial

statements can assess the effectofleasesonthelessee'sfinancialposition,financialperformanceandcashflows.

Leaseaccountingbylessors

IFRS16requiresthatlessorsshouldclassifyeachoftheirleases (attheinceptiondate)as eithera"financelease"oran"operatinglease".Thesetermsaredefinedasfollows:

(a) A finance lease is "*Aleasethattransferssubstantiallyalltherisksandrewardsincidentaltoownershipofanunderlyingasset*".

(b) An operating lease is "*Aleasethatdoesnottransfersubstantiallyalltherisksandrewardsincidentaltoownershipofanunderlyingasset*".

As these definitions make clear, the classification of a lease concentrates on the extent towhichthe"risksandrewards"normallyassociatedwithownershipoftheunderlyingasset lie with the lessor or the lessee. Risks include the possibility of losses from idle capacity or technologicalobsolescence.Rewardsincludetheexpectationofprofitableoperationover the asset's useful life and gain from any appreciation in its value. Situations which would normallyleadtoaleasebeingclassifiedasafinanceleaseinclude:

(a) theleasetransfersownershipoftheassettothelesseebytheendoftheleaseterm

(b) thelesseehastheoptiontopurchasetheassetatapriceexpectedtobesufficiently lowerthantheasset'sfairvalueonthedatethattheoptionisexercisable,soasto makeitreasonablycertain(attheinceptiondate)thatthisoptionwillbeexercised

(c) theleasetermisforthemajorpartoftheeconomiclifeoftheasset

(d) at the inception date, the present value of the lease payments amounts to (at least) substantiallyall ofthefairvalueoftheunderlyingasset

(e) theunderlyingassetisofsuchaspecialisednaturethatonlythelesseecanuseit without major modifications.

However,thefactorsillustratedbytheseexamplesarenotalwaysconclusive.Ifitisclear fromotherfeaturesoftheleaseagreementthataleasedoesnottransfersubstantiallyallof therisksandrewardsofownership,thentheleasewillbeclassifiedasanoperatinglease.

Leasesoflandandbuildings

Foraleaseofbothlandandbuildings,thelandelementandthebuildingselementshould be considered separately for the purposes of lease classification. In such a case, the lease paymentsareallocatedbetweentheelementsoftheleaseinproportiontothefairvaluesof theleaseholdinterestsinthelandelementandthebuildingselementattheinceptiondate.

Leasesoflandareclassifiedaseitherfinanceleasesoroperatingleasesinthesameway asotherassets.However,landnormallyhasanindefiniteeconomiclifeandsoaleaseof landcannotbefor"themajorpartoftheeconomiclifeoftheasset".Nonetheless,therisks andrewardsincidentaltotheownershipoflandcanbetransferredtoalesseeiflegaltitle is expected to be transferred by the end of the lease term or if the lease is for such a

longperiod(e.g.severaldecades)thatthepresentvalueoftheresidualvalueofthelandatthe end of the lease is negligible.

Recognitionandmeasurementforfinanceleases

Atthecommencementdateofafinancelease,thelessorisrequiredtorecognisetheasset heldundertheleaseasareceivableequaltothe"netinvestment"inthelease.Thisamount is initially measured at the present value of:

(a) theleasepaymentsreceivablebythelessorafterthecommencementdate,plus
(b) theestimatedresidualvalueoftheunderlyingassetforthelessor(ifany)attheendof the lease term.

Thediscountrateusedinthiscalculationistheinterestrateimplicitinthelease.Because ofthewayinwhichthisrateisdetermined(seeearlier)thenetinvestmentfigurewillbe equalinamounttothefairvalueoftheunderlyingassetatthecommencementdate,less anypaymentsreceivedfromthelesseeonorbeforethatdate,plusanyinitialdirectcosts borne by the lessor.

Subsequently, the income element of each payment made by the lessee is recognised as financeincomeinthelessor'sstatementofcomprehensiveincome.Theremainderofthe lease payment reduces the amount owed by the lessee. The way in which finance income is allocatedtoaccountingperiodsshouldgiveaconstantperiodicrateofinterestonthe lessor'snetinvestmentinthelease.Attheendoftheleaseterm,thenetinvestmentfigure willbeequaltoanyresidualvalue(forthelessor)oftheunderlyingasset.

EXAMPLE3

On1January2019,alessorcompanywhichpreparesaccountsto31Decemberbuysafactorymac hinefor£138,000andimmediatelygrantsathree-yearfinanceleaseofthismachinetoalessee.Requiredleasepaymentsare£50,000perannum.Th esepaymentsfalldueon31December2019,2020and2021.

Afterthreeyears,themachinewillreturntothelessorwithanestimatedresidualvalueof £10,000andaremainingeconomiclifeoflessthanoneyear.Thelessor'sinitialdirectcostsare£1,3 60andtheinterestrateimplicitintheleaseis7%perannum.

Explainhowthisleaseshouldbeaccountedforbythelessorinaccordancewiththerequirementso fIFRS16.

Solution

On1January2019,thelessorshouldrecogniseareceivableequaltothepresentvalueofthethreele asepaymentsandtheresidualvalueofthemachineattheendofthelease.

Discountfactorsforone,twoandthreeyearsare0.935(1/1.07),0.873($1/1.07^2$)and0.816($1/1.07^3$) respectively.Thesumofthesefactorsis2.624.Thereforethepresentvalueofthethreeleasepaym entsis£131,200(2.624×£50,000).Thepresentvalueoftheresidualvalueofthemachineis£8,160(0.816×£10,000)sothereceivableisinitiallymeasuredat £139,360(£131,200+£8,160).

Financeincomeforeachyearoftheleaseandthebalanceofthereceivableattheendofeachyearar ecalculatedasfollows:

Year	*Receivable b/f*		*Financeincome @7%*		*Lease payment*		*Receivable c/f*
	£		£		£		£
2019	139,360	+	9,755	–	(50,000)	=	99,115
2020	99,115	+	6,938	–	(50,000)	=	56,053
2021	56,053	+	3,947	–	(50,000)	=	10,000

Notes:

(i) Asexpected,thebalanceattheendoftheleasetermisequaltotheresidualvalueoftheunderly ingasset.Ifthelessornowsellsthemachine,anyamountbywhichsaleproceedsdifferfrom£ 10,000isaprofitorlossondisposal.

(ii) Financeincomefor2021hasbeenroundeduptoensurethatthereceivableisexactly £10,000afterthefinalleasepaymentismade.Thisisnecessarybecausethediscountfactor swereroundedtothreedecimalplaces.

Recognitionandmeasurementforoperatingleases

If a lease is classified as an operating lease, the underlying asset should be shown in thelessor'sfinancialstatementsanddepreciatedasusual.Theleasepaymentsmadebythe lessee are recognised as income, generally on a straight-line basis over the lease term. Any direct costs incurred by the lessor on arranging an operating lease should be added to the carryingamountoftheassetconcernedandwrittenoffovertheleaseterm.

Presentationanddisclosurerequirementsforlessors

ThemaindisclosurerequirementsofIFRS16forlessorsareasfollows:

(a) **Financeleases**:
- theamountoffinanceincomeforthereportingperiod
- amaturityanalysisofleasepaymentsreceivable,showingundiscountedamounts to be received in each of the following five years and the total to be received in remainingyears(reconciledtothenetinvestmentinfinanceleases)

(b) **Operatingleases**:
- theamountofleaseincomeforthereportingperiod
- amaturityanalysisofleasepaymentsreceivable,showingundiscountedamounts to be received in each of the following five years and the total to be received in remaining years

There should also be additional qualitative and quantitative information with regard to the nature of the lessor's leasing activities and the way in which the lessor manages the risks associatedwithanyrightsthatitretainsinunderlyingassets.

Saleandleasebacktransactions

A sale and leaseback transaction occurs when an entity (the "seller-lessee") sells an asset to anotherentity(the"buyer-lessor")andthenimmediatelyleasestheassetbackfromthat other entity. The outcome of such a transaction is that the seller-lessee continues to use theassetconcernedforaperiodoftime,eventhoughithasbeensoldtothebuyer-lessor.

The accounting treatment of sale and leaseback transactions depends upon whether the transfer of the asset to the buyer-lessor qualifies as a genuine sale, in accordance with the requirementsofIFRS15*RevenuefromContractswithCustomers*(seeChapter13).For thistobethecase,thebuyer-lesseemustobtaincontroloftheasset,beforethenleasingit backtotheseller-lessee.ControlisdefinedbyIFRS15as"*theabilitytodirecttheuseof,andobtainsubstantiallyallo ftheremainingbenefitsfrom,theasset*".Therequirementsof IFRS16withregardtosaleandleasebacktransactionsarebroadly†asfollows:

(a) **Transferoftheassetisasale**.Ifthetransferqualifiesasasale(i.e.thebuyer-lessor hasobtained control), the seller-lessee should derecognise the transferred asset and recognisearight-of-useassetinstead.Thisright-of-useassetismeasuredinitiallyat theproportionofthepreviouscarryingamountofthetransferredasset"*thatrelatestotheri ghtofuseretainedbytheseller-lessee*".Theprofit/lossondisposalisrestricted inproportion"*totherightstransferredtothebuyer-lessor*"(seeexamplebelow).

The buyer-lessor accounts for the purchase of the asset by applying the relevantstandard (e.g. IAS16 *Property,PlantandEquipment*) and accounts for the lease to the seller-lessee by applying IFRS16.

(b) **Transferoftheassetisnotasale**.Ifthetransferoftheassetdoesnotqualifyasa sale (i.e. the buyer-lessor has notobtained control), the seller-lessee must continue to recognise the transferred asset. The buyer-lessor should not recognise this asset. The transferproceedsaretreatedasaloanandarerecognisedasafinancialliabilityfor theseller-lesseeandafinancialassetforthebuyer-lessor(seeChapter11).

†*Foratransferwhichqualifiesasasale,furtheradjustmentsarerequiredifthesaleisnotatfairvalueoriftheleasepaymentsarenotatmarketrates*.

EXAMPLE4

On1July2019,aseller-lesseewhichpreparesaccountsto30Junesellsabuildingtoabuyer-lessorfor£500,000(whichisitsfairvalue).Onthesamedate,theseller-lesseeentersintoacontractwiththebuyer-lessortoleasebackthebuildingforaperiodoffiveyears.Thepresentvalueoftheleasepayments(whicharepayableon30June2020,2021,2022,2023and2024)is£105,000.Theseleasepaymentsareatmarketrate.

Immediatelybeforethistransaction,thebuildinghadacarryingamountof£400,000.Thetransfer

ofthebuildingtothebuyer-lessorqualifiesasasaleinaccordancewithIFRS15andthebuyer-lessorclassifiestheleasebackasanoperatinglease.

Explainhowthistransactionshouldbeaccountedforon1July2019bytheseller-lesseeandbythebuyer-lessor(ignoreinitialdirectcosts).

Solution

Iftheassethadbeensoldwithoutaleaseback,thesellerwouldhaverecognisedaprofitonsaleof£100,000.Buttherightofuseretainedbytheseller-lesseerepresents21%ofthefairvalueoftheassetonthecommencementdateofthelease,so21%oftheprofitonsale(£21,000)cannotberecognisedimmediately.Instead,this£21,000issubtractedfromtheright-of-useassetrecognisedbytheseller-lesseeon1July2019,sothattheright-of-useassetbecomes£84,000.Effectively,£21,000oftheprofitonsaleisspreadoverthenextfiveyearsintheformofreduceddepreciationcharges.Insummary,thesaleandleasebacktransactionisaccountedforbytheseller-lesseeasfollows:

DrBank£500,000,DrRight-of-useasset£84,000
CrBuilding£400,000,CrProfitonsale£79,000,CrLeaseliability£105,000

On1July2019,thebuyer-lessorrecognisesthebuildingatitscostof£500,000.Theleasepaymentswillberecognisedasincomeovertheleaseterm.

Summary

- Inmostcases,IFRS16(whichreplacesIAS17)requiresthatlesseesshouldrecognise a right-of-use asset and a lease liability at the commencement of a lease. But there are exceptionsforleasesof12monthsorlessandforleasesoflow-valueassets.
- Aright-of-useassetismeasuredinitiallyatcost.Thisincludestheinitialamountof theleaseliability,leasepaymentsmadeonorbeforetheleasecommencementdate andinitialdirectcosts(ifany)bornebythelessee.Subsequentmeasurementis usuallyatcostlessaccumulateddepreciationandaccumulatedimpairmentlosses.
- Aleaseliabilityis initiallymeasuredat thepresent valueof theleasepayments which fall due after the date of commencement of the lease. These payments are generally discounted at the interest rate implicit in the lease.
- Each lease payment made by the lessee should be apportioned between the interest (financecharge)elementandtheamountwhichreducestheleaseliability.Intereston theleaseliabilityshouldbecalculatedsoastoproduceaconstantperiodicrateof interest on the remaining balance of the liability.
- IFRS16requiresthatlessorsshouldclassifyleasesaseitherfinanceleasesor operatingleases.Afinanceleaseisonewhichtransferssubstantiallyalloftherisks andrewardsincidentaltoownershipoftheunderlyingasset.
- Onthecommencementofafinancelease,thelessorrecognisesthe "netinvestmentin thelease"asthepresentvalueoftheleasepaymentsreceivableplusthepresentvalue of the estimated residual value of the asset (if any). The income element of each lease payment is then recognised as finance income.
- Lease payments receivable by a lessor in connection with an operating lease are recognisedasincome,generallyonastraightlinebasisovertheleaseterm.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

9.1 (a) Definetheterm"lease"inaccordancewithIFRS16*Leases*andexplainwhatis meant by the inception of a lease and the commencement of a lease.

(b) Distinguishbetweenlessorsandlessees.

(c) Define the term"right-of-use asset". Explain howa right-of-use asset and a lease liability are measured at the commencement of a lease.

(d) Outline the circumstances in which a lessee is notrequired to recognise a right-of- use asset and a lease liability at the commencement of a lease.

9.2 On 1 July 2019, Helvelyn Ltd enters into a lease to acquire use of a machine. The lease agreement specifies that the company will make four lease payments, each of £45,303,on 30 June 2020, 2021, 2022 and 2023. The interest rate implicit in the lease is 14% per annum. Helvelyn Ltd prepares accounts to 30 June each year.

(a) Calculatethefinancechargewhichshouldbeshownasanexpenseinthecompan y's financial statements for each of the years to 30 June 2020, 2021, 2022 and2023.Alsoshowhowtheliabilitytothelessorshouldbepresentedinthe statement of financial position of Helvelyn Ltd on 30 June 2020.

(b) Calculatetheinitialamountoftheright-of-useassetandexplainhowthisasset should be measured subsequently in the company's financial statements, assuming that legal ownership of the machine is not transferred to Helvelyn Ltd at the end of the lease term.

9.3 On1January2019,CrimmockLtd(whichpreparesaccountsto31December)entersint o a four-year lease of office machinery. The company is required to make four lease payments of £30,000 and these fall due on 1 January 2019, 2020, 2021 and 2022. The rate of interest implicit in the lease is 9% per annum.

Explain how thislease should be accounted forby Crimmock Ltd in accordance with the requirements of IFRS16 *Leases*.

9.4 On1April2020,EndaleLtd(whichpreparesaccountsto31Marcheachyear)entersinto aleaseofcomputerequipment.Thecompanyisrequiredtomakesixhalf-yearly lease payments of £7,674 each and the first payment falls due on 1 April 2020. The rate of interest implicit in the lease is 6% *perhalf-year*.

Calculate the finance charge which should be recognised as an expense in the company's financial statements for each of the years to 31 March 2021, 2022 and 2023 (*prepareatablewithonerowforeachhalf-year*). Also calculate the initial amount of the right-of- use asset that should be recognised on 1 April 2020.

9.5 On1January2019,GlassmereLtd(whichpreparesaccountsto31December)entersinto a lease for the use of an asset. Details of the lease agreement are as follows:

Leaseterm	5years
InitialdirectcostsbornebyGlassmereLtd	£500
Paymentsdueannuallyinadvance	£6,595each
Usefullifeofunderlyingasset(forGlassmereLtd)	7years
Residualvalueatendofusefullife	£3,000
Rateofinterestimplicitinlease	10%perannum

Glassmere Ltd will obtain legal ownership of the asset at the end of the lease term. The company calculates depreciation on the straight-line basis.

Calculate the finance charge and the depreciation charge which should be shown in the company's financial statements for each of the years to 31 December 2019, 2020, 2021, 2022 and 2023. Also calculate the liability to the lessor at the end of each year and show how this should be split between current liabilities and non-current liabilities.

9.6 On 1 January 2020, Lessor plc leases a machine to Lessee Ltd. The lease term is three yearsandleasepaymentsof£1,000permontharerequired.Themachinehasausefullife of eight years and its fair value at 1 January 2020 is £50,000.

(a) Explainwhythisleaseisanoperatinglease.

(b) Explain how the machine itself and the lease payments should be dealt with in the financial statements of Lessor plc, assuming that the company prepares accounts to 30 June each year.

***9.7** On 1 October 2019, Conston Ltd (which prepares accounts to 30 September) leases an assettoalessee.Theleasetermisfiveyearsandthelesseeisrequiredtomakelease paymentsof£27,500eachon1October2019,2020,2021,2022and2023.Thefairvalue of the asset on 1 October 2019 is £112,500. Conston Ltd incurs initial direct costs of £430 and the rate of interest implicit in the lease is 12.5%.

Attheendoftheleaseterm,ownershipoftheassetwillremainwithConstonLtd,by which time the asset is expected to have come to the end of its economic life and to have a scrap value of £5,000.

Required:

(a) Explainwhythisleaseisafinanceleaseandnotanoperatinglease.

(b) Calculatethenetinvestmentintheleaseatcommencement.

(c) Calculatethefinanceincomewhichshouldberecognisedinthefinancialstatements of Conston Ltd for each of the five years of the lease term.

***9.8** IFRS16*Leases*replacesIAS17*Leases*foraccountingperiodsbeginningonorafter1 January2019.Themainaimofthenewstandardistoensurethatalessee'sfinancial statements provide a faithful representation of the lessee's financial position†.

(a) Outline the way in which IFRS16 requires lessees to account for leases and explain why this provides a faithful representation.

(b) ExplaintherecognitionexemptionsavailableinIFRS16.Arelesseesrequiredto take advantage of these exemptions?

On 1 April 2019, Triste Ltd (which prepares accounts to 31 March) enters into a three- yearleaseofamotorlorry.Thecompanyisrequiredtomakealeasepaymentof £50,000 on 1 April 2019 and three further lease payments of £42,500 each on 31 March 2020, 2021 and 2022. The company also incurs initial direct costs of £940. Legal title to the lorry will be transferred to Triste Ltd at the end of the lease term. The rate of interest implicit in the lease is 11% per annum.

(c) Explain (with calculations) how this lease should be accounted for in the financial statements of Triste Ltd for each of the three years to 31 March 2022.

(d) How should the lessor account for this lease? Assume that the lorry has a fair value at inception of £153,000 and that the lessor incurs initial direct costs of £870.

†*Inthecaseofoperatingleases,IAS17requiredlesseessimplytorecognisetheleasepaymentsasanexpenseovertheperiodofthelease.Suchleaseswerenotreflectedinthelessee'sstatementoffinancialpositionatall(apartfromtherecognitionofanyaccruedorprepaidleasepayments).*

Chapter10

Inventories

Introduction

In general terms, inventories are stocks of goods. For a manufacturing business, these will usually consist of raw materials, partly-completed products (work in progress) and finished products awaiting sale to customers. For a retailer or wholesaler, inventories will comprise mainly stocks of goods acquired for resale.

The value placed on inventories affects the cost of sales figure shown in the statement of comprehensiveincomeandsohasadirectimpactonreportedprofit.Furthermore,the value of inventories is often very significant, so that even a small percentage error in their measurement could lead to a material mis-statement of profit. IAS2 *Inventories*provides guidanceonthevaluationofinventoriesandthepurposeofthisshortchapteristoexplain the main requirements of that standard.

Contractswithcustomers

IFRS15 *RevenuefromContractswithCustomers*prescribes the accounting treatment of customer contracts. This standard identifies the circumstances in which a sale of goods is deemedtohaveoccurred,sothatsalesrevenueisrecognisedandtheassociatedinventories arederecognised.TherequirementsofIFRS15areexplainedinChapter13ofthisbook.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- definetheterm"inventories"anddeterminethecostofinventoriesinaccordancewith the requirements of IAS2 *Inventories*
- applycostformulassuchasfirst-in,first-outandweightedaveragecost
- determinethenetrealisablevalue ofinventoriesandcorrectlymeasureinventoriesat the lower of cost and net realisable value
- list themaindisclosuresrelatingtoinventories that shouldbemadeinthenotes tothe

financial statements.

Inventories

IAS2definesinventoriesas"*assets:*

(a) heldforsaleintheordinarycourseofbusiness;

(b) intheprocessofproductionforsuchsale;or

(c) intheformofmaterialsorsuppliestobeconsumedintheproductionprocessorintherenderingofservices".

The standard also prescribes a well-known rule for the valuation of inventories. This rule isthat "*inventoriesshallbemeasuredatthelowerofcostandnetrealisablevalue*". The remainderofIAS2providesguidanceonthedeterminationofthecostandnetrealisable valueofinventoriesandmakescertaindisclosurerequirements.

Costofinventories

IAS2 states that the cost of inventories "*shallcompriseallcostsofpurchase,costsofconversionandothercostsincurredinbringingtheinventoriestotheirpresentlocationandcondition*". Note the following points:

(a) Costs of purchase consist of the purchase price of inventories, including import dutiesand other taxes (if these are irrecoverable), transport and handling costs and any other costsdirectlyattributabletotheacquisitionofthegoodsconcerned.Tradediscounts are deducted when calculating costs of purchase.

(b) Costsofconversionarerelevantmainlytomanufacturingbusinessesandconsistof directcostsofproduction(suchasdirectlabour)togetherwithasystematicallocation offixedandvariableoverheadsincurredinconvertingmaterialsintofinishedgoods. Fixedproductionoverheadsareindirectproductioncoststhatremainrelatively constant regardless of the volume of production (e.g. factory rent and rates). Variable productionoverheadsareindirectproductioncoststhatvarymoreorlessinlinewith thevolumeofproduction,suchasindirectmaterialsandsomeindirectlabourcosts.

(c) Theallocationoffixedproductioncoststounitsofproductionshouldbebasedupon the normal capacity of the production facilities.

  (i) If production is abnormally low, there will be unallocated fixed production overheads. These should be recognised as an expense in the period in which theyareincurredandshould*not*beincludedinthecostofinventories.

  (ii) If production is abnormally high, the amount of fixed production overheadsallocated to each item of production should be decreased so as to ensure that thecost of inventories is not overstated.

(d) Certaincostsareexplicitlyexcludedfromthecostofinventories.Themainitemsare:

(i) thecostsofabnormalwastageofmaterials,labourorotherproductioncosts

(ii) storagecosts,unlessthesecostsarenecessaryintheproductionprocessbeforea further production stage

(iii) administrativeoverheadsthatdonotcontributetobringinginventoriestotheir present location or condition

(iv) sellingcosts.

(e) Techniquessuchasstandardcostingandtheretailmethodmaybeusedtodetermine thecostofinventories,solongastheyprovideareasonableapproximationtocost.

(i) Standard costs are computed in accordance with normal prices and usage of materials, labour etc. and normal levels of efficiency. Standard costs should be reviewed regularly and revised if necessary.

(ii) The retail method is often used in the retail industry for measuring inventorieswhich consist of large numbers of rapidly changing items with similar profit margins. This method determines the cost of inventories by reducing their salesvalue by the appropriate percentage profit margin.

EXAMPLE1

Amanufacturingcompany'sinventoryattheendofanaccountingperiodincludesafinishedprodu ctwiththefollowingcoststodate:

	£
Purchasepriceofmaterials	9,000
Less:5%tradediscount	450
	8,550
Importdutyat10%	855
Directlabourcosts	5,850
Allocationoffixedproductionoverheads	
2,840Storagecostssinceproductcompleted	225
Advertisingcosts	317
Totalcost	18,637

Notes:

(i) AllofthesecostsexcludeVAT.ThecompanyisabletorecoveranyVATwhichitischargedbyit ssuppliersbutcannotrecoverimportduties.

(ii) One-thirdofthematerialsincludedabovewerewastedastheresultofanabnormalmachinemalfu nction.

(iii) Fixedproductionoverheadsareallocatedtoproductsontheassumptionthatproductionisru nningatnormalcapacity.Infact,productionwasunusuallylowduringtheperiodinwhichthis productwasmadeandafurtherallocationof£820wouldberequirediffixedoverheadswerea llocatedonthebasisofactualproduction.

(iv) Theadvertisingcostswereincurredwhilsttryingtofindabuyerfortheproduct.Nobuyerhadb eenfoundbytheendoftheaccountingperiod.

CalculatethecostofthisproductinaccordancewiththerequirementsofIAS2.

Solution

Forinventoryvaluationpurposes,thecostoftheproductisasfollows:

	£
Purchasepriceofmaterials,netoftradediscount	5,700
Importdutyat10%	570
Directlabourcosts	5,850
Allocationoffixedproductionoverheads	2,840
Totalcost	14,960

Notes:

(i) RecoverableVATisnotacosttothecompanyandisthereforeexcludedfromthecostofinvent ories.

(ii) Thecostofabnormalwastageisalsoexcludedfromthecostofinventories.Thecostofthere mainingtwo-thirdsofthematerialswas£5,700(2/3x£8,550).

(iii) Thefurther£820offixedproductionoverheadsistreatedasanexpenseandisnotincludedint hecostofinventories.

(iv) Thestoragecostswereincurredafterproductionwascomplete.Theadvertisingcostsarese llingcosts.Neitherofthesecanbeincludedinthecostofinventories.Further- more,thefailuretofindabuyerfortheproductmaycastdoubtonitsnetrealisablevalue(seelat erinthischapter).

Costformulas

In general, IAS2 requires that the cost of inventory items should be ascertained "*byusingspecificidentificationoftheirindividualcosts*".Inotherwords,eachitemofinventor y shouldbeconsideredseparatelyanditscostshouldbeindividuallyestablished.

However, it is not always possible to distinguish one inventory item from another. For instance,abusinessmayhaveaninventoryofidenticalmachinepartswhichhavebeen boughtondifferentdatesandatdifferentprices.Insuchacase,itisfrequentlyimpossible todeterminethecostofeachindividualitemwithanycertainty.IAS2referstosuchitems as "interchangeable" and requires that their cost should be ascertained by means of a cost formula. Two cost formulas are allowed. These are:

(a) **First-in,first-out(FIFO)**. The FIFO formula assumes that inventory items which are purchasedorproducedfirstaresoldorusedfirst,sothattheitemsremainingatthe endofanaccountingperiodarethosemostrecentlypurchasedorproduced.

(b) **Weightedaveragecost(AVCO)**. Use of the AVCO formula generally involves computinganewweightedaveragecostperitemaftereachacquisitiontakesplace. Thecostoftheitemsremainingattheendofanaccountingperiodisthencalculated byusingthemostrecently-computedweightedaveragecostperitem.

IAS2 allows either of these cost formulas to be used and there is no requirement that thechoice of formula should mirror the actual physical flow of the items concerned. However, thereisarequirementthatthesamecostformulashouldbeusedforallinventorieshaving a similar nature and use.

LIFOnotallowed

ItisimportanttonotethatIAS2does*not*allowtheuseoflast-in,first-out(LIFO).This costformulaassumesthatthenewestinventoryitemsaresoldorusedfirst,sothatthe itemsremainingattheendofanaccountingperiodaretheoldest.IAS2objectstothe LIFO formula for a number of reasons:

(a) LIFOisgenerallynotareliablerepresentationofactualinventoryflows.

(b) TheuseofLIFOisoftentax-driven,sinceitmatchessalesrevenueagainstthecostof the newest items acquired. In times of rising prices, this will result in lower reported profits and a lower tax liability (so long as the tax authorities will accept LIFO for tax purposes).However,theIASBtakestheviewthattaxconsiderationsdonotprovide anadequateconceptualbasisfortheselectionofanaccountingtreatment.

(c) TheuseofLIFOresultsininventoriesbeingshowninthefinancialstatementsat values which bear little relation to recent cost levels.

Even though the use of LIFO has been eliminated, IAS2 does not rule out "*specificcostmethodsthatreflectinventoryflowsthataresimilartoLIFO*".Forinstance,inven tories maybeheldinpilesorbinswhicharebothdepletedandreplenishedfromthetop.Insuch acase,itcouldbearguedthatthereisnoneedtoapplyacostformulaatall,sincethe itemsremainingonthepileorinthebincanbeclearlyidentified.Aspecificcosting approachwhichreflectedthephysicalflowofitemsinthesecircumstanceswouldnotbe ruled out purely because it gave similar results to LIFO.

EXAMPLE2

On1April2019,acompany'sinventoryincluded12,000brickswhichhadbeenacquiredfor£140pe rthousand.Purchasesandsalesofbricksduringtheyearto31March2020wereasfollows:

Purchases	*Numberbought*	*Costperthousand*	*Sales*	*Numbersold*
		£		
14July2019	10,000	142	26August2019	16,000
11October2019	8,000	145	5November2019	7,000
19January2020	15,000	147	12March2020	17,000

Calculatethecostofthebrickssoldduringtheyearandthecostoftheinventoryofbricksremainingat31March2020,using:

(a) first-in,first-out(FIFO)

(b) last-in,first-out(LIFO)

(c) weightedaveragecost(AVCO).

Whichofthesethreecostformulasshouldthecompanyuse?

Solution

(a)**FIFO**

	Numberofbricks			*Cost(£)*
Sold26August	16,000	12,000@14.0p	1,680	
		4,000@14.2p	568	2,248
Sold5November	7,000	6,000@14.2p	852	
		1,000@14.5p	145	997
Sold12March	17,000	7,000@14.5p	1,015	
		10,000@14.7p	1,470	2,485
Costofgoodssold				5,730
Inventoryat31March	5,000	5,000@14.7p		**735**

(b)**LIFO**

	Numberofbricks			*Cost(£)*
Sold26August	16,000	10,000@14.2p	1,420	
		6,000@14.0p	840	2,260
Sold5November	7,000	7,000@14.5p		1,015
Sold12March	17,000	15,000@14.7p	2,205	
		1,000@14.5p	145	
		1,000@14.0p	140	2,490
Costofgoodssold				5,765
Inventoryat31March	5,000	5,000@14.0p		**700**

(c) AVCO

	Numberof Bricks		*Total cost*	*Weighted average*	*Cost(£)*
Openinginventory	12,000	@14.0p	1,680		
Bought14July	10,000	@14.2p	1,420		
	22,000		3,100	14.09p	
Sold26August	16,000	@14.09p	2,254		2,254
	6,000		846		
Bought11October	8,000	@14.5p	1,160		
	14,000		2,006	14.33p	
Sold5November	7,000	@14.33p	1,003		1,003
	7,000		1,003		
Bought19January	15,000	@14.7p	2,205		
	22,000		3,208	14.58p	
Sold12March	17,000	@14.58p	2,479		2,479
Costofgoodssold					5,736
Inventoryat31March	5,000	@14.58p	729		**729**

ThecompanymayuseeitherFIFOorAVCObutmustusethesamecostformulaforallinventoriesofasimilarnatureanduse.ThebusinessisnotallowedtouseLIFO.

Netrealisablevalue

Asstatedabove,IAS2requiresthatinventoriesshouldbemeasuredatthelowerofcost andnetrealisablevalue.Netrealisablevalue(NRV)isdefinedas"*estimatedsellingpriceintheordinarycourseofbusinesslesstheestimatedcostsofcompletionandtheestimatedcostsnecessarytomakethesale*".Theeffectofmeasuringinventoriesatthelowerofcost and NRV is that any loss expected on the sale of items at less than cost is accounted for immediatelyratherthanwhentheitemsaresold.Notethat:

(a) ThecostsandNRVofinventoriesarenormallycompareditembyitem.However, IAS2 accepts that it may sometimes be appropriate to group similar or related items togetherandtocomparethetotalcostofthegroupwithitstotalNRV.

(b) Materialsandothersuppliesheldforuseinproductionarenotwrittendownbelow costsolongasthefinishedproductsinwhichtheywillbeincorporatedareexpected to be sold at cost or above.

EXAMPLE3

Theinventoryofamotorvehiclesdealerattheendofanaccountingperiodincludesthefollowingusedvehicles:

	Costsincurredtodate	*Expectedfurthercostsbeforesale*	*Expectedsellingprice*
	£	£	£
VehicleA	14,200	1,250	18,000
VehicleB	17,500	1,000	20,000
VehicleC	11,900	1,240	14,000
VehicleD	13,000	2,760	15,000

Thedealer'ssalesstaffarepaidacommissionwhentheysellavehicle.Thiscommissioniscalculatedat5%ofsellingprice.Calculatethevalueatwhichtheseitemsshouldbeshowninthedealer'sfinancialstatements.

Solution

	Cost	*NRV*	*LowerofcostandNRV*
	£	£	£
VehicleA	14,200	(18,000x95%)–1,250=15,850	14,200
VehicleB	17,500	(20,000x95%)–1,000=18,000	17,500
VehicleC	11,900	(14,000x95%)–1,240=12,060	11,900
VehicleD	13,000	(15,000x95%)–2,760=11,490	11,490
	56,600	57,400	55,090

ForvehiclesA,BandC,costislessthanNRV,sothesevehiclesarevaluedatcost.ButthecostofvehicleDexceedsitsNRV,sothisvehiclemustbevaluedatNRV.Theclosinginventoryshouldbevaluedatatotalof£55,090.Itwouldnotbepermissibletovaluethevehiclesattheloweroftotalcostandtotal NRV(i.e.£56,600).

Disclosuresrelatingtoinventories

ThemaindisclosuresrequiredbyIAS2areasfollows:

(a) theaccountingpoliciesadoptedinmeasuringinventories,includingcostformulas

(b) the total carrying amount of inventories (i.e. the amount at which the inventories are shown or "carried" in the entity's financial statements) together with an analysis into appropriate categories

(c) theamountofinventoriesrecognisedasanexpenseduringtheperiod

(d) theamountofanywrite-downtonetrealisablevalueduringtheperiodandthe amount of any reversal of previous write-downs.

Thesedisclosureswillbemadeinthenoteswhichformpartofthefinancialstatements.

Summary

- International standard IAS2 defines "inventories" and requires that inventories are measured at the lower of cost and net realisable value.
- Thecostofinventoriescomprisescostsofpurchase,conversioncostsandanyother costsincurredinbringingtheinventoriestotheirpresentlocationandcondition.
- The cost of interchangeable inventory items should be established by use of a cost formula.Permittedformulasarefirst-in,first-outandweightedaveragecost.Theuse of last-in, first-out is not permitted.
- The net realisable value of inventories is their estimated selling price in the ordinary courseofbusiness,lessestimatedcostsofcompletionandsellingcosts.
- IAS2makescertaindisclosurerequirementswithregardtoinventories.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

10.1 (a) Explaintheterm"inventories"asdefinedbyinternationalstandardIAS2.

(b) Listthecostswhichshouldbeincludedwhenmeasuringthecostofinventoriesand identify any costs which should be excluded.

(c) Explaintheterm"netrealisablevalue"inrelationtoinventories.

10.2 (a)Identifythecircumstancesinwhichacostformulamaybeusedtoestablishthe cost of inventories.

(b) A company's inventories at 30 April 2020 include 11,000kg of a chemical which is usedinthecompany'smanufacturingprocesses.Purchasesandissuesofthis chemical during the year to 30 April 2020 were as follows:

		Numberofkg	*Costperkg*
May2019	Openinginventory	32,000	£7.50
June2019	Issuedtoproduction	25,000	
August2019	Purchased	15,000	£8.75
September2019	Issuedtoproduction	12,000	
October2019	Issuedtoproduction	5,000	
January2020	Purchased	10,000	£9.50
February2020	Issuedtoproduction	4,000	

Calculatethecostofthecompany'sinventoryofthechemicalat30April2020 using each of the following cost formulas:

(i) first-in,first-out(FIFO)

(ii) weightedaveragecost(AVCO).

10.3 Kellerstone Ltd buys used machines which it reconditions and sells on to customers. The company'sinventoryattheendofitsmostrecentaccountingperiodincludedthe following machines:

	Purchase price	*Reconditioning costsbefore todate*	*Expectedfurther costsincurred before selling*	*Expected sale price*
	£	£	£	£
MachineW	10,300	650	-	12,500
MachineX	15,750	850	400	17,500
MachineY	18,450	500	2,100	23,000
MachineZ	8,300	-	900	9,500
	52,800	2,000	3,400	62,500

Sellingexpensesareexpectedtoabsorb4%oftheexpectedsellingprice.

(a) Explain why it is not permissible to value the inventory of machines at the lower of their total purchase price (£52,800) and their total net realisable value.

(b) Compute the value at which the inventory of machines should be measured in the company's financial statements.

10.4 Acompanywhichmakesonlyonetypeofproductincursfixedproductionoverheadsof £240,000 during the year to 31 March 2020. Normal production capacity is 80,000 units per annum. Calculate the amount of fixed production overheads that should be allocated to each unit of production when determining the cost of inventories at 31 March 2020 if actual production for the year is:

(a)80,000units(b)100,000 units(c)50,000 units.

***10.5** ParrisonLtdisamanufacturingcompany.Thecompany'sinventoryat30June2020 includes the following items of work in progress:

	ProductX	*ProductY*
Numberofunitsheldat30June2020	6,400	3,800
Costsincurredperunittodate	£8	£12
Estimatedfurthercostsperunittocompletion	£7	£8
Estimatedsellingcostsperunit	£2	£4
Estimatedsellingpriceperunit	£15	£30

ThecompanycomplieswithIAS2*Inventories*.

(a) Definetheterm"inventories".

(b) Explainhowthecostofinventoriesshouldbedetermined.

(c) Definetheterm"netrealisablevalue".

(d) ExplainhowinventoriesshouldbemeasuredinaccordancewithIAS2.

(e) Calculate the figure at which the work in progress of Parrison Ltd should be shown in the company's financial statements for the year to 30 June 2020.

*10.6 The main activity of J&T Ltd is to buy old vehicles which are sold after converting them into a saleable condition. At 29 February 2020 (the end of the company's financial year) J&T Ltd had the following vehicles that were at various stages in the process of being converted to be ready for sale.

Vehicle	*Purchase price*	*Costs incurredon bringingto present location*	*Conversion costs incurredto date*	*Expected further costs before sale*	*Expected selling price*
	£	£	£	£	£
W	9,470	1,080	880	-	14,000
X	12,830	940	1,540	150	19,300
Y	3,550	750	1,260	600	6,000
Z	7,680	460	-	2,200	11,800

Notes:

1. Expectedsellingexpensesforeachvehicleare6%oftheexpectedsellingprice.
2. Aquarteroftheconversioncostsrelatetomaterials.But20%ofthecostofthe materialsusedintheconversions isconsideredtobeabnormalwastage,duetoa poor quality type of material that has been used.

In an attempt to reduce the abnormal wastage of materials, material P has been used by thecompanysince5January2020,when25kiloswerepurchasedforatotalcostof £550.Subsequentpurchasesandusageofthismaterialwereasfollows:

Date	*Transaction*	*Numberofkilos*	*Totalcost(£)*
Jan7	Used	19	
Jan20	Purchased	20	520
Jan28	Used	18	
Feb7	Used	4	
Feb15	Purchased	15	315
Feb29	Used	3	

To ensure that the correct valuation of the company's inventories is reflected in the final accounts, the company follows the guidance provided in IAS2 *Inventories*.

Required:

(a) Compute, in accordance with IAS2 *Inventories*, the value at which the inventory of vehicles as at 29 February 2020 should be shown in the final accounts of J&T Ltd.

(b) Determinethetotalcostoftheabnormalwastageofmaterialsthathasbeenincurr ed on the conversion of the four vehicles.

(c) CalculatethetotalcostofmaterialPthathasbeenusedandthecostoftheinventor y of this material as at 29 February 2020, using each of the following cost formulas:

(i) First-in,first-out(FIFO)(ii)Weightedaveragecost(AVCO).

(CIPFA)

Chapter11

Financialinstruments

Introduction

Broadlyspeaking,a"financialinstrument"isameansofraisingfinance.Inpractice,the termcoversawiderangeofsophisticatedfinancialarrangements,butsimpleexamples includeloansofvarioustypesandshareissues.Therearethreeinternationalstandards which deal with financial instruments. These are:

IAS32 *FinancialInstruments:Presentation*IFRS7 *FinancialInstruments:Disclosures*IFRS9 *FinancialInstruments*

Thesestandardsdefinetheterm"financialinstrument",identifyseveraldifferenttypesof financialinstrumentandprescribetheaccountingtreatmentofeachtype.

Thisareaofaccountingisverycomplexandadetailedcoverageoffinancialinstruments isbeyondthescopeofthisbook.Thischapterprovidesabasicintroductiontothetopic.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- definetheterm"financialinstrument"
- define the terms "financial asset", "financial liability" and "equity instrument" andgive examples of each of them
- correctlyclassifyfinancialinstrumentsaseitherliabilitiesorequity
- separateacompoundfinancialinstrumentintoitsliabilityandequitycomponents
- explainthecircumstancesinwhichafinancialassetorliabilityshouldberecognised
- calculate the amounts at which financial assets and financial liabilities should bemeasured on initial recognition and subsequently
- listthemaindisclosuresrequiredinrelationtofinancialinstruments.

Definitions

IAS32 *FinancialInstruments:Presentatio*n provides four key definitions which apply throughout all of the standards which deal with financial instruments. The main features of these definitions are as follows:

- Afinancialinstrumentis"*anycontractthatgivesrisetoafinancialassetofoneentityandafinancialliabilityorequityinstrumentofanotherentity*".
- Afinancialassetis"*anyassetthatis:*
  (a) cash;
  (b) anequityinstrumentofanotherentity;
  (c) acontractualrighttoreceivecashoranotherfinancialassetfromanotherentity".
- A financial liability is "*anyliabilitythatisacontractualobligationtodelivercashoranotherfinancialassettoanotherentity*".
- Anequityinstrumentis"*anycontractthatevidencesaresidualinterestintheassetsofanentityafterdeductingallofitsliabilities*". Ordinary shares are the most commoninstance of an equity instrument.

The full definitions given in IAS32 are actually longer and more complex than this, but the versionsgivenabovearesufficientformostpurposes.Thesedefinitionsareillustratedin the following example.

EXAMPLE1

ExplainwhyeachofthetransactionslistedbelowgivesrisetoafinancialinstrumentasdefinedbyinternationalstandardIAS32:

(a) acompanymakesanissueofloanstock
(b) acompanysellsgoodstoacustomeroncredit
(c) acompanydepositsmoneyintoitsbankaccount
(d) acompanyoverdrawsitsbankaccount
(e) acompanymakesanissueofordinaryshares
(f) acompanyinvestsinnewly-issuedordinarysharesofanothercompany.

Solution

(a) Theissueofloanstockcreatesacontractualobligationonthepartofthecompanytorepaytheloanatsometimeinthefuture.Thecontractbetweenthecompanyandthelendersisafinancialinstrumentbecause:
  (i) thelendersnowhavetherighttoberepaid(afinancialasset)
  (ii) thecompanyisnowunderanobligationtorepaytheloan(afinancialliability)

(b) Asaleoncreditcreatesacontractualobligationonthepartofthecustomertopayforthegoods.Thecontractwiththecustomerisafinancialinstrumentbecause:
  (i) thecompanynowhasatradereceivable(afinancialasset)
  (ii) thecustomernowhasatradepayable(afinancialliability).

(c) Ineffect,abankdepositisaloantothebankandthebankiscontractuallyobligedtorepaythismoney.Thecontractwiththebankisafinancialinstrumentbecause:
  (i) thecompanynowhastherighttowithdrawitscash(afinancialasset)
  (ii) thebankisnowunderanobligationtorepaythecash(afinancialliability).

(d) Abankoverdraftisaformofbankloanandthecompanyiscontractuallyobligedtorepaythisloan.Thecontractwiththebankisafinancialinstrumentbecause:
  (i) thebanknowhastherighttoberepaid(afinancialasset)
  (ii) thecompanyisnowunderanobligationtorepaythebank(afinancialliability).

(e) Ordinarysharesareanequityinstrument,asdefinedbyIAS32.Theissueofordinarysharescreatesacontractbetweenthecompanyanditsshareholders.Thiscontractisafinancialinstrumentbecause:
  (i) theshareholdersnowowntheshares(afinancialasset)
  (ii) thecompanynowhasextrasharecapital(anequityinstrument).

(f) Thispurchaseofordinarysharescreatesacontractbetweentheinvestingcompanyandtheissuingcompany.Thiscontractisafinancialinstrumentbecause:
  (i) theinvestingcompanynowownstheshares(afinancialasset)
  (ii) theissuingcompanynowhasextrasharecapital(anequityinstrument).

Classificationoffinancialinstruments

TheobjectiveofIAS32istoclarifythedistinctionbetweenliabilitiesandequityandso ensure that financial liabilities and equity instruments are correctly identified in financial statements. If IAS32 did not exist, an entity might be able to incur a financial liability but present this liability as equity. This would artificially increase the company's net assets and improve its gearing ratio (see Chapter 22) thus reducing the extent to which the financial statementsprovidedafaithfulrepresentationoftheentity'sfinancialposition.

IAS32 takes a "substance over form" approach to distinguishing between liabilities and equity. Even though the legal form of a financial instrument might be a share issue, the instrument could still be regarded as giving rise to a financial liability if the underlying substance of the transaction indicates that this is the case. IAS32 states that a financial instrumentshouldbeclassifiedasanequityinstrumentifandonlyif:

> *"theinstrumentincludesnocontractualobligation...todelivercashoranotherfinancial assettoanotherentity...".*

Ordinarysharesareanexampleofanequityinstrument,sincethecompanywhichissues thesharesisundernocontractualobligationtopaydividendsandisusuallypreventedby law from repaying the share capital.

Ordinaryshareholdersmayinfactreceivedividendsfromtimetotimebuttheimportant point is that the company cannot be *required*to deliver cash or any other financial asset tothese shareholders. This situation should be contrasted with a loan, where the borrower is generallyobligedtomakeinterestpaymentsthroughoutheperiodoftheloanandtorepay the loan itself at the end of that period.

Redeemablepreferenceshares

As stated above, IAS32 adopts a substance over form approach to distinguishing between liabilities and equity. This approach is illustrated by the required treatment of redeemable preferenceshares.Thesearepreferenceshareswhicheither:

(a) provideformandatoryrepaymentofthesharecapitalatafuturedate,or

(b) give the shareholders the right to require repayment of the share capital on or after a particular date, for a fixed or determinable amount.

In these circumstances, it is clear that the issuing company has a contractual obligation to deliver cash. Therefore redeemable preference shares must be classified as liabilities ratherthan equity, despite their legal form. Furthermore, IAS32 states that interest and dividends relatingtofinancialliabilitiesshouldberecognisedasanexpensewhencalculatingthe issuing company's profit or loss. Therefore dividends paid to the holders of redeemable preferencesharesmustbetreatedasanexpense.Anyaccrueddividendsunpaidattheend ofanaccountingperiodmustbetreatedinthesamewayasaccruedinterest.Dividends thatareclassifiedasanexpensearepresentedinthestatementofcomprehensiveincome eithertogetherwithinterestonotherliabilitiesorasaseparateitem.

Itmayseemstrangetotreatsharesasiftheywereliabilitiesandtotreatdividendsasif theywereinterest,butthisissimplyalogicalconsequenceoftheIAS32requirementthat theaccountingtreatmentofafinancialinstrumentshouldfollowitssubstanceratherthan its legal form.

Compoundfinancialinstruments

Some financial instruments (known as "compound financial instruments") contain both a liabilitycomponentandanequitycomponent.Forexample,loanstockthatisconvertible to ordinary shares at the option of the holder is a compound financial instrument. IAS32 requiresthatcompoundfinancialinstrumentsshouldbeseparatedintotheirtwo componentsandthateachofthesecomponentsshouldthenberecognisedseparately,one as a financial liability and the other as equity. The separation of a compound financial instrumentintoitstwocomponentsisachievedasfollows:

(a) Thefairvalueoftheliabilitycomponentisdeterminedfirst.Thisisequaltothefair value of a similar instrument without an associated equity component. In the case of convertibleloanstock,IAS32statesthefairvalueoftheliabilitycomponentshould

bedeterminedbycalculatingthepresentvalueofthescheduledpaymentsofinterest and principal, ignoring the conversion option.

(b) Thefairvalueoftheequitycomponentisthendeterminedbydeductingthefairvalue oftheliabilitycomponentfromthefairvalueofthewholeinstrument.Thefairvalue ofthewholeinstrumentisnormallyequaltotheamountoftheconsiderationwhich was received when the instrument was issued.

IAS32repeatstheIFRS13definitionoffairvalueas"*thepricethatwouldbereceivedtosellanasse torpaidtotransferaliabilityinanorderlytransactionbetweenmarketparticipantsattheme asurementdate*" (seeChapter 5).

EXAMPLE2

On1January2019,acompanyissues£200,000of7%loanstockatpar.Interestonthisloanstockis payableon31Decembereachyear.Thestockisdueforredemptionatparon31December2022but maybeconvertedintoordinarysharesonthatdateinstead.

Calculatethefairvalueoftheliabilitycomponentandtheequitycomponentofthisloanstock,assu mingadiscountingrateof9%perannum(whichistherateofinterestthatwouldbeexpectedoncom parableloanstockswithouttheconversionoption).

Solution

Ignoringtheconversionoption,thecompanywillpayinterestof£14,000on31December2019,202 0,2021and2022andwillthenmakea£200,000repaymentoftheloanstockon31December2022. Usingadiscountingrateof9%,thepresentvalueofthesecashflowsmaybecalculatedasfollows:

	Workings	*Presentvalue*
		£
Paymentdue31December2019	£14,000÷1.09	12,844
Paymentdue31December2020	£14,000÷$(1.09)^2$	11,784
Paymentdue31December2021	£14,000÷$(1.09)^3$	10,811
Paymentdue31December2022	£214,000÷$(1.09)^4$	151,603
Totalpresentvalue		187,042

Thisshowsthatthepresentvalueon1January2019oftherighttoreceive£14,000on31Decemberf oreachofthenextthreeyears,followedby£214,000attheendofthefourthyearis£187,042.Thisist hefairvalueoftheliabilitycomponentoftheloanstock.

Thelendersarepaying£200,000tobuythisstockandthisexceedsthefairvalueoftheliabilitycomp onentby£12,958.Theextra£12,958mustbethepricethatthelendersarepayingfortheoptiontoco nvertandthisisthevalueoftheequitycomponent.

On1January2019,thecompanywillreceive£200,000andrecogniseafinancialliabilityof £187,042andanincreaseinequityof£12,958.Theliabilitywillbeaccountedforusinganeffectivei nterestrateof9%(seelaterinthischapter)andwillincreaseto£200,000at31December2022.Atthi spointitwilleitherberepaidincashorconvertedintoordinaryshares.IAS32statesthattheoriginal equitycomponentof£12,958"*remainsasequity*".

Recognitionandmeasurement

The recognition and measurement rules which relate to financial assets and liabilities are located in IFRS9 *FinancialInstruments*. The recognition rules determine when a financialasset or liability should be shown in an entity's statement of financial position. The measurement rules determine the amount at which a financial asset or liability should becarried in the financial statements.

IFRS9 was developed in three phases over a period of several years and replaced IAS39 *FinancialInstruments:RecognitionandMeasurement*. The three phases of development of international standard IFRS9 were as follows:

Phase1:Classificationandmeasurementoffinancialassetsandfinancialliabilities

Phase2:Impairmentmethodology

Phase3:Hedgeaccounting(whichisoutsidethescopeofthisbook).

Application of IFRS9 is mandatory for accounting periods beginning on or after 1 January2018 (although earlier application was permitted).

Recognitionoffinancialassetsandliabilities

The recognition principles which relate to financial assets and liabilities are fairly straight-
forward.IFRS9statesthatafinancialassetorafinancialliabilityshouldberecognised when (and only when) the entity "*becomespartytothecontractualprovisionsoftheinstrument*". In other words, recognition occurs when the financial instrument becomesbinding. As regards derecognition:

(a) Afinancial asset is derecognised (removed fromthe statement of financial position)whentheentity'scontractualrightstoreceivecashflowsfromtheassetexpire.

(b) Afinancialliabilityisderecognisedwhentheentity'scontractualobligationsexpireor are discharged or cancelled.

Initialmeasurementoffinancialassetsandliabilities

IFRS9 requires that financial assets and liabilities should be measured initially at their fair value,whichisnormallyequaltotheamountoftheconsiderationwhichwasgivenor receivedwhentheassetwasacquiredortheliabilityincurred.

In general, transaction costs that are directly attributable to the acquisition of a financialassetortheissueofafinancialliabilityshouldbeaddedtotheinitialcarryingamounto f theassetorsubtractedfromtheinitialcarryingamountoftheliability.However,thisdoes not apply to financial assets and liabilities which are subsequently measured at "fair value
throughprofitorloss"(seebelow).Transactioncostsrelatingtosuchassetsandliabilities are written off as an expense when incurred.

Subsequentmeasurementoffinancialassets

IFRS9 classifies financial assets into three categories and then prescribes the way in which assets falling into each category should be measured after initial recognition. The three categoriesandtheassociatedmeasurementrulesareasfollows:

(a) **Financialassetsatamortisedcost**.Afinancialassetfallsintothiscategoryif:

(i) thecontractualtermsofthefinancialassetgiveriseonspecifieddatestocash flowsthataresolelypaymentsofprincipalandinterest,and

(ii) the asset is held within a "business model" whose objective is to hold financialassets in order to collect these cash flows.

After initial recognition, such assets are measured at their amortised cost using the effective interest method (see below) and the interest calculated for each period is recognisedasincomewhencalculatingtheentity'sprofitorloss.Anexampleofthis typeofassetisaholdingofloanstocksthattheentityintendstoholduntilmaturity.

(b) **Financialassetsatfairvaluethroughothercomprehensiveincome**.Afinancial asset falls into this category if:

(i) thecontractualtermsofthefinancialassetgiveriseonspecifieddatestocash flowsthataresolelypaymentsofprincipalandinterest,and

(ii) the asset is held within a business model whose objective is achieved by both collecting these cash flows and selling financial assets. In general, this business modelwillinvolvemorefrequentsalesofassetsthanin(a)above.

After initial recognition, interest is calculated using the effective interest method and recognisedasincomewhencalculatingprofitorloss.Butchangesintheasset'sfair value are generally shown in other comprehensive income and are then reclassified to profitorlosswhentheassetisderecognised(seeChapter3).

(c) **Financialassetsatfairvaluethroughprofitorloss**. This category comprises all financial assets that do not fall into either of the other two categories. After initial recognition.suchassetsaremeasuredattheirfairvalue†.Changesinfairvalueare takenintoaccountwhencalculatingtheentity'sprofitorloss.

An example of a financial asset measured at fair value through profit or loss is aholdingofordinaryshares.Note,however,thatanentitymayelectthatgainsand lossesarisinginrelationtoaninvestmentinanequityinstrumentmayberecognised inothercomprehensiveincome(aslongastheinstrumentisnotheldfortrading). Suchgainsandlossescannotsubsequentlybereclassifiedtoprofitorloss.

Note also that an entity may designate any financial asset as "at fair value throughprofitorloss"ifthiswouldresultinmorerelevantinformation.

† *Tradereceivablesfallintothiscategoryand(strictlyspeaking)thefairvalueofatradereceivableisthepresentvalueoftheamounttobereceived.However,tradereceivablesmaybemeasuredattheirinvoiceamountiftheeffectofdiscountingisnotsignificant.*

Theeffectiveinterestmethod

As stated above, IFRS9 requires that certain financial assets should be measured at their amortisedcostusingtheeffectiveinterestmethod.Insimpleterms:

(a) The "amortised cost" of a financial asset is equal to the amount at which the asset was initially recognised, plus the amount of interest earned to date, minus any repayments received to date.

(b) The"effectiveinterestmethod"isawayofcalculatingtheamountofinterestearned to date. This method uses an interest rate that exactly discounts estimated future cash receiptstotheinitialcarryingamountoftheasset.Thecalculationtakesintoaccount notonlyinterestreceivable,butalsoitemssuchaspremiumsanddiscounts.

Thetechniqueisverysimilartothemethodusedinconnectionwiththemeasurementof leaseliabilities(seeChapter9)andisillustratedinthefollowingexample.

EXAMPLE3

On1January2019,acompanybuys£100,000of6%loanstockfor£93,930.Interestwillbereceived on31Decembereachyearandthestockwillberedeemedatparon31December2023.Afterinitialr ecognition,theloanstockistobemeasuredatamortisedcostusinganeffectiveinterestrateof7.5 %perannum.

(a) Statetheamountatwhichthisloanstockshouldbemeasuredon1January2019.

(b) Calculatetheamountatwhichtheloanstockshouldbemeasuredon31December2019,202 0,2021,2022and2023.

(c) Showthattheeffectiverateof7.5%exactlydiscountsestimatedfuturecashreceiptstotheini tialcarryingamountoftheasset.

Solution

(a) Theloanstockismeasuredinitiallyat£93,930.

(b) Theamortisedcostoftheloanstockattheendofeachyeariscalculatedasfollows:

Year	*Balance b/f*	*Interest @7.5%*	*Amount received*	*Amortised cost*
	£	£	£	£
2019	93,930	7,045	(6,000)	94,975
2020	94,975	7,123	(6,000)	96,098
2021	96,098	7,207	(6,000)	97,305
2022	97,305	7,298	(6,000)	98,603
2023	98,603	7,397	(106,000)	0
		36,070		

Notes:

(i) Theinterestearnedeachyearis7.5%ofthebalancebroughtforward.Thisisrecognised asincomeinthecompany'sfinancialstatements.Interestat7.5%for2023wouldinfact be£7,395butthishasbeenadjustedto£7,397toensurethatthebalanceremainingatth eendoftheyearis£nil.

(ii) Theeffectiveinterestrate(7.5%)ishigherthantherate(6%)atwhichannualinterestpay mentsarecalculatedbecausethecompanywillreceiveapremiumof£6,070(£100,000 −£93,930)whentheloanstockisredeemed.Theeffectiveinterestmethodspreadsthis premiumfairlyoverthelifeoftheloanstock.

(iii) Totalincomeis£36,070.Thisamountisequaltoannualinterestof£6,000forfiveyearsp lusthepremiumof£6,070.

(c) Iftheamountsreceivableduringthelifeoftheloanstockarediscountedatanannualrateof7.5 %,thepresentvalueofeachamountisasfollows:

	Workings	*Presentvalue* £
Receivable31December2019	£6,000÷1.075	5,581
Receivable31December2020	£6,000÷$(1.075)^2$	5,192
Receivable31December2021	£6,000÷$(1.075)^3$	4,830
Receivable31December2022	£6,000÷$(1.075)^4$	4,493
Receivable31December2023	£106,000÷$(1.075)^5$	73,835
Totalpresentvalue		93,931

Apartfromasmallroundingdifference,aneffectiverateof7.5%doesindeeddiscountestimatedfu turecashreceiptstotheinitialcarryingamountof£93,930.

Impairmentoffinancialassetscarriedatamortisedcost

Ifthereisevidencethatanimpairmentloss(seeChapter7)hasbeenincurredinrelationto a financial asset measured at amortised cost, IFRS9 requires that this loss should berecognised.Suchalosswouldariseifthereisashortfallbetweenthecashflowsthatthe entitywasoriginallyduetoreceiveandthecashflowsthattheentitynowexpectsto receive.Ingeneral,theamountofanimpairmentlossisequaltothedifferencebetween:

(a) thecurrentcarryingamountoftheasset,and

(b) thepresentvalueofthefuturecashflowsthattheentityexpectstoreceive,discounted attheeffectiverateofinterestwhichwascalculatedatinitialrecognition.

Whenanimpairmentlossisrecognised,thecarryingamountoftheassetshouldbe reducedbytheamountoftheloss,eitherdirectlyorthroughtheuseofanallowance account.Thelossitselfshouldbewrittenoffasanexpense.

Inthecaseoftradereceivablescarriedatoriginalinvoiceamount(seeabove)theamount of any impairment loss is simply the difference between the current carrying amount of the receivablesandtheundiscountedcashflowsexpectedtobereceivedinrelationtothem.

Dividendsreceivable

IFRS9requiresthatdividendsreceivableshouldberecognisedinthecalculationofanentity's profit or loss only when:

(a) theentity'srighttoreceivethedividendhasbeenestablished
(b) itisprobablethattheeconomicbenefitsconcernedwillflowtotheentity,and
(c) theamountofthedividendcanbemeasuredreliably.

Subsequentmeasurementoffinancialliabilities

After initial recognition, financial liabilities should usually be measured at amortised costusing the effective interest method. This is precisely the same method as is used for certain typesoffinancialasset(seeabove).Therearesomeexceptionstothisgeneralrule,but thesearemainlybeyondthescopeofthisbook.However,therearetwoimportant exceptions which must be mentioned here. These are:

(a) **Financialliabilitiesatfairvaluethroughprofitorloss**. This category of financial liabilitiesissimilartotheequivalentcategoryoffinancialassetsandconsistsmainly of financial liabilities that are held for trading. However, as with financial assets, anentitymaydesignateanyfinancialliabilityas"atfairvaluethroughprofitorloss"if this would result in more relevant information.

    After initial recognition, financial liabilities which fall into this category should be measured at fair value. Gains or losses that arise from fluctuations in fair value areusuallyrecognisedinthecalculationoftheentity'sprofitorlossfortheperiodin which they arise.

    However,ifafinancialliabilityhasbeendesignatedtobeatfairvaluethrough profitorloss(seeabove)anygainsorlossesattributabletochangesinthe"credit risk" of the liability are recognised in other comprehensive income. Credit risk is considered later in this chapter.

(b) **Tradepayables**.Short-termpayables(e.g.mosttradepayables)maybemeasuredat theoriginalinvoiceamountiftheeffectofdiscountingisnotmaterial.

EXAMPLE4

On1July2019,acompanyissues£1millionof8%loanstock.Thestockisissuedata10%discount(soonly£900,000isreceivedfromthelenders)andissuecostsof£39,300areincurred.Interestispayableinarrearson30Juneeachyearandtheloanstockisredeemableatparon30June2022.Theeffectiveinterestrateis14%p.a.Thecompanypreparesfinancialstatementsto30Juneeachyear.

(a) Statetheamountatwhichthisloanstockshouldbemeasuredon1July2019.
(b) Calculatetheamountatwhichtheloanstockshouldbemeasuredon30June2020,2021and2022.

Solution

(a) Theloanstockshouldbemeasuredinitiallyat£860,700(£900,000–£39,300).Thisistheamountoftheconsiderationreceivedwhenthestockwasissued,lessdirectlyattributabletransactioncosts.

(b) Theloanstockshouldbemeasuredatamortisedcostusingtheeffectiveinterestmethod.Amortisedcostattheendofeachyeariscalculatedasfollows:

Yearto 30June	*Balance b/f* £	*Interest @14%* £	*Amount paid* £	*Amortised cost* £
2020	860,700	120,498	(80,000)	901,198
2021	901,198	126,168	(80,000)	947,366
2022	947,366	132,634	(1,080,000)	0
		379,300		

Notes:

(i) Theinteresteachyearis14%ofthebalancebroughtforward.Thisisrecognisedasanexpenseinthecompany'sfinancialstatements.Interestat14%for2022isactually£132,631butthishasbeenadjustedto£132,634toensurethatthebalanceremainingat30June2022is£nil.

(ii) Theeffectiveinterestrate(14%)ishigherthantherate(8%)atwhichannualinterestpaymentsarecalculatedbecausetheloanwasissuedatadiscountandthecompanyhashadtopaytransactioncosts.Theeffectiveinterestmethodspreadsthesetwoitemsfairlyoverthelifeoftheloanstock.

(iii) Totalexpensesare£379,300.Thisamountisequaltoannualinterestof£80,000forthreeyearsplusthediscountof£100,000andissuecostsof£39,300.

Disclosurerequirements

InternationalstandardIFRS7*FinancialInstruments:Disclosures*requiresentitiestomakeanumberofdisclosuresrelatingtofinancialinstruments.Thepurposeofthesedisclosures is to enable users to evaluate two things. These are:

(a) thesignificanceoffinancialinstrumentsforthefinancialpositionandthefinancial performance of the entity concerned, and

(b) thenatureandextentofriskstowhichtheentityisexposedinrelationtofinancial instruments,andthewayinwhichthoserisksarebeingmanaged.

Thesetwomattersareconsideredseparatelybelow.

Significanceoffinancialinstruments

The main disclosures required by IFRS7 to enable users to evaluate the significance offinancialinstrumentsforanentity'sfinancialpositionandperformanceareasfollows:

(a) **Carryingamounts**. The carrying amount of each category of financial asset and each category of financial liability should be disclosed either in the statement of financial position or in the notes. These categories are:

(i) financialassetsmeasuredatfairvaluethroughprofitorloss
(ii) financialassetsmeasuredatfairvaluethroughothercomprehensiveincome
(iii) financialassetsmeasuredatamortisedcost
(iv) financialliabilitiesmeasuredatfairvaluethroughprofitorloss
(v) financialliabilitiesmeasuredatamortisedcost.

For each category of assets or liabilities measured at fair value, the disclosures should show separately the carrying amount of those assets or liabilities that the entity haschosentodesignateinthatcategorysoastoprovidemorerelevantinformation.

(b) **Fairvalue**. The fair value of each class of financial asset and liability should bedisclosedinawaythatfacilitatescomparisonwithcarryingamounts.Thisdisclosure isnotrequiredifthecarryingamountisareasonableapproximationoffairvalue.

(c) **Itemsofincome,expense,gainsandlosses**. The entity should disclose the following items,eitherinthestatementofcomprehensiveincomeorinthenotes:

(i) net gains or losses on each class of financial assets and liabilities (e.g. gains orlosses arising from fair value fluctuations)
(ii) total interest income and total interest expense for financial assets and liabilities measured at amortised cost.

(d) **Accountingpolicies**. The entity should disclose the measurement bases and other accountingpoliciesusedinrelationtofinancialinstruments,wherethesearerelevant to an understanding of the financial statements.

Natureandextentofrisks

IFRS7definesthreemaintypesofriskassociatedwithfinancialinstruments.Theseare:

(a) **Creditrisk**.Creditriskis"*theriskthatonepartytoafinancialinstrumentwillcauseafinanciallossfortheotherpartybyfailingtodischargeanobligation*".

(b) **Liquidityrisk**. Liquidity risk is "*theriskthatanentitywillencounterdifficultyinmeetingobligationsassociatedwithfinancialliabilities*".

(c) **Marketrisk**. Market risk is "*theriskthatthefairvalueorfuturecashflowsofafinancialinstrumentwillfluctuatebecauseofchangesinmarketprices*".Market prices may change because of changes in exchange rates ("currency risk"), changes in

marketinterestrates("interestraterisk")orforotherreasons("otherpricerisk").

In general, IFRS7 requires entities to disclose information which enables the users of the financial statements to evaluate the nature and extent of any risks arising from financial instrumentstowhichtheentityisexposedattheendofthereportingperiod.Foreachtype of risk, this information should include:

(a) theexposurestoriskandthewayinwhichtheyarise
(b) themethodsusedtomeasuretherisk
(c) theentity'spoliciesandprocessesformanagingtherisk
(d) quantitativedataabouttheexposuretoriskattheendofthereportingperiod.

Specificdetaileddisclosuresarealsorequiredinrelationtocreditrisk,liquidityriskand market risk. The main disclosures are as follows:

(a) **Creditrisk**.Foreachclassoffinancialinstrument,theentityshoulddisclose:
    (i) theamountofthemaximumexposuretocreditrisk(beforetakingaccountof any collateral held as security)
    (ii) adescriptionofanycollateralheldassecurity
    (iii) quantificationoftheextenttowhichthiscollateralmitigatesthecreditrisk.
(b) **Liquidityrisk**.Theentityshoulddiscloseamaturityanalysisforfinancialliabilities andadescriptionofhowanyinherentliquidityriskismanaged.
(c) **Marketrisk**. Theentityshoulddiscloseasensitivityanalysis for eachtypeof market risktowhichtheentityisexposedattheendofthereportingperiod.Thisanalysis shouldshowhowprofitorlossandequitywouldbeaffectedbychangesinthe relevantriskvariable(e.g.exchangeratesormarketinterestrates).

Summary

- Afinancial instrument is acontract whichgives risetoafinancial asset for oneentity andafinancialliability(orequityinstrument)foranother.Financialinstrumentsare dealtwithininternationalstandardsIAS32,IFRS7andIFRS9.
- IAS32 establishes rules for distinguishing between financial liabilities and equity instruments. The standard adopts a substance over form approach and states that anequityinstrumentisonewhichincludesnocontractualobligationtodelivercash(or any other financial asset) to another entity.
- Redeemable preference shares are generally classed as financial liabilities. Dividends relating to such shares are treated as an expense.
- Acompoundfinancialinstrumentisseparatedintoitstwocomponentsbyevaluating the liability component first and then deducting this from the fair value of the whole instrument to give the equity component.

- Financial assets and liabilities are recognised when the relevant financial instrument becomesbindingandarederecognisedwhentheentity'scontractualrightsor obligations under the instrument cease.
- Financial assets and liabilities are measured initially at fair value. This is normally the amountoftheconsiderationwhichwasgivenorreceivedwhentheassetwas acquired or the liability incurred.
- Subsequent toinitial recognition, all financial assetsaremeasuredat fairvalueapart fromthosemeasuredatamortisedcost.Afinancialassetismeasuredatamortised costifitgivesrisetocashflowsthataresolelypaymentsofprincipalandinterestand if the asset is held in order to collect these cash flows.
- Subsequenttoinitialrecognition,mostfinancialliabilitiesaremeasuredatamortised cost using the effective interest method. However, financial liabilities "at fair value through profit or loss" are measured at their fair value.
- Theeffectiveinterestmethodusesaninterestratethatexactlydiscountsestimated futurecashflowstotheinitialcarryingamountoftheassetorliabilityconcerned.
- ThedisclosurerequirementsofIFRS7enableusersofthefinancialstatementsto evaluatethesignificanceofanentity'sfinancialinstrumentsandthenatureandextent ofanyriskstowhichtheentityisexposedinrelationtofinancialinstruments.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

11.1 (a) Define the terms "financial instrument", "financial asset", "financial liability" and "equity instrument".

(b) ExplainthewayinwhichinternationalstandardIAS32distinguishesbetween financial liabilities and equity instruments.

(c) ExplaintheIAS32accountingtreatmentofredeemablepreferenceshares.

11.2 (a)Explainwhatismeantbya"compound"financialinstrument.Alsoexplainthe required accounting treatment of such an instrument.

(b)On 1 April 2018, a company issues a £500,000 4% convertible bond at par. Interest ispayableon31Marcheachyear.Thebondisredeemableatparon31March2023 but may be converted into ordinary shares at any time before maturity. The market rate of interest to be used in discounting calculations is 6.5%.

Calculatetheliabilitycomponentandtheequitycomponentofthisbond.

11.3 (a)International standard IFRS9 classifies financial assets into three main categories. Identify and explain each of these categories. Also explain the way in which each category of financial asset should be measured subsequent to initial recognition.

(b)On 1 January 2019,acompany which preparesfinancialstatementsto 30 Juneeach year buys £400,000 of 5% loan notes for £411,225. Interest will be received half- yearly on 30 June and 31 December and the loan notes will be repaid at a premium of 10% on 31 December 2021. The effective rate of interest is 3.5% per half year.

Calculate the amount of interest income that should be recognised in the company's financial statements for each of the years to 30 June 2019, 2020, 2021 and 2022. Also calculatetheamountatwhich theloan notesshould beshown in thestatement of financial position at the end of each of these years.

11.4 (a)Explain the terms "credit risk", "liquidity risk" and "market risk" which are used in international standard IFRS7.

(b)OutlinethemaindisclosuresrequiredbyIFRS7inrelationtoeachoftheserisks.

11.5 On 1 May 2019, a company which prepares financial statements to 30 April each year issues £750,000 of 3% loanstock at a discount of 5%. Issue costs are £13,175.Interest is payableon30April eachyear andthestockisredeemableon30April 2023at apremium of 10%. The effective rate of interest is 7.25% per annum.

(a) Statetheamountatwhichtheloanstockshouldbemeasuredon1May2019.

(b) Calculatetheamountatwhichtheloanstockshouldbeshowninthecompany's statement of financial position on 30 April 2020, 2021, 2022 and 2023.

***11.6**Querkplcpreparesfinancialstatementsto31Decembereachyear.On1January2019 the company bought £500,000 of 6% loan stock for £490,420. Interest is receivable on31 December each year and the loan stock will be redeemed at a 15%premiumon 31 December 2023. The effective rate of interest is 9% per annum and Querk plc intends to hold the loan stock until it is redeemed.

(a) Definetheterm"financialinstrument".Explainwhytheloanstockreferredto above falls within this definition.

(b) Definetheterms"financialasset"and"financialliability".Explainwhytheloan stock is a financial asset for Querk plc but is a financial liability for the borrower.

(c) Identifythecategoryoffinancialassettowhichtheloanstockbelongs.Explainho w financial assets of this type should be measured, both at initial recognition and subsequently.

(d) Calculate the amount of interest income that should be recognised in the financial statementsofQuerkplcforeach oftheyearsto31December2019, 2020, 2021, 2022 and 2023. Also calculate the amount at which the loan stock should be shown in the statement of financial position at each of those dates.

(e) Explain why the accounting treatment required for this loan stock by international standards gives a fair measure of the interest income for each year.

Chapter12

Provisionsandeventsafterther eportingperiod

Introduction

Themainpurposeofthischapterisexplaintherequirementsofinternationalstandard IAS37*Provisions,ContingentLiabilitiesandContingentAssets*.TheaimsofIAS37are:

(a) toensurethatallnecessaryprovisionsarerecognisedandproperlymeasuredinthe financial statements of business entities

(b) topreventtherecognitionofunjustifiedprovisions

(c) toprescribeanaccountingtreatmentforcontingentliabilitiesandcontingentassets

(d) toensurethatsufficientdisclosuresaremadesoastoenableuserstounderstandthe nature,timingandamountofprovisions,contingentliabilitiesandcontingentassets.

IAS37 defines a provision to be a type of liability (see below) and this usage of the word "provision" should be carefully distinguished from other usages. In particular, IAS37 is *not*concernedwithprovisionsfordepreciationorfordoubtfuldebts,sincethesearereductio ns in the carrying amounts of assets and are not a type of liability. Such reductions are in factmoreproperlyreferredtoas"allowances"ratherthan"provisions".

This chapter also covers IAS10 *EventsaftertheReportingPeriod*, which prescribes the accountingtreatmentofeventswhichoccuraftertheendofthereportingperiodbutbefore thedateonwhichthefinancialstatementsareauthorisedforissue.

ScopeofIAS37

Ingeneral(subjecttocertainexceptions)IAS37doesnotapplytoprovisions,contingent liabilitiesandcontingentassetswhicharedealtwithinotherstandards.Theseinclude:

(a) IAS12*IncomeTaxes*(seeChapter15)

(b) IFRS16*Leases*(seeChapter9)

(c) IAS19*EmployeeBenefits*(seeChapter14)

(d) IFRS15*RevenuefromContractswithCustomers*(seeChapter13).

Furthermore, IAS37 does not apply to financial instruments which are within the scope of international standard IFRS9 (see Chapter 11).

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- define the terms "provision", "contingent liability" and "contingent asset" inaccordance with international standard IAS37
- statetheconditions under whichaprovisionshouldberecognisedandexplainhow the amount of a provision should be measured
- explaintherequiredaccountingtreatmentofcontingentassetsandliabilities
- explain the requirements of IAS37 with regard to future operating losses, onerouscontracts and restructuring costs
- listthemaindisclosurerequirementsofIAS37
- distinguishbetweenadjustingandnon-adjustingevents after thereportingperiodand explainthemainrequirementsofinternationalstandardIAS10.

Recognitionofaprovision

IAS37definesaprovisionas"*aliabilityofuncertaintimingoramount*"andstatesthata provisionshouldberecognisedwhenallofthefollowingconditionsaresatisfied:

(a) theentityhasapresentobligation(legalorconstructive)asaresultofapastevent

(b) itisprobablethatanoutflowofresourcesembodyingeconomicbenefitswillbe required to settle the obligation

(c) areliableestimatecanbemadeoftheamountoftheobligation.

If any of these conditions are not satisfied, a provision must *not*be recognised. It should be noted that the first two conditions stem from the definition of a liability given in the IASB *ConceptualFramework*(seeChapter2).Thisreinforcesthepointthataprovisionisakind ofliabilityandtheonlydifferencebetweenaprovisionandanyotherliabilityisthedegree ofuncertaintyinvolved.Althoughmanyliabilitiesinvolveuncertainty(e.g.theamountof anaccruedexpense)thiswillgenerallybemuchgreaterinthecaseofaprovision.

IAS37alsostatesthattheamountofaprovisionshouldbeequalto"*thebestestimateofthee xpenditurerequiredtosettlethepresentobligationattheendofthereportingperiod*".

EXAMPLE1

Acompanygiveswarrantiesatthetimeofsaletocustomerswhobuythecompany'sproducts.The sewarrantiescommitthecompanytomakegoodanymanufacturingdefectsthatbecomeappare ntwithinthreeyearsfromthedateofsale.Onpastexperience,itisprobablethatsomevalidwarrant yclaimswillarise.

Whenpreparingitsfinancialstatementsfortheyearto30June2020,shouldthecompanymakea provisionforwarrantyclaims?Ifso,howshouldthisbemeasured?

Solution

Itisclearthatthecompanyisobligedat30June2020tomeetanyvalidclaimswhichariseunderwarrantiesgiveninthepreviousthreeyears.Thereforethereisapresentobligationarisingfromapastevent.Itisalsoclearthatsuchclaimswillprobablyoccurandsoitisprobablethatanoutflowofresourceswillberequiredtosettlethisobligation.Iftheamountandtimingoftheclaimswerecertain,aliabilitycouldberecognisedintheusualway.Butthereisconsiderableuncertaintywithregardtoboththeandtheamountofthisliabilityandthereforeaprovisionisrequired.

Theamountoftheprovisionshouldbethecompany'sbestestimateofthecostofmeetingwarrantyclaimsarisinginrelationtoproductssoldinthelastthreeyears.Thisestimatewillpresumablybebasedonpastexperience.

Obligatingevents

Apasteventwhichleadstoapresentobligationisknownasan"obligatingevent".Fora past event to be an obligating event, the business entity involved must have no realistic alternativebuttosettletheobligationcreatedbytheevent.Thiswillbethecaseif:

(a) theobligationislegallyenforceable,or

(b) theentityhasa"constructiveobligation",whichoccurswhenanentityhasindicated thatitwillacceptanobligationandhascreatedavalidexpectationinotherparties thatitwilldischargethatobligation,eventhoughthisisnotlegallyenforceable.

Forinstance,abusinessentitywhichoperatesinacountrywithenvironmentallegislation may have a legal obligation to decontaminate land which it has contaminated by its pastactions.Anentitywhichoperatesinacountrywithnosuchlegislationmaynonetheless haveawidely-publishedpolicyofcleaningupallcontaminationwhichitcausesanda recordofhonouringthispolicy,inwhichcasethereisaconstructiveobligation.

Withoutanobligatingevent,therecannotbeaprovision.Whetherornotsuchanevent hasoccurredisusuallyamatteroffactbutinrarecasesthismaynotbeclear.Forinstance, ifanentityisinvolvedinalawsuitattheendofareportingperiod,theremaybesome disputeastowhethercertaineventshaveoccurred,orwhetherpasteventshaveresultedin apresentobligation.Inthesecircumstances,theentityshouldconsiderallavailable evidence (possibly including expert opinion) and then:

(a) if it is more likely than not that a present obligation exists at the end of the reporting period(andiftheotherrecognitioncriteriaaremet)aprovisionshouldberecognised

(b) ifitismorelikelythatthereisnopresentobligationattheendofthereportingperiod, a contingent liability should be disclosed (see below) unless there is only a remote possibility of an outflow of economic benefits.

It should be stressed that a provision is recognised only if the obligation in question exists independently of the entity's future actions. For this reason, no provision can be made in relation to future operating costs, since these could be avoided by changing the method of operation or by ceasing the operations concerned.

Probableoutflowofeconomicbenefits

As stated above, a provision cannot be recognised unless it is probable that an outflow of economic benefits will be required to settle the obligation in question. For this purpose, the word "probable" means "more likely than not".

If a number of similar obligations (e.g. product warranties) exist at the end of a reporting period, IAS37 requires that the probability of an outflow of benefits should be assessed by consideringtheclassofobligationsasawhole.Eventhoughitmaynotbeprobablethat any one obligation will result in an outflow of benefits, it may indeed be probable that an outflowwillbeneededtosettletheentireclassofobligations.

Reliableestimateoftheobligation

Thefinalconditionwhichmustbesatisfiedinorderforaprovisiontoberecognisedisthatareliableestimatecanbemadeoftheamountoftheobligation.IAS37takestheviewthat it will usually be possible to determine a range of possible outcomes and then make anestimate that is sufficiently reliable for this purpose.

If (rarely) a reliable estimate cannot be made, a liability exists but a provision cannot be recognised.Thisliabilitymustbedisclosedasacontingentliability(seebelow).

Measurementofaprovision

Asmentionedearlierinthischapter,theamountofaprovisionshouldbethebestestimate of the expenditure required to settle the obligation concerned. This is of course a matter of judgementandmayrequireadvicefromindependentexperts.Notethat:

(a) The "best estimate" of the required expenditure is the amount that the entity would rationallypaytosettletheobligationortransferittoathirdparty.

(b) Iftheeffectofthetimevalueofmoneyismaterial,theamountofaprovisionshould becalculatedasthepresentvalueoftheexpenditurerequiredtosettletheobligation.

(c) Futureeventsthatmayaffecttheamountrequiredtosettleanobligationshouldbe taken into account when measuring a provision, so long as there is sufficient objective evidence that these events will occur. For instance, the estimated costs of cleaning up environmentaldamagemightbereducedbyanticipatedchangesintechnology.

If a single obligation is being measured and there are several possible outcomes, the best estimateoftherequiredexpenditureisusuallythecostofthemostlikelyoutcome.Butif most of the other possible outcomes would involve a higher cost, the best estimate of the expenditurewillbeahigheramount.Similarly,ifmostoftheotherpossibleoutcomes wouldinvolvealowercost,thebestestimateoftheexpenditurewillbealoweramount.

Incaseswhereaprovisionrelatestoalargepopulationofitems,theamountofthe provisionshouldbeestimatedbycalculatingthe"expectedvalue"oftheobligationatthe end of the reporting period. This statistical method of estimation involves weighting

allpossibleoutcomesbytheirassociatedprobabilitiesandisillustratedinthenextexample.

EXAMPLE2(*baseduponanexampleprovidedinIAS37)*

Acompanysellsgoodsunderwarranty.Ifallofthegoodscoveredbywarrantiesattheendoftherep ortingperiodhadminordefects,thecompanywouldincurrepaircostsof£1m.Ifallofthesegoodsh admajordefects,repaircostswouldbe£4m.Experienceshowsthat75%ofgoodssoldhavenodef ects,20%haveminordefectsandtheremaining5%havemajordefects.Whatistheexpectedvalue ofthecostofrepairsunderwarranties?

Solution

Theexpectedvalueis(75%×£nil)+(20%×£1m)+(5%×£4m)=£400,000.

Changesinprovisionsanduseofprovisions

IAS37 requires that provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate of the required expenditure†. If it is no longer probable that an outflow of economic benefits will be required to settle an obligation, the relatedprovisionshouldbereversed.IAS37alsorequiresthataprovisionshouldbeused onlyforthepurposeforwhichitwasoriginallyestablished.Itisnotpermittedtoset unrelatedexpenditureagainstaprovisionthatwassetupforadifferentpurpose.

† *Ifaprovisioniscarriedatitspresentvalue,theamountoftheprovisionisincreasedattheendofeac hperiodtoreflectthe"unwinding"ofthediscountingovertime.Thisincreaseisrecognisedasafi nancechargeinthestatementofcomprehensiveincome.*

Applicationoftherecognitionandmeasurementrules

Having established the recognition and measurement rules described above, IAS37 then explains how these general rules should be applied in three specific cases. The three cases identified are future operating losses, onerous contracts and restructuring costs. A brief summaryoftherequirementsofIAS37inrelationtoeachoftheseisgivenbelow.

(a) **Futureoperatinglosses**.Futureoperatinglossesarenotpresentobligationsanddo not satisfy the recognition criteria for a provision. Therefore, provisions should not be recognisedforfutureoperatinglosses.However,thefactthatfutureoperatinglosses areexpectedindicatesthattheassetsusedintheoperationconcernedmaybe impaired.Thereforetheseassetsshouldbetestedforimpairment(seeChapter7).

(b) **Onerouscontracts**.Anonerouscontractisacontract"*inwhichtheunavoidablecostsof meetingtheobligationsunderthecontractexceedtheeconomicbenefitsexpectedtobe receivedunderit*".Ifanentityhassuchacontract,thepresentobligationunder that contract should be recognised as a provision.

The amount of the provision is the *lower*of the net cost of fulfilling the contract andany penalties payable as a result of failing to fulfil it.

(c) **Restructuringcosts**.Aprovisionforrestructuringcostsshouldberecognisedonlyif thegeneralrecognitioncriteriasetoutinIAS37aresatisfied.Inparticular:

(i) A constructive obligation to restructure arises only when the entity has a detailed formalplanfortherestructuringandhasraisedavalidexpectationinthose affectedthatitwillcarryouttherestructuring,eitherbybeginningtoimplement the plan or by announcing its main features.

(ii) If the restructuring involves the sale of an operation, no obligation for that salearises until there is a binding sale agreement.

(iii) Aprovisionforrestructuringcostsshouldincludeonlythedirectcostsarising from the restructuring. These costs must be necessarily incurred and must not be associated with the ongoing activities of the entity.

Staffretrainingandrelocationcosts,marketingcostsandthecostofinvestmentin newsystemscannotbeincludedintheamountofaprovisionforrestructuringcosts.

EXAMPLE3

Thefollowinginformationrelatestoacompanywhichpreparesfinancialstatementsto31Decembereachyear:

(a) On1January2019,thecompanyacquirednewplantcosting£10million.Thisplantwillrequireacompleteoverhaulafterfiveyearsofuse,atanestimatedcostof£1million.Accordingly,thecompanywishestomakeaprovisionof£200,000forplantoverhaulcostsinitsfinancialstatementsfortheyearto31December2019andthentoincreasethisprovisionby£200,000ineachofthenextfouryears.Thiswillhavetheeffectofspreadingtheoverhaulcostsevenlyoverthe years2019to2023.

(b) On1August2019,thecompanytookouta12-monthleaseonfactorypremisesatamonthlyrentalof£10,000.However,thesepremisesarenowsurplustorequirementsandwillstandemptyuntiltheleasecomestoanend.Theleaseisnon-cancellableandthepremisescannotbesub-let.Thecompanywishestomakeaprovisionof £70,000initsfinancialstatementsfortheyearto31December2019.

(c) InNovember2019,thecompanydecidedtoselloffoneofitsoperations.Nobuyerhadbeenfoundat31December2019,butthesaleisexpectedtoresultinalossof £500,000whenitoccurs.Thecompanywishestoprovideforthislossinthefinancialstatementsfortheyearto31December2019.

AccordinglytotherulesofIAS37,mayanyofthesethreeprovisionsbemade?

Solution

(a) At31December2019,thereisnopresentobligationtoundertaketheoverhaulthatisdueinfouryearstime.Theplantcouldinfactbesoldbeforetheoverhaulisrequired.Thereforenoprovisioncanbemadefortheoverhaulcosts.InternationalstandardIAS16*Property,PlantandEquipment*prescribestheaccountingtreatmentofthistypeofexpenditure(seeChapter5).

(b) Ingeneral,IAS37doesnotapplytoleases.Butthisisanexampleofashort-termlease(seeChapter9)andIAS37doesapplytosuchleasesiftheybecomeonerous.Theobligationof£70,000(£10,000permonthfrom1January2020to31July2020)isunavoidableandshouldbeprovidedfor.

(c) Thereisnobindingsalesagreementinexistenceat31December2019andsothereisnopresentobligationonthatdate.Aprovisioncannotbemade.

However,dependingonthecircumstances,thenon-currentassetsoftheoperationmightbeclassifiedas"heldforsale"andmeasuredinaccordancewiththerequire-mentsofIFRS5(seeChapter8).AssetsoftheoperationthatarenotclassifiedasheldforsaleshouldbetestedforimpairmentunderIAS36(seeChapter7).

Contingentliabilitiesandcontingentassets

IAS37definesacontingentliabilityas:

"*(a)apossibleobligationthatarisesfrompasteventsandwhoseexistencewillbeconfirmedonlybytheoccurrenceornon-occurrenceofoneormoreuncertainfutureeventsnotwhollywithinthecontroloftheentity;or*

(b) apresentobligationthatarisesfrompasteventsbutisnotrecognisedbecause:

(i) itisnotprobablethatanoutflowofresourcesembodyingeconomicbenefitswillberequiredtosettletheobligation;or

(ii) theamountoftheobligationcannotbemeasuredwithsufficientreliability."

Anexampleofa"possibleobligation"mayarisewhenanentityisinvolvedinalegalcase and will be required to pay damages if the case is lost. If it is probable that the case will belost,theentityshouldrecogniseaprovision.Butifitismerelypossiblethatthecasewill belost,theentityshouldtreattheobligationasacontingentliability.

IAS37 requires that contingent liabilities should not be recognised in the statement of financial position but should instead be disclosed in the notes, unless the possibility of an outflow of economic benefits is remote.

Contingentassets

A contingent asset is defined as "*apossibleassetthatarisesfrompasteventsandwhoseexistencewillbeconfirmedonlybytheoccurrenceornon-occurrenceofoneormoreuncertainfutureeventsnotwhollywithinthecontroloftheentity*". An example of such anassetmayariseifanentityisinvolvedinalegalcaseandwillreceivedamagesifthecase iswon.Ifitisvirtuallycertainthatthecasewillbewon,theentityshouldtreatthe damages as an asset in the usual way. Otherwise, the entity should treat the damages as a contingent asset.

IAS37requiresthatcontingentassetsshouldnotberecognisedinthestatementof financialposition.However,contingentassetsshouldbedisclosedinthenotesifthe inflowof economic benefits is judged to be probable.

EXAMPLE4

InMay2019,ABCplc(whichpreparesfinancialstatementsto31December)guaranteeda £100,000bankloanprovidedtoDEFLtd.DEFLtdwasinastrongfinancialpositionat31December2019,butthishadworsenedby31December2020anditseemedlikelyonthatdatethatABCplcwouldberequiredtohonouritsguarantee.

ExplainhowthisguaranteeshouldbetreatedinthefinancialstatementsofABCplcat31December 2019and2020.

Solution

At31December2019,thereisapresentobligationarisingfromapastevent.However,anoutflowof economicbenefitsdoesnotseemprobable,sonoprovisioncanbemade.Theguaranteefallswithin thedefinitionofacontingentliabilityandshouldbedisclosedinthenotestothefinancialstatements,unlessthepossibilityofanoutflowofbenefitsisjudgedtoberemote.

At31December2020,thereisstillapresentobligationarisingfromapastevent,butnowitseemspr obablethattherewillbeanoutflowofeconomicbenefits.Aslongasareliableestimateoftheobligationcanbemade(whichwillalmostcertainlybethecase)aprovisionshouldbemadeinrelationtothisobligation.

Disclosurerequirements

Thefollowingdisclosuresarerequiredforeachclassofprovisionthatisrecognisedinthe financial statements:

(a) thecarryingamountatthebeginningandendoftheaccountingperiod
(b) additionalprovisionsmadeintheperiod,includingincreasesinexistingprovisions
(c) amountsusedandamountsreversedduringtheperiod
(d) increasesduringtheperiodindiscountedamounts(arisingfromthepassageoftime)
(e) abriefdescriptionofthenatureoftheobligation,theexpectedtimingofanyresulting expenditureandanindicationof theuncertainties involved.

Unlessthepossibilityofanoutflowofbenefitsisremote,thefollowingdisclosuresare required for each class of contingent liability:

(a) abriefdescriptionofthenatureofthecontingentliability
(b) anestimateofitsfinancialeffect
(c) anindicationoftheuncertaintiesinvolved.

Finally, in cases where an inflow of benefits is probable, the entity should disclose a brief description of the nature of any contingent assets at the end of the reporting period, with an estimate of their financial effect.

Eventsafterthereportingperiod

IAS10*EventsaftertheReportingPeriod*defineseventsafterthereportingperiodas:

"*thoseevents,favourableandunfavourable,thatoccurbetweentheendofthereportingperiodandthedatewhenthefinancialstatementsareauthorisedforissue*".

Sucheventsareclassifiedintotwotypes.Theseare:

(a) **Adjustingevents**. Adjusting events are defined as "*thosethatprovideevidenceofconditionsthatexistedattheendofthereportingperiod*". An example is the sale of inventorieswhichwereheldattheendofthereportingperiod.Thiseventprovides useful evidence of the net realisable value of those inventories. Further examples of adjusting events listed in IAS10 include:

  (i) thesettlementofacourtcaseinwhichthecompanywasinvolvedattheendof the reporting period

  (ii) thebankruptcyofacustomerwhoowedmoneytothecompanyattheendofthe reporting period

  (iii) thediscoveryoffraudorerrorswhichshowthatthefinancialstatementsforthe period are incorrect.

(b) **Non-adjustingevents**.Non-adjustingeventsaredefinedas"*thosethatareindicativeofconditionsthataroseafterthereportingperiod*".Anexampleofanon-adjusting eventisadeclineinthefairvalueofinvestmentsheldattheendofthereporting period.Suchadeclinedoesnotusuallyrelatetotheconditionoftheinvestmentsat theendoftheperiodbutreflectscircumstancesthathavearisensubsequently.

IAS10requiresthatthefinancialstatementsshouldbeadjustedtoreflectadjustingevents thatoccuraftertheperiod.Thefinancialstatementsshould*not*beadjustedto reflectnon-adjustingevents.However,materialnon-adjustingeventsshouldbedisclosedin the notes to the financial statements. For each such event, the notes should disclose thenatureoftheeventand(ifpossible)anestimateofitsfinancialeffect.Notethat:

(a) IAS10 does not specifically state that the financial statements should be adjusted toreflect only *material*adjusting events, but this is implied by the materiality principle establishedintheIASB*ConceptualFramework*(seeChapter2).

(b) Dividendstoequityshareholderswhicharedeclaredaftertheendofthereporting period but before the financial statements are authorised for issue do not qualify as a "presentobligation"attheendoftheperiodandsoshouldnotberecognisedasa liability. Such dividends should be disclosed in the notes in accordance with the requirements of IAS1 (see Chapter 3).

Summary

- A provision is defined by IAS37 as a liability of uncertain timing or amount. Torecognise a provision, there must be a present obligation arising from a past event, itmustbeprobablethatanoutflowofbenefitswillberequiredtosettlethisobligation anditmustbepossibletomakeareliableestimateoftheamountinvolved.
- An obligation may be legally enforceable or it may be constructive. A constructive obligation is one which arises because the entity has created a valid expectation that itwilldischargetheobligationandhasnorealisticalternativebuttodoso.
- Theamountofaprovisionshouldbethebestestimateoftheexpenditureinvolved.
- Provisions should be reviewed at the end of each reporting period and adjusted orreversedifnecessary.Aprovisionshouldbeusedonlyforthepurposeforwhichit was established.
- Acontingentliabilityiseitherapossibleobligationorapresentobligationthatdoes notsatisfyallofttheconditionsnecessarytorecogniseaprovision.Contingent liabilities are not recognised in the financial statements but are disclosed in the notes unlessthepossibilityofanoutflowofbenefitsisremote.
- A contingent asset is a possible asset. Contingent assets are not recognised in thefinancialstatementsbutaredisclosedinthenotesifaninflowofbenefitsisjudgedto be probable.
- IAS37 makes a number of disclosure requirements with regard to provisions and with regard to contingent liabilities and assets.
- IAS10 requires that financial statements should be adjusted to reflect adjusting eventsthatoccuraftertheendofthereportingperiodbutbeforethedateonwhichthe financialstatementsareauthorisedforissue.Non-adjustingeventsthatoccurduring this interval should be noted if material.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

12.1 Hullman Ltd prepares financial statements to 31 March each year. Consider each of the followingsituationsanddetermineineachcasewhetherornotaprovisionshouldbe recognised in the company's financial statements for the year to 31 March 2020.

(a) On23January2020,theboardofdirectorsdecidedtoclosedownoneofthe company's operations. By 31 March 2020, this decision had been announced to the workforceandadetailedplanhadbeendrawnupforitsimplementation.The closure would involve redundancy payments of £375,000.

(b) On 12 March 2020, the directors decided to close down another of the company's operations.Thiswouldinvolveredundancypaymentsof£250,000.At31March 2020, the decision had not been announced and had not yet been acted upon.

(c) Forthepastfewyears,thecompanyhasbeenconductingtwooperationswhich causeenvironmentaldamage.Oneoftheseoperationsisinacountrywith legislationwhichrequirescompaniestorectifyanyenvironmentaldamagewhich they cause. The other is in a country with no such legislation. The costs of rectify- ing the damage caused to date by these two operations are estimated at £5 million and £10 million respectively.

(d) At 31 March 2020, the company owns a fleet of motor lorries, all of which require an annual service. This servicing work is expected to occur in the first few months of the year to 31 March 2021, at an estimated cost of £50,000.

12.2 (a)Explainhowtheamountofaprovisionshouldbemeasured.

(b)Acompanyneedstomakeaprovisionforthecostofrepairingafaultyproduct suppliedtoacustomersomeweekspreviously.Thecompanyestimatesthatther eis a 60% chance that this repair will cost £100,000. However, there is a 30% chance thatthecostwillbe£150,000anda10%chancethatthecostwillbe£200,000. How should the amount of the provision be measured?

12.3 Attheendofanaccountingperiod,acompanyhaseachofthefollowing:

(a) apresentobligationwhichwillprobablyrequireanoutflowofresources

(b) apresentobligationwhichwillprobablynotrequireanoutflowofresources

(c) apossibleobligationarisingfromadisputedpast event;thecompanydeniesthat this event occurred and a legal case is currently proceeding; it seems likely that the company will win the case and that an outflow of resources will not be required

(d) a possible obligation arising from another disputed past event; the company again deniesthatthiseventoccurredandagainalegalcaseiscurrentlyproceeding;it

seems likely that the company will lose this case and that an outflow of resources will be required.

State, for each of these obligations, whether the company should recognise a provision, discloseacontingentliabilityordonothing.Assumethatalloftheobligationsarisefrom past events and that reliable estimates can be made of the amounts concerned.

12.4 Kenistone Ltd prepares financial statements to 30 April each year. At 30 April 2020, the companyisbeingsuedbyacustomerwhoclaimstohavebeenharmedbyoneofthe company's products. The case will come before the courts in late 2020. Explain how this matter should be dealt with in the financial statements for the year to 30 April 2020 if:

(a) thecompany'slawyersadvisethatthecompanywillprobablybefoundliable

(b) thecompany'slawyersadvisethatthecompanywillprobablynotbefoundliable.

12.5 The annual accounting date of Lawston plc is 31 May. The following matters need to be dealt with before the financial statements for the year to 31 May 2020 can be finalised:

(a) Thecompanyiscurrentlysuingoneofitssuppliersforfailuretosupplygoods accordingtocontract.Legaladvicesuggeststhat Lawstonplcwillprobablywinth e case and will probably be awarded damages.

(b) The company operatesan open-castmineand islegally obliged to restorethe environmentwhenmineworkingsarecomplete.Thisisexpectedtooccurinthe year2030.Theestimatedcostofrectifyingtheenvironmentaldamagecausedsof aris£3million.Theestimatedtotalcostofrectifyingthedamagecauseduntilmine workings are complete is £25 million.

Explainhowthesetwomattersshouldbedealt withinthefinancialstatementsforthe year to 31 May 2020.

12.6 Acompanypreparesfinancialstatementsto31Decembereachyear.Thefollowing events occurred after 31 December 2019 but before the financial statements for the year to 31 December 2019 were authorised for issue:

(a) Inventoryheldat31December2019wassoldtoacustomer.

(b) Thecompanymadeamajorinvestmentinplantandequipment.

(c) Thecompanymadeatake-overbidforanothercompany.

(d) A customer who owed an amount of money to the company on 31 December 2019 was declared bankrupt.

(e) Thecompanyannouncedamajorrestructuringplan.

(f) It was discovered that cash shown as an asset in the statement of financial position at 31 December 2019 had been stolen on 28 December 2019.

(g) It was discoveredthat aitem of equipment shownas anasset inthe statement offinancial position at 31 December 2019 had been stolen on 12 January 2020.

(h) The government announced a change in tax rates that will have a significant effect on the company's tax liability at 31 December 2019.

Classify each of these events as either an adjusting event or a non-adjusting event and explainhoweacheventshouldbedealtwithinthecompany'sfinancialstatementsforth e year to 31 December 2019. It may be assumed that all of the events are material.

12.7 Triangle,apubliclistedcompany,isintheprocessofpreparingitsdraftfinancial statements for the year to 31 March2020. The following matters have been brought to your attention:

(i) On1April2019thecompanybroughtintouseanew processingplantthathadcost £15milliontoconstruct andhadanestimatedlifeoftenyears.Theplantuses hazardouschemicalswhichareputintocontainersandshippedabroadforsafe disposalafterprocessing.Thechemicalshavealsocontaminatedtheplantitself and thisoccurred as soon as the plant was used. It is a legal requirement that the plantis decontaminated at the end ofits life. The estimated present value of the cost of thisdecontamination,usingadiscountrateof8%perannum,is£5million.The financialstatementshavebeenchargedwith£1.5million(£15million/10years)f or plantdepreciationandaprovisionof£500,000(£5million/10years)hasbeenmad e towards the cost of the decontamination.

(ii) On15May2020thecompany'sauditorsdiscoveredafraudinthematerial requisitions department. A seniormember of staff who took up employment with Triangle in August 2019 had been authorising payments for goodsthat had never beenreceived.Thepaymentsweremadetoafictitiouscompanythatcannotbe traced.Thememberofstaffwasimmediatelydismissed.Calculationsshowthatt hetotalamountofthefraudtothedateofitsdiscoverywas£240,000ofwhich £210,000relatedtotheyearto31March2020.(Assumethefraudismaterial).

(iii) The companyhas contactedits insurers inrespect of the above fraud. Triangle is insuredfortheft,buttheinsurancecompanymaintainsthatthisisacommercial fraudandisnotcoveredbythetheft clauseintheinsurancepolicy. Triangle hasnot yet had an opinion from its lawyers.

Required:

Explainhow theitemsin(i)to(iii)aboveshouldbetreatedinTriangle'sfinancial statementsfortheyearto31March2020inaccordancewithcurrentinternational accounting standards. Your answer should quantify the amounts where possible.
(ACCA)

*12.8(a)SparklingPicturesplcisacompanywhichspecialisesinvideoproduction.The company is preparing its financial statements for the financial year ended 30 April 2020.

Duringthefinancialyearended30April2019SparklingPicturesplcwas responsibleforvideoinganimportantprizeawardsceremonyforsubsequent broadcastontelevision.Shortlyaftertheceremonytwenty-twopeoplewhohad beentherebecameseriouslyill.TheyclaimedthatSparklingPicturesplcwas responsible because a poisonous chemical used in the manufacture of digital video tapes had been found in a soup tureen which had been used during the ceremony.

LegalproceedingsseekingdamagesfromSparklingPicturesplcwerestarteddur ingthefinancialyearended30April2019.SparklingPicturesplcdenied liability and up to the date of authorisation of the financial statements for the year ended30April2019thecompany'slawyerswereconfidentthattheevidence againstthecompanywasweakandcircumstantialandthatitwasprobablethat Sparkling Pictures plc would not be found liable.

However, additional evidence emerged during the year ended 30 April 2020 which has caused Sparkling Pictures plc's lawyers to change their advice. They are nowof the opinion that it is probable that Sparkling Pictures plc will be found liable.

Required:

Explain,withreasons,howthismatterwouldhavebeenreportedinthefinancial statements for the year ended 30 April 2019 and how it should be reported in the financial statements for the year ended 30 April 2020.

(b)Stenberg plc is preparing its financial statements for the year ended 30 November 2019.

Anemployeeisclaimingdamagesof£15,000againstStenbergplcbecauseof injuriesreceivedwhiledrivingoneofthecompany'sdeliveryvansinSeptember 2019. The employee is claiming that Stenberg plc was negligent in its maintenance ofthevanandthatthevancrashedbecauseofpoormaintenance.Stenbergplc's lawyerisoftheopinionthattheprobabilityoftheemployeewinningthecaseis 80%.

Stenbergplcismakingaclaimfordamagesof£25,000againstacontractortocov ertheadditionalcostsofmaking good faulty work on acontract.Thecontractor had refused to make good the work because they were too busy with work on other contracts.Stenbergplc'slawyerisoftheopinionthattheprobabilityofwinningthis claim is 85%.

Required:

For each of the two legal claims Stenberg plc is involved in discuss whether or notaprovisionshouldbemadeinthefinancialstatementsfortheyearended30 November 2019.

(CIPFA)

Chapter13

Revenuefromcontractswithcustomers

Introduction

The original introduction to IFRS15 *RevenuefromContractswithCustomers*stated that revenueisan"importantnumber"totheusersofthefinancialstatementswhenassessing anentity'sfinancialperformanceandposition.Itisessential,therefore,thattherevenue figurewhichispresentedinasetoffinancialstatementsshouldbereliable.

The main problem in accounting for revenue is that of determining whenit should be recognised.Afurtherproblemisthemeasurementoftheamountofrevenuewhichshould berecognised.ThesemattersareaddressedbyIFRS15,which:

(a) setsoutcriteriafortherecognitionofrevenue

(b) establishesrulesforthemeasurementofrevenue,and

(c) providesextensiveapplicationguidance.

IFRS15 (which was developed jointly with the US FASB) was issued in 2014 and must be appliedforaccountingperiodsbeginningonorafter1January2018.Earlierapplication was permitted.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explainthescopeofIFRS15*RevenuefromContractswithCustomers*
- statethepurposeofIFRS15andidentifythecoreprincipleofthisstandard
- explain the "five-step model" relating to the recognition and measurement of revenueand apply this model in a variety of circumstances
- accountcorrectlyforcontractcostsasrequiredbyIFRS15
- statethemainpresentationanddisclosurerequirementsofIFRS15
- summarisetheguidanceprovidedbyIFRS15inrelationto sales withright ofreturn and a number of other specific situations.

PurposeandscopeofIFRS15

ThepurposeofIFRS15istoestablishtheprinciplesthatanentityshouldapplytoreport useful information in the financial statements concerning "*thenature,amount,timinganduncertaintyofrevenueandcashflowsarisingfromacontract withacustomer*". Keydefinitions given in the standard are as follows:

- Revenueis"*incomearisinginthecourseofanentity'sordinaryactivities*".
- Income is "*increasesineconomicbenefitsduringtheaccountingperiodintheformofinflowsorenha ncementsofassetsordecreasesofliabilitiesthatresultinanincreaseinequity,otherthant hoserelatingtocontributionsfromequityparticipants*".
- Acustomeris"*apartythathascontractedwithanentitytoobtaingoodsorservicesthatare anoutputoftheentity'sordinaryactivitiesinexchangeforconsideration*".

Thesedefinitionsmakeitclearthatrevenuearisesfromordinaryactivities(e.g.theselling of goods or services) and excludes:

(a) borrowings,sinceborrowingsincreaseliabilities,notequity
(b) amountscontributedbyshareholders(e.g.shareissues)
(c) gains(e.g.revaluationgainsandgainsarisingonthedisposalofnon-currentassets).

Furthermore,certaintypesofincomeareexplicitlyexcludedfromthescopeofIFRS15. The main exclusions and the applicable standards are:

(d) rentalincome(IFRS16*Leases*)
(e) interestanddividends(IFRS9*FinancialInstruments*).

Note,however,thatIFRS15doesapplytolicencesofintellectualproperty.Theseinclude itemssuchassoftwarelicences,franchises,copyrightlicencesetc.

Thefive-stepmodel

ThecoreprincipleofIFRS15isthatanentityshouldrecogniserevenue"*todepictthetransferof promisedgoodsorservicestocustomersinanamountthatreflectstheconsiderationtowhic htheentityexpectstobeentitledinexchangeforthosegoodsorservices*".Thiscoreprincipleis achievedbyapplyingthefollowingsteps:

(a) **Step1**:Identifyacontractwithacustomer
(b) **Step2**:Identifytheperformanceobligationsinthecontract
(c) **Step3**:Determinethetransactionprice
(d) **Step4**:Allocatethetransactionpricetotheperformanceobligationsinthecontract
(e) **Step5**: Recognise revenue when or as the entity satisfies a performance

obligation.Each of these steps is explained below.

Step1:Identifyingthecontract

IFRS15 defines a contract as "*anagreementbetweentwoormorepartiesthatcreatesenforceablerightsandobligations*". Contractsforthesaleofgoodsorservicesmaybe written, oral or implied by customary business practices. Such contracts may relate torelatively simple transactions (e.g. the sale of goods in a shop) or to much more complex situations(e.g.theconstructionofabuildingforacustomer).

IFRS15statesthatacontract† whichfallswithinitsscopeshouldbeaccountedforbyan entityonlywhen*all*ofthefollowingconditionsaresatisfied:

(a) Thepartiesconcernedhaveapprovedthecontractandarecommittedtoperformtheir contractual obligations.

(b) Theentitycanidentifyeachparty'srightswithregardtothegoodsorserviceswhich are to be transferred under the contract.

(c) Theentitycanidentifythepaymenttermsforthegoodsandservicestobetransferred.

(d) Thecontracthascommercialsubstance(i.e.theentity'scashflowsareexpectedto change as a result of the contract).

(e) Itisprobablethattheentitywillcollecttheconsiderationtowhichitisentitledin exchangeforthegoodsorservicesthatwillbetransferredtothecustomer.

Acontractshouldnotbeaccountedforifthecontractis"whollyunperformed"andeach partytothecontracthastheunilateralrighttoterminateit.Acontractiswholly unperformediftheentityhasnotyettransferredanygoodsorservicestothecustomerand hasnotyetreceivedanypayment(orotherconsideration)fromthecustomer.

Ingeneral,apaymentwhichisreceivedfromacustomerbeforeallofthe conditions listedabovearesatisfiedmustberecognisedasaliability.Thisliabilityrepresentsthe entity's obligationeither totransfer goods or services tothe customer at some time inthe future or to refund the amount received.

† *IFRS15normallyrequirescontractstobeaccountedforonanindividualbasis.However,asapractic alexpedient,thestandardmaybeappliedtoaportfolioofcontractsaslongasthesecontracts havesimilarcharacteristicsandtheresultsobtainedbyapplyingthestandardtotheportfoliodo notdiffermateriallyfromtheresultsthatwouldhavebeenobtainedifthestandardhadbeenappli edtotheindividualcontracts.*

Combiningcontracts

IFRS15requiresthattwo(ormore)contractsthatareenteredintowiththesamecustomer at(ornear)thesametimeshouldbecombinedandaccountedforasasinglecontractif:

(a) thecontractsarenegotiatedasapackagewithasinglecommercialobjective,or

(b) theconsiderationpayableinonecontractdependsuponthepriceorperformanceof the other contract, or

(c) thegoodsorservicestobetransferredtothecustomerbyvirtueofthecontractscompris e a single performance obligation (see Step 2).

Contractmodifications

A contract modification is a change to a contract with a customer that is approved by thepartiestothatcontract.Suchamodificationmaymakechangestothegoodsorservicesto be transferred to the customer or may amend the contract price (or both). A contract modificationwillbetreatedasaseparatecontractforthepurposesofIFRS15if:

(a) themodificationadds"distinct"goodsorservicestothecontract(seeStep2),and

(b) the contract price increases by an amount that reflects the "stand-alone price" of the additional goods or services which are to be transferred (i.e. the price at which thesegoods or services wouldnormallybesoldseparately).

Amodificationthatdoesnotsatisfybothoftheseconditionsiseffectivelyaccountedforas an adjustment to the existing contract.

EXAMPLE1

(a) Acompanyagreestosell100itemstoacustomerataprice of£200peritem.Theseitemsareto betransferredtothecustomeroveraoneyearperiod.Aftersixmonths,thepartiesagreeamo dificationtothiscontract.Thenumberofitemstobesoldincreasesto150andtheextra50ite msaretobepricedat£210each.Theextraitemsrankas"distinct"goods(seeStep2)andthepr icechargedforthemisequaltothestand-alonesellingpricethatwouldnormallybechargedtoacustomer.

(b) Acompanyentersintoacontracttoconstructanofficebuildingforacustomerataprice of£5 m.Whentheconstructionworkispartiallycompleted,thepartiesagreeamodificationtothed esignofthebuildingandthecontractpricerisesto£6m.Thiscontractmodificationdoesnota dd"distinct"goodsorservicestothecontract.

Foreachofthesesituations,wouldthecontractmodificationbetreatedasaseparatecontractora sanadjustmenttotheexistingcontract?

Solution

(a) Themodificationaddsdistinctgoodstothecontractandtheincreaseincontractpricereflect sthestand-alonepriceofthosegoods.Thereforethemodificationwouldbetreatedasaseparatecontra ct.Thetwocontractswouldbeaccountedforseparatelyandtheexistingcontractwouldnotb eaffectedbythemodification.

(b) Thismodificationwillbetreatedasanadjustmenttotheexistingcontract.Thiswillinvolveam endmentofthetransactionpriceandcontractcostsandwillalsoinvolveremeasurementoft heprogressthathasbeenmadetowardscompletionofthecontract(seelaterinthischapter).

Step2:Identifyingperformanceobligations

At contract inception (i.e. when a contract begins) the entityconcerned should assess thegoods or services which it has promised to transfer to the customer and so identify the performanceobligationsinthecontract.Aperformanceobligationisdefinedas"*apromisein acontractwithacustomertotransfertothecustomereither:*

(a) agoodorservice(orabundleofgoodsorservices)thatisdistinct;or

(b) aseriesofdistinctgoodsorservicesthataresubstantiallythesameandthathavethesa mepatternoftransfertothecustomer".

It is important to identify performance obligations correctly, since the revenue arising from eachobligationisaccountedforseparately.Agoodorserviceisregardedas"distinct"if both of the following conditions are satisfied:

(a) Thecustomercouldbenefitfromthegoodorserviceeitheronitsownortogether withotherresourcesthatarereadilyavailabletothecustomer.Inotherwords,the good or service is *capable*of being distinct. If a particular good or service is regularlysold separately by the entity, this would usually indicate that a customer could benefit from the good or service on its own.

(b) The promise to transfer the good or service to the customer is "separately identifiable" from other promises in the contract (i.e. the promise to transfer the good or service is *distinctwithinthecontextofthecontract*). Factors which indicate that a promise to transferagoodorserviceisnotseparatelyidentifiableinclude:

  (i) thegoodorserviceissignificantlyintegratedwithothergoodsorservicesthat are promised in the contract

  (ii) thegoodorservicemodifiesorcustomisesothergoodsorservicesthatare promised in the contract

  (iii) thegoodorserviceishighlyinter-dependentwith(orhighlyinter-relatedto)othergoodsorservicesthatarepromisedinthecontract.

If a promised good or service is not distinct, the entity should combine that good or servicewith other goods or services that are promisedin the contract so as to forma "bundle" ofgoodsorservicesthatisdistinct.Thismaymeanthatallofthegoodsorservicespromised inacontractwillbeaccountedforasasingleperformanceobligation.

IFRS15providesalistofthetypesofgoodsorservicesthatmaybepromisedbyan entityinacontractwithacustomer.Thislist(whichisnotexhaustive)includes:

(a) thesaleofgoodsmanufacturedbytheentityorpurchasedforresalebytheentity

(b) theconstructionordevelopmentofanassetonbehalfofthecustomer

(c) performingatask(ortasks)forthecustomer

(d) actingasanagentofanotherpartyandarrangingforthatpartytoprovidegoodsor services to the customer

(e) grantingalicenceofintellectualproperty.

EXAMPLE2

(a) Acompanyentersintoacontracttosupplyacustomerwithacomputersystem.Thecontract alsoprovidesthecustomerwithtechnicalsupportforthenext12months.Thecomputerisus ablewithoutthetechnicalsupportandthecompanyoftensellscomputersandtechnicalsup portservicesseparately.

(b) Acompanyentersintoacontracttobuildafactoryforacustomer.Thecompanywillinstalheat ing,lightingandairconditioningsystemsintothebuildingbeforehandingitovertothecustom er.Thecompanyfrequentlysuppliessuchsystemsseparatelyandinstalsthemintoexisting buildingsownedbycustomers.

Identifytheperformanceobligationsineachofthesecontracts.

Solution

(a) Itappearsthatthecustomercouldbenefitfromuseofthecomputersystemwithouttechnical support.Furthermore,thecomputersystemwillbecomea"readilyavailableresource"assoo nasitisdeliveredandthecustomercouldthenbenefitfromacquiringtechnicalsupportatalat erdate.Thereforethecomputerandthetechnicalsupportaredistinctandeachrepresentsas eparateperformanceobligation.

(b) Thecustomercouldbenefitfromthecompany'sheating,lightingandairconditioningsystem sbyacquiringtheseforinstallationinanexistingbuilding.Sothesesystemsarecapableofbei ngdistinctgoodsandservices.However,thecontractrequiresthecompanytosignificantlyi ntegratethesesystemsintothefactorybuildingandsothepromisetosupplythemisnotsepa ratelyidentifiablefromthepromisetoprovidethefactoryitself.Thereforeallofthegoodsand servicesinthecontractshouldbeaccountedforasasingleperformanceobligation.

Step3:Determiningthetransactionprice

Transactionpriceis"*theamountofconsiderationtowhichanentityexpectstobeentitledinex changefortransferringpromisedgoodsorservicestoacustomer,excludingamountscollect edonbehalfofthirdparties*". The exclusion of amounts collected on behalf of third parties means that sales taxes (such as VAT) are not regarded as revenue. Nor are amounts collected by an agent on behalf of a principal.

The consideration for a contract may be fixed or may vary because of items such as discounts†,refunds,priceconcessions,incentives,performancebonusesandpenalties.In these circumstances, IFRS15 requires that the entity should estimate the amount of anyvariable consideration by using either the "expected value" method or the "most likelyamount"method(seebelow).Thechosenmethodshouldbetheonewhichbestpredicts theamount ofconsiderationtowhichtheentityisentitled.

† *Itappearsthat(contrarytopreviouspractice)promptpaymentdiscountsshouldbetreatedasgiv ingrisetovariableconsiderationandshouldthereforebetakenintoaccountwhendeterminingtr ansactionprice.*

(a) **Expectedvalue**.Thisstatisticalmethodofestimationinvolvesmultiplyingall possibleamountsofthevariableconsiderationbytheirassociatedprobabilitiesand then adding the weighted amounts (see Chapter 12).

(b) **Mostlikelyamount**.Thismethodselectsthesinglemostlikelyamountfromthe rangeofpossibleamountsofthevariableconsideration.Thismaybeasuitable approachiftherearеonlytwopossibleamounts(e.g.ifaspecifiedperformance bonuswillbeeitherbereceivedinfullornotreceivedatall).

Inthecaseofacontractwhichfallsintomorethanoneaccountingperiod,itisnecessary to update the transaction price at the end of each period so as to reflect the circumstances present at the end of that period.

EXAMPLE3

(a) Acompanyentersintoacontracttoconstructanassetforacustomer.Theagreedpriceis£500,000andthespecifieddeliverydateis30September2020.However,iftheassetisdeliveredafterthisdate,thecompanywillsufferalatedeliverypenaltyof £20,000foreachweekbetween30September2020andtheactualdateofdelivery.Thecompanyestimatesthattheprobabilityoftheassetbeingdeliveredontimeis 80%.Butthereisa10%probabilitythattheassetwillbedeliveredoneweeklateandafurther10%probabilitythattheassetwillbedeliveredtwoweekslate.

(b) Acompanywhichisbuildinganassetforacustomerwillreceiveanincentivebonusof£100,000iftheassetiscompletedbytheendof2020.However,thisbonuswillnotbepaidifthecompletiondateisanylaterthanthis(evenbyasingleday).Thebonusisinadditiontotheagreedpriceof£1mandthecompanyestimatestheprobabilityofcompletionbytheendof2020tobe95%.

Determinethetransactionpriceforeachofthesecontracts.

Solution

(a) Assumingthattheexpectedvaluemethodprovidesthebestpredictionoftheamountofconsiderationtowhichthecompanywillbeentitled,thetransactionpriceis £494,000((80%×£500,000)+(10%×£480,000)+(10%×£460,000)).

(b) Withonlytwopossibleoutcomes,themostlikelyamountmethodwillprobablyprovidethebestpredictionoftheamounttowhichthecompanywillbeentitled.Itislikelythattheincentivebonuswillbereceived,sothetransactionpriceis£1,100,000.

Existenceofasignificantfinancingcomponent

A contract contains a significant financing component if the agreed date of payment by the customerislaterthanthedateonwhichgoodsorservicesaretransferredandtheeffectsof thetimevalueofmoneyaresignificant.Inthiscase,partoftheconsiderationshouldbe treatedasfinanceincome(notrevenue).However,thisadjustmentisnotrequiredifthe periodbetweentransferofgoodsorservicesandpaymentdatedoesnotexceedoneyear.

Step4:Allocatingthetransactionprice

Having determined the transaction price, the next step is to allocate that price between the performance obligations in the contract. The objective of this step is to determine the considerationtowhichtheentityisentitledforeachperformanceobligation.Notethat:

(a) IFRS15requiresthetransactionpricetobeallocatedbetweenperformanceobligations onthebasisofthestand-alonesellingpriceofeachobligation.Stand- alone selling prices may be estimated, if necessary.

(b) Ifthetotaltransactionpriceforthecontractislessthanthesumofthestand-alone selling prices of each performance obligation, the customer is effectively receiving a discount for purchasing a bundle of goods and services. Such a discount is usually allocatedproportionatelyamongstperformanceobligations.

(c) If part of the transaction price is variable, the variable amount is allocated to a single performanceobligationifitrelatesspecificallytothatobligation.Otherwise,the variableamountisallocatedbetweenperformanceobligations.

(d) If the transaction price changes after contract inception, the amount of the change is allocated amongst performance obligations on the same basis as the allocation of the originaltransactionprice(disregardinganychangestostand-alonesellingpricesin themeantime).Anyamountallocatedtoaperformanceobligationthathasalready beensatisfiedisrecognisedasanincreaseordecreaseinrevenuefortheperiodin which the change in transaction price occurs.

EXAMPLE4

Acompanyentersintoacontracttosellfourdistinctproductstoacustomer.Thepromisetotransfereachoftheseproductsisaseparateperformanceobligationandtheagreedcontractpriceis£14,400.Stand-alonesellingpricesareasfollows:

ProductA£4,800ProductB£7,500ProductC£2,700ProductD£3,000Howshouldthetransactionpricebeallocatedtoperformanceobligations?

Solution

Thetotalofthestand-alonesellingpricesis£18,000.Thereforethecustomerisreceivingadiscountof£3,600(£18,000–£14,400)forpurchasingabundleofgoods.Thisdiscountshouldbeallocatedproportionately,sotheallocationofthetransactionpriceis:

	£
ProductA	3,840(£4,800×(£14,400÷£18,000))
ProductB	6,000(£7,500×(£14,400÷£18,000))
ProductC	2,160(£2,700×(£14,400÷£18,000))
ProductD	2,400(£3,000×(£14,400÷£18,000))
	–14,40

Step5:Satisfactionofperformanceobligations

Thefinalstepintheprocessistorecogniserevenuewhen(oras)aperformanceobligation issatisfiedbytransferringapromisedgoodorservicetothecustomer.Theamountof revenuerecognisedistheamountofthetransactionpricewhichwasallocatedtothe satisfied performance obligation. IFRS15 states that goods and services are assets ("if only momentarily")andthatanassetistransferredwhen(oras)thecustomerobtainscontrolof thatasset.Controlrefersto"*theabilitytodirecttheuseof,andobtainsubstantiallyallofthereming benefitsfrom,theasset*".Thesebenefitsmaybeobtainedby:

(a) usingtheassettoproducegoodsorprovideservices
(b) sellingtheassetorusingtheassettosettleliabilities
(c) pledgingtheassetassecurityforaloan
(d) holdingtheasset.

For each performance obligation in a contract it is necessary for the entity to determinewhether that obligation is satisfied *overtime*or *atapointintime*. This distinction is very importantsinceitgovernsthetimingofrevenuerecognition.

Performanceobligationssatisfiedovertime

Anentityisregardedastransferringcontrolofagoodorserviceovertime(andsosatisfies aperformanceobligationovertime)ifanyofthefollowingconditionsaresatisfied:

(a) Thecustomersimultaneouslyreceivesandconsumesthebenefitsprovidedbythe entity's performance whilst the entity performs its obligation (e.g. routine or recurrent cleaning services).
(b) Theentity'sperformancecreatesanassetthatthecustomercontrolsasitiscreated (e.g.abuildingcontractwherethecustomerhascontroloverthe workinprogress).
(c) Theentity'sperformancedoesnotcreateanassetwithanalternativeusetotheentity and the entity has an enforceable right to payment for the performance that has been completed to date.

Foreachperformanceobligationthatissatisfiedovertime, theentityshouldrecognise revenue over time by measuring the progress made towards complete satisfaction of the obligation.IFRS15suggestsalternativemethodsformeasuringprogress.Theseinclude:

(a) **Outputmethods**.Thesemethodsmeasureprogressonthebasisofdirectmeasure- mentsofthegoodsandservicestransferredtodate,relativetothegoodsandservices thatremaintobetransferred.Suchmethodsincludesurveysoftheworkdonetodate andappraisalsofresultsachieved(e.g.unitsdelivered,timeelapsed).
(b) **Inputmethods**.Thesemethodsmeasureprogressonthebasisoftheentity'sefforts orinputstodate(e.g.hoursexpended,costsincurred)relativetothetotalexpected inputsrequiredinordertoachievetheperformanceobligation.

Themethodchosenshouldfaithfullydepicttheentity'sprogress.

Noreasonablemeasureofprogress

In certain circumstances (especially during the early stages of a contract) there may be no reasonablewayinwhichtomeasureprogress.Inthesecircumstances,sufficientrevenue mayberecognisedtocoverthecostsincurredtodate,solongastheentityexpectsto recoverthecostsincurredinordertosatisfytheperformanceobligation.

Performanceobligationssatisfiedatapointintime

If a performance obligationis not satisfiedover time thenit must be satisfiedat a point in time. In this case, revenue will be recognised when the customer obtains control of the promisedasset(seeabove)andtheobligationissatisfied.Indicationsofthetransferof controltothecustomerinclude(butarenotlimitedto)thefollowing:

(a) Theentityisnowentitledtopaymentforthegoodsorservicesprovided.
(b) Thecustomerhaslegaltitletotheassetconcerned.
(c) Theentityhastransferredphysicalpossessionoftheasset.
(d) Thecustomernowhasthesignificantrisksandrewardsthatwouldnormallybe associated with ownership of the asset.
(e) Thecustomerhasacceptedtheasset.

Contractcosts

Ifthecostsincurredbyanentitywhilstitisfulfillingacustomercontractfallwithinthe scopeofanotherinternationalstandard,thosecostsshouldbeaccountedforinaccordance with that standard. For instance, direct materials and direct labour costs will generally be recognised as an asset (work in progress) and measured in accordance with the applicable standard which is IAS2 *Inventories*. Similarly, plant and machinery or intangible assets acquired for use in fulfilling a customer contract will be accounted for in accordance with IAS16*PlantandMachinery*or IAS38*IntangibleAssets*.

But if any of the costs incurred by the entity do not fall within the scope of another internationalstandard,theymayberecognisedasanassetonlyif:

(a) thecostsrelatedirectlytoaspecificcontractwithacustomer,and
(b) thecostsgenerateresourcesthatwillbeusedinsatisfying(orcontinuingtosatisfy) performance obligations in the future, and
(c) thecostsareexpectedtoberecovered.

Coststhatdonotmeetthesecriteriaarerecognisedasanexpense.Generalandadminis- trative costs must also be recognised as an expense (unless these can be charged to the customer)asmustthecostofwastedmaterials,labourorotherresources.

Reclassification,amortisationandimpairmentofcontractcosts

Contractcoststhathavebeenrecognisedasanasset(e.g.workinprogress)arereclassified as an expense (e.g. cost of sales) when the related goods or services are transferred to the customer and revenue is recognised. Note that:

(a) Ifaperformanceobligationissatisfiedatapointintime,therelatedcontractcosts willbereclassifiedasanexpensewhenthatobligationissatisfied.

(b) Ifaperformanceobligationissatisfiedovertime,contractcostswillbereclassifiedas an expense each time that the stage of progress of the contract is measured and the associated revenue is recognised.

Insomecases,itwillbenecessarytoamortisecostsonasystematicbasisasgoodsor servicesaretransferredtothecustomer.Forinstance,designcostsincurredatthe beginning of a contract might be amortised over a period of years if they relate to goods or serviceswhicharesuppliedthroughoutthedurationofalong-termcontract.

IFRS15alsorequiresthatanimpairmentlossshouldberecognisedif(broadly)the carryingamountofcontractcoststhathavebeenrecognisedasanassetexceeds:

(a) theremainingamountofconsiderationthattheentityexpectstoreceiveinexchange forthegoodsorservicestowhichthecontractassetrelates,*less*

(b) theremainingcoststhatwillbeincurredinprovidingthosegoodsorservices.

EXAMPLE5

Acompanyhasrecognisedcontractcostsasanassetandthecarryingamountofthatassetiscurre ntly£350,000.Itisestimatedthatfurthercostsof£120,000willberequiredtocompletethecontrac t.Theremainingamountofconsiderationthatthecompanyexpectstoreceiveis£400,000.Calcul atetheamountofanyimpairmentloss.

Solution

Theremainingamountofconsiderationlesstheremainingcostsis£280,000(£400,000– £120,000).Sothereisanimpairmentlossof£70,000(£350,000–£280,000).

Presentationanddisclosure

Ifanentityhasperformedanobligationbytransferringgoodsorservicestothecustomer and the customer has not yet paid for these goods or services, the entity should present a "contractasset"initsstatementoffinancialposition(excludinganyamountwhichis presented as a receivable). In general, amounts are presented as a receivable only when the customer has been invoiced.

Similarly,a"contractliability"shouldbepresentedinthestatementoffinancialposition ifpaymentismadebeforetheentitytransfersthegoodsorservicestothecustomer.

EXAMPLE6

Acompanywhichpreparesaccountsto31Decembereachyearbeginsworkonaconstructioncontractforacustomeron21February2019.Theagreedpriceis£750,000andthecontractistobetreatedasasingleperformanceobligationwhichissatisfiedovertime.Thecontractiscompletedon13May2021.Relevantinformationisasfollows:

	31/12/2019	31/12/2020	31/12/2021
	£000	£000	£000
Certifiedvalueofworkcompletedtodate	285	615	750
Totalcostsincurredtodate	270	545	630
Costsrelatingtofutureactivity	15	10	-
Invoicedtocustomertodate	240	600	750
Amountsreceivedfromcustomertodate	190	510	750

Thecostsincurredtodateof£270,000asat31December2019and£545,000asat31December2020include£15,000and£10,000respectivelyformaterialstobeusedinthefollowingyear'scontractwork.Thecompanymeasurescontractprogressinaccordancewithcertificatesobtainedfromanindependentsurveyor.

Explainhowthiscontractshouldbereflectedinthecompany'sfinancialstatementsfortheyearsto31December2019,2020and2021.

Solution

	31/12/2019	31/12/2020	31/12/2021
	£000	£000	£000
Statementsofcomprehensiveincome			
Contractrevenue	285	330	135
Costofsales	255	280	95
Contractprofitfortheyear	30	50	40
Statementsoffinancialposition			
Inventory	15	10	-
Contractasset	45	15	-
Tradereceivables	50	90	-

Thesefigureshavebeenderivedasfollows:

(i) Eachyear'srevenuefigureisequaltothevalueoftheworkcompletedtodate,lesstherevenuerecognisedinpreviousyears(ifany).

(ii) Thecostoftheworkdonein2019is(£270,000–£15,000)=£255,000.Similarly,thecostoftheworkdonetodatebytheendof2020is£535,000.Sothecostoftheworkdoneduring2020is£280,000(£535,000–£255,000)andthecostoftheworkdoneduring2021is£95,000(£630,000–£535,000).

(iii) Thecontractassetattheendofeachyearisequaltothedifferencebetweencontractrevenuetodateandtheamountinvoicedtodate.Tradereceivablesareequaltothedifferencebetweentheamountinvoicedtodateandtheamountreceivedtodate.

Disclosurerequirements

IFRS15 requires that entities disclose sufficient information to enable users of the financial statements to understand the "*nature,amount,timinganduncertainty*" of revenue and cash flowsarisingfromcontractswithcustomers.Themaindisclosurerequirementsare:

(a) **Contractswithcustomers**.Theentityshoulddisclose:

  (i) theamountofrevenuefortheperiodarisingfromcontractswithcustomersand an analysis of this revenue into appropriate categories

  (ii) any impairment losses recognised during the period in relation to either contract assetsorreceivablesarisingfromtheentity'scontractswithcustomers

  (iii) the opening and closing balances of receivables, contract assets and contract liabilities rising from contracts with customers, together with an explanation of significantchangesinthecontractassetandliabilitybalancesduringtheperiod

  (iv) descriptiveinformationabouttheentity'sperformanceobligationsincontracts withcustomers,includingwhen(typically)theentitysatisfiesitsobligationsand the entity's significant payment terms

  (v) for performanceobligationsthat remainunsatisfiedat theendof theperiod, the total amount of therevenueallocatedtotheseobligations.

(b) **Significantjudgements**.Theentityshouldexplainthesignificantjudgementsmade inapplyingtherequirementsofIFRS15.Inparticular,theentityshoulddisclose:

  (i) forperformanceobligationsthataresatisfiedovertime,themethodsusedtomeas uretheprogressmadetowardssatisfactionofthoseobligations

  (ii) forperformanceobligationsthataresatisfiedatapointintime,thejudgements madesoastodeterminewhenacustomerobtainscontrolofgoodsorservices

  (iii) othersignificantjudgementsrelatingtomatterssuchasdeterminingtransaction prices,estimatingvariableconsideration,allocatingtransactionpricesetc.

GuidancetotheapplicationofIFRS15

IFRS15 provides application guidance to help entities apply the standard's requirements in specificsituations.Someofthemaintopicscoveredinthisguidanceareasfollows:

(a) *Saleswitharightofreturn*. If customers are granted the right to return products andobtain a refund, the entity should estimate the expected returns (possibly using the expected value method) and recognise as revenue only the amount of consideration to which it expects to be entitled. If the customer pays more than this amount, the entity should also recognise a refund liability for the amount of consideration to which itexpects notto be entitled.

An asset should be recognised (and cost of sales should be adjusted) to

represent the entity's right to recover inventory from customers.

(b) *Warranties.*Acontractwithacustomermayprovideawarranty.Ifthecustomerhas the option to purchase a warranty separately (perhaps because the warranty is priced separately) the warranty represents a distinct performance obligation and part of the transactionpriceshouldbeallocatedtoit.However,ifthewarrantycannotbe purchased separately, it should normally be accounted for in accordance with IAS37 *Provisions,ContingentLiabilitiesandContingentAssets*(seeChapter12).

(c) *Repurchaseagreements.*Arepurchaseagreementisacontractinwhichanentitysells anassetbutisalsoobliged(orhastheright)torepurchasetheassetatalaterdate.
Thefactthattheentityhasanobligationorrighttorepurchasetheassetmeansthat thecustomer'sabilitytoobtainsubstantiallyalloftheremainingbenefitsfromthe asset is curtailed. Accordingly, if the repurchase price is less than the original sellingprice, the entity should account for the contract as a lease in accordance with IFRS16 *Leases.*Otherwisethecontractshouldbetreatedasafinancingarrangement.Thisis an application of "substance over form" (see Chapter 2).

(d) *Consignmentarrangements.*Ifaproductisshippedtoarecipientwhoundertakesto sellthosegoodsonbehalfoftheshipper,revenueshouldnotberecognisedbythe shipper until thegoods havebeensoldtoathirdparty.

(e) *Billandholdarrangements.*Thesearecontractsinwhichtheentityinvoicesa customerforaproductbutretainsphysicalpossessionoftheproductuntilsuchtime as thecustomer requests delivery. For suchcontracts, theentityshoulddetermine whether or not the customer has yet obtained control of the product (see above) andshould recognise revenue only if this is the case.

Summary

- IFRS15setsoutafive-stepmodelfortherecognitionandmeasurementofrevenue from contracts with customers. Entities are required to identify the performance obligations in a contract with a customer and to recognise revenue when (or as) each performance obligation is satisfied.
- Transactionpriceistheconsiderationtowhichtheentityexpectstobeentitledwhen a customer contract is complete. Transaction price is allocated between performance obligationsonthebasisofthestand-alonesellingpriceofeachobligation.
- Performanceobligationsaresatisfiedbytransferringpromisedgoodsorservicesto the customer so that the customer obtains control of those goods or services.Performanceobligationsmaybesatisfiedovertimeoratapointintime.
- Contract costs relating to an obligation are normally treated as an asset until theobligationissatisfied.Thesecostsbecomeanexpensewhenrevenueisrecognised.
- IFRS15providesextensiveapplicationguidancerelatingtospecificsituations.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

13.1 Definetheterm"revenue".Alsoexplainthe"five-stepmodel"fortherecognitionandmeasurement of revenue which is set out in international standard IFRS15.

13.2 A company is contracted to build an asset for a customer. The contract price is £5m but thecontractstipulatesthatthecompanywillreceiveanincentivepaymentofafurther £1miftheassetiscompletedbytheendof2020.However,thecompanywillincura penalty of £1m if the asset is not completed by the end of June 2021.

The company estimates that the probability of completing the asset by the end of 2020 is 25% and the probability of not completing the asset by the end of June 2021 is 5%.

Determinethetransactionpriceforthiscontract.

13.3 Acompanysellsgoodstoacustomerfor£12,500.Thecontractstipulatesthatthe customerwillpay£2,500whenthegoodsaredelivered(andthecustomerobtainscontrolof them)and willthen pay a further£10,000 three years afterdelivery.Assuming aneffectiveinterestrateof8% perannum,calculatetheamountofrevenuewhichshould be recognised at the delivery date.

13.4 A customer buys three DVDs from a mail order company. These DVDs could have been boughtseparatelyandareregardedasdistinct.ThepricesnormallychargedfortheDVDs(ifboughtseparately)are£11,£14and£15respectively.Butthepricechargedfor the three DVDs if bought together is £30. How should this price be allocated?

13.5 Laidlow plc is a construction contractor which prepares financial statements to 31 May each year. The following information relates to a contract with a customer which began during the year to 31 May 2020 and which was still in progress on that date:

	£000
Contractprice	600
Costsincurredtodate:	
-forworkperformedupto31May2020	190
-toacquirematerialsforuseinfuturework	30
Estimatedfurthercoststocompletion	280
Invoicedtocustomerupto31May2020	175
Amountsreceivedfromcustomer	130

The contract is to be treated as a single performance obligation which is satisfied over time.Thecompanymeasurestheprogressmadeonacontractbycomparingthecosts incurred for the work performed to date with the estimated total contract costs.

(a) Showhowthiscontractwouldbereflectedinthecompany'sfinancialstatementsfor the year to 31 May 2020.

(b) How would the accounting treatment differ if the contract price was £480,000 but all of the other figures remained unaltered?

13.6 A companyentersintoacontracttobuildahouseforacustomeranddeterminesthatthis isasingleperformanceobligation.Thecustomerpaysanon-refundable5%depositat contract inception. The balance of the contract price is payable when the building workis finished and the customer takes possession of the house.

Isthisperformanceobligationsatisfiedovertimeorsatisfiedatapointintime?

*13.7Acompanyentersinto10,000contractswithcustomers,allonthesamedate.These contractshaveverysimilarcharacteristicsandtherefore(asapracticalexpedient)the company decides to apply the requirements of IFRS15 to the portfolio of contracts rather than accounting for each contract individually.

Each contract involves the sale of a single product at a price of £30. Customers pay for the product when it is delivered and obtain control of the product on the delivery date. Thetermsofthecontractentitlecustomerstoreturntheproductwithin60daysand receive a full refund of the purchase price. Based on previous experience, the company estimates that 4% of customers will exercise their right of return.

Explainhowthecompanyshouldaccountforthesetransactions.

*13.8Triangle,apubliclistedcompany,isintheprocessofpreparingitsdraftfinancial statements for the year to 31 March 2020.

On 1 April 2019, Triangle sold maturing inventory that had a carrying value of £3m (at cost)to Factorall,a finance house,for£5m.Itsestimated marketvalue atthisdate wasin excessof£5m. Theinventorywill not bereadyforsaleuntil 31March2023andwill remainonTriangle'spremisesuntilthisdate.Thesalecontractincludesaclause allowing Triangle to repurchase the inventory atany time up to 31 March 2023 ata price of £5m plus interest at 10% per annum compounded from 1 April 2019. The inventory willincurstoragecostsuntilmaturity.Thecostofstorageforthecurrentyearof £300,000 has been included in tradereceivables (in the name of Factorall). If Triangle choosesnotto repurchase the inventory,Factorallwillpay the accumulated storage costs on 31 March 2023. The proceeds of the sale have been debited to the bank and thesale has been included in Triangle's sales revenue.

Required:

Explain how this item should be treated in Triangle's financial statements for the year to 31 March 2020 in accordance with internationalaccounting standards.Youranswer shouldquantifytheamountswherepossible. *(ACCA)*

Chapter14

Employeebenefits

Introduction

This chapter is mainly concerned with IAS19 *EmployeeBenefits*. This standard prescribes accounting and disclosure requirements for all forms of benefits that are provided byemployers to their employees (except those covered by IFRS2 *Share-basedPayment*). The categories of employee benefits identified in IAS19 are:

(a) short-termemployeebenefits
(b) post-employmentbenefits(e.g.pensions)
(c) otherlong-termemployeebenefits
(d) terminationbenefits.

Thischapterexplainstheaccountingtreatmentrequiredforeachofthesecategories.A briefsummaryoftherequirementsofIFRS2isgivenattheendofthechapter.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- define each of the main categories of employee benefits which are identified ininternational standard IAS19 *EmployeeBenefits*
- explainandapplytherequiredaccountingtreatmentforshort-termemployeebenefits
- explain the term "post-employment benefit plan" and distinguish between definedcontribution plans and defined benefit plans
- explain and apply the required accounting treatment for defined contribution plansand for defined benefit plans
- outlinetheIAS19rulesrelatingtootherlong-termbenefitsandterminationbenefits
- list the main disclosures that should be made in the financial statements in relation toemployee benefits
- summarisetherequirementsofIFRS2*Share-basedPayment*.

Short-termemployeebenefits

IAS19 defines short-term employee benefits as "*employeebenefits(otherthanterminationbenefits)thatareexpectedtobesettledwhollybeforetwelvemonthsaftertheendoftheannualreportingperiodinwhichtheemployeesrendertherelatedservice*".Thismeans thatshort-termemployeebenefitsarethosewhichfalldueeitherduringtheperiodin whichtheemployeeprovidesservicestotheemployerorwithintwelvemonthsoftheend ofthatperiod.Thedefinitionofshort-termemployeebenefitscoversitemssuchas:

(a) wages,salariesandemployer'ssocialsecuritycontributions

(b) short-termholidaypayandsickpay

(c) profit-sharing payments and bonuses payable within twelve months of the end of the periodinwhichtherelatedemployeeservicesareperformed

(d) non-monetarybenefits(e.g.medicalcare,companycars)forcurrentemployees.

In general, accounting for short-term employee benefits presents no great difficulties. If an employeehasrenderedservicestoanemployerduringanaccountingperiod,the employer'sfinancialstatementsforthatperiodshouldusuallyrecognise:

(a) anexpenseequaltotheamountoftheshort-termemployeebenefitsdueinexchange for those services, and

(b) aliability(accruedexpense)equaltoanypartofthisexpensethathasnotbeenpaid by the end of the period.

Anexceptiontotherequirementtorecogniseanexpensearisesifanotherstandardrequires orpermitsthecostofthebenefitstoberecognisedasanasset.Forinstance,IAS16 requires employee benefits to be capitalised if they arise directly from the construction or acquisitionofanitemofproperty,plantorequipment(seeChapter5).

Note that short-term employee benefits are measured on an undiscounted basis, since the required payments are made either during the relevant accounting period or within twelve monthsofitsend,sothattheeffectofdiscountingwouldbeminimal.

Short-termpaidabsences

IAS19usestheexpression"short-termpaidabsences"torefertopaidemployeeabsences (e.g. paid holidays and paid sick leave) which occur during the period in which the related employeeservicesareperformedorwhichareexpectedtooccurwithintwelvemonthsof theendofthatperiod.Entitlementtopaidabsencesfallsintotwocategories:

(a) "accumulating"paidabsences,whichcanbecarriedforwardandusedinafuture periodifthecurrentperiod'sentitlementisnotusedinfull

(b) "non-accumulating"paidabsences,whichcannotbecarriedforward.

In the case of accumulating short-term paid absences, the employer's statement of financial position should show a liability equal to the expected amount payable during

the following twelvemonthsasaresultofunusedentitlementcarriedforward.

EXAMPLE1

Acompanyhas1,000employees,eachofwhomisentitledtotendaysofpaidsickleaveineachcalendaryear.Unusedsickleaveattheendofeachyearmaybecarriedforwardforuptoonefurthercalendaryear.Sickleaveistakenfirstoutofthecurrentyear'stendayentitlementandthenoutofanyunusedentitlementbroughtforward.

At31December2019,theaverageunusedentitlementissixdaysperemployee.Basedonpastexperience,thecompanyexpectsthat85%ofemployeeswilltakenomorethantendayssickleaveintheforthcomingyearbutthattheremaining15%ofemployeeswilleachtakeanaverageoftwelvedays.

Assuminganaveragecosttothecompanyof£120perdayofpaidsickleave,calculatetheliabilitywhichshouldappearinthecompany'sstatementoffinancialpositionat31December2019inrelationtopaidsickleave.

Solution

850employeesarenotexpectedtomakeuseoftheirunusedentitlementandthereforetheamountexpectedtobepaidinrelationtotheseemployeesis£nil.Theremaining150employeesareeachexpectedtousetwodaysoftheirunusedentitlement.Therefortheliabilitywhichshouldappearinthecompany'sstatementoffinancialpositionasat31December2019is£36,000(150x2x£120).

Profit-sharingandbonuspayments

Profit-sharingandbonuspaymentspayablewithintwelvemonthsoftheendoftheperiod in which the employees render the related services are short-term employee benefits andshouldberecognisedasanexpenseinthatperiod,solongas:

(a) thereisapresentobligationtomakethepaymentsasaresultofpastevents,and

(b) areliableestimateoftheobligationcanbemade.

A"presentobligation"existswhentheemployerhasnorealisticalternativebuttomake the payments concerned. This may be a legal or a constructive obligation. A constructive obligationisnotlegallyenforceablebutderivesfromtheentity'sactions(seeChapter12).

Profit-sharingandbonuspaymentswhichfallduemorethantwelvemonthsaftertheendoftheperiodaretreatedas"otherlong-termemployeebenefits"(seelaterinthischapter).

Disclosuresrelatingtoshort-termemployeebenefits

IAS19makesnospecificdisclosurerequirementsrelatingtoshort-termemployeebenefits. However,certaindisclosuresarerequiredbyotherstandards.Forinstance:

(a) IAS1*PresentationofFinancialStatements*requiresdisclosureofthetotalemployee benefitsexpenseforeachaccountingperiod(seeChapter3),and

(b) IAS24*RelatedPartyDisclosures*requires disclosures relatingtobenefits providedfor key management personnel (see Chapter 21).

Post-employmentbenefits

Post-employment benefits consist mainly of retirement benefits, such as pensions. In some cases,thepost-employmentbenefitsschemeisadministereddirectlybytheemployer.In other cases, a separate entity (a pension fund) is set up to receive contributions and pay employeebenefits.Ineithercase,therequirementsofIAS19shouldbeapplied.

IAS19distinguishesbetweentwotypesofpensionschemeor"plan":

(a) **Definedcontributionplans**. Defined contribution plans are post-employment benefit planswhereanemployerpaysfixedcontributionsintoapensionfundeachyearand is not obliged to make any further contributions, even if the pension fund's assets are insufficienttopaytheexpectedlevelofemployeebenefits.Theriskthatbenefitswill belessthanexpectedfallsupontheemployees,nottheemployer.

(b) **Definedbenefitplans**.Definedbenefitplansarepost-employmentbenefitplans whereretheemployerisobliged(eitherlegallyorconstructively)toprovideanagreed levelofpost-employmentbenefits.Theemployer'scontributionsarenotlimitedto anyfixedamountandthesecontributionsmayneedtobeincreasedifthepension fundhasinsufficientassetstopaytheagreedlevelofbenefits.Theriskofhavingto makefurthercontributionsisbornebytheemployer,nottheemployee.

Accountingfordefinedcontributionplans

Accounting for defined contribution plans is straightforward. If an employee has rendered servicestoanemployerduringanaccountingperiod,theemployer'sfinancialstatements for that period should usually recognise:

(a) an expense equal to the amount of the contributions payable by the employer into the definedcontributionplaninexchangeforthoseservices,and

(b) aliability(accruedexpense)equaltoanypartofthisexpensethathasnotbeenpaid by the end of the period.

If the contributions already paid exceed the amount due to date, the excess should berecognisedasanasset(prepaidexpense)totheextentthatthisprepaymentwillleadto eitherareductioninfuturepaymentsoracashrefund.Notealsothat:

(a) As for short-term benefits, the requirement that an expense should be recognised in relation to post-employment benefits may be over-ruled by another standard which requiresorpermitsthecostofthosebenefitstobeincludedinthecostofanasset.

(b) Contributions to a defined contribution plan are measured on an undiscounted basisunless they fall due more than twelve months after the end of the period in which employees render the related services.

(c) Theamountrecognisedasanexpenseinrelationtodefinedcontributionplansshould bedisclosedinthenoteswhichformpartoftheemployer'sfinancialstatements.

Accountingfordefinedbenefitplans

Accountingfordefinedbenefitplansisacomplexmatterandmuchof IAS19isdevotedto this topic. The complexity arises because the expense recognised in each accounting period should be the cost to the employer of the retirement benefits that will eventually be paid to employeesasaresultoftheservicesthattheyhaveprovidedduringthatperiod.The problemisthatthesebenefitsmaybepayableinmanyyears'timeandtheircostwill depend upon a number of factors which are difficult to determine in advance, such asemployeemortalityratesandfuturereturnsoninvestments.Theemployerisexposedto both the "actuarial risk" that employees will live longer than expected (which increases thecost of providing benefits) and the "investment risk" that assets invested in the plan will be insufficient to pay the required benefits.

In these circumstances, the calculation of the expense which should be recognised in an accountingperiodinrelationtoadefinedbenefitplanisnotstraightforward.Furthermore, a liability (or asset) must be shown in the employer's financial statements in relation to theplanandtheamountofthisliabilityorassetalsohastobecalculated.Asimplified summaryofthemainfeaturesofthesecalculationsisgivenbelow.

Mainstepsinthedefinedbenefitcalculations

AccountingfordefinedbenefitplansinaccordancewiththerequirementsofIAS19 involves the following main steps:

(a) Attheendofeachaccountingperiod,reliableestimatesmustbemadeof:

(i) the amount of the accumulated benefits which past and present employees have earnedinreturnfortheirservicestodateandwhichwillbepayabletothemin the future ("the defined benefit obligation")

(ii) the extra amount of such benefits that employees have earned in return for their servicesduringthecurrentperiod(the"currentservicecost").

These estimates involve the making of assumptions with regard to such matters as employeemortalityratesandfuturesalaryincreases.Employersareencouraged(but notrequired)byIAS19toengageaqualifiedactuarytomakethenecessaryestimates.

(b) Theseestimatesarediscountedsoastodeterminethepresentvalueofthedefined benefitobligationandthepresentvalueofthecurrentservicecost.

(c) The "interest cost" for the period is calculated. This is equal to the increase during the current accounting period of the present value of the defined benefit obligation whichwas calculated at the end of the previous period (adjusted if part of that obligation hasnow been discharged as a result of benefit payments). This increase arises because the accumulatedbenefitswhichemployeeshadearnedattheendofthepreviousperiod are now one period closer to being paid.

(d) "Actuarialgainsandlosses"withregardtothedefinedbenefitobligationmaynowbe calculated. These are caused by:

(i) differencesbetweenactuarialassumptionswhichweremadeattheendofthe previousperiodandeventsthatactuallyoccurredduringthecurrentperiod

(ii) changesinactuarialassumptionsbetweenthestartandendoftheperiod.

The overall actuarial gain or loss with regard to the defined benefit obligation for an accountingperiodiscalculatedbysummarisingthechangesinthatobligationduring theperiodandinsertingabalancingfigure,asillustratedbelow:

	£000
PresentvalueofDBobligationatstartofperiod	xxx
Add:Interestcost	xxx
Presentvalueofcurrentservicecost	xxx
Less:Benefitspaidduringtheperiod	(xxx)
	xxx
Actuariallosses/(gains)	xxx(balancingfigure)
PresentvalueofDBobligationatendofperiod	xxx

(e) Thefinalstepintheprocessistodeterminethefairvalueoftheplanassets(ifany)at the end of the accounting period and to reconcile this figure with the fair value of plan assetsatthestartoftheperiod.Thereconciliationisasfollows:

	£000
Fairvalueofplanassetsatstartofperiod	xxx
Add:Interestincome	xxx
Returnonplanassets	xxx
Contributionsreceivedfromemployer	xxx
Contributionsreceivedfromemployees	xxx
Less:Benefitspaidduringtheperiod	(xxx)
Fairvalueofplanassetsatendofperiod	xxx

Notethat:

(i) The "interest income" for the period is obtained by multiplying the fair value ofplan assets at the start of the period by the interest rate used when calculating the interestcost(buttakingaccountofchangesinplanassetsduringtheperiod).

(ii) Return on plan assets is defined as "*interest,dividendsandotherincomederivedfromtheplanassets,togetherwithrealisedandunrealisedgainsorlosses*", less interest income for the period.

These calculations provide all the figures required in order to compute the defined benefit expenseforthe periodandthedefinedbenefitliability(orasset)attheendoftheperiod. Thewayinwhichtheseamountsarederivedisexplainedbelow.

Thedefinedbenefitexpenseandthedefinedbenefitliability

Thedefinedbenefitexpensewhichisshowninthestatementofcomprehensiveincome whencalculatingprofitorlossforanaccountingperiodisarrivedatby*adding*:

(a) thepresentvalueofthecurrentservicecostfortheperiod

(b) interest cost for the

period and then *subtracting*:

(c) theamountofanyemployeecontributionsmadeduringtheperiod(sincethesehave helped to fund the current service cost)

(d) interestincomefortheperiod.

IAS19 requires that any actuarial gains or losses and the return on plan assets (less interest income) should be shown in other comprehensive income. These amounts may not be reclassifiedtoprofitorlossinasubsequentaccountingperiod(seeChapter3).

Thedefinedbenefitliability(i.e.deficit)showninthestatementoffinancialpositionis equaltothepresentvalueofthedefinedbenefitobligationattheendoftheperiod,lessthe fairvalueoftheplanassetsatthatdate.Asurplusisrecognisedasanasset.

EXAMPLE2

Acompanywhichpreparesannualaccountsto31Decemberhasoperatedadefinedbenefitpensi onschemeformanyyears.Theschemeisnon-contributory(i.e.employeesarenotrequiredtomakecontributions).At31December2018,theco mpany'sstatementoffinancialpositionshowedadefinedbenefitliabilityof£575,000,madeupasf ollows:

	£000
Presentvalueofdefinedbenefitobligation	
2,430Fairvalueofplanassets	1,855
Definedbenefitliability	575

Thefollowingfiguresrelatetotheyearto31December2019:

	£000
Presentvalueofcurrentservicecostfortheyear	415
Interestcost	170
Interestincome	130
Returnonplanassets(beforedeductinginterestincome)	235
Employercontributions	450
Benefitspaid	375
Presentvalueofdefinedbenefitobligationatendofyear	2,760
Fairvalueofplanassetsatendofyear	2,165

Calculatethedefinedbenefitexpensefortheyearto31December2019.Alsocalculatethedefined benefitliability(orasset)whichshouldbeshowninthecompany'sstatementoffinancialpositiona satthatdate.

Solution

Calculationofactuarialgainsorlosses:

	£000
PresentvalueofDBobligationatstartofyear	2,430
Interestcost	170
Presentvalueofcurrentservicecostfortheyear	415
Benefitspaidduringtheyear	(375)
	2,640
Actuariallosses(balancingfigure)	120
Presentvalueofdefinedbenefitobligationatendofyear	2,760

Reconciliationofthefairvalueofplanassets:

	£000
Fairvalueofplanassetsatstartofyear	1,855
Interestincome	130
Returnonplanassets(afterdeductinginterestincome)	105
Employercontributions	450
Benefitspaidduringtheyear	(375)
Fairvalueofplanassetsatendofyear	2,165

Theamountswhichshouldbeshowninthecompany'sfinancialstatementsfortheyearto31December2019areasfollows:

Definedbenefitexpense:

	£000
Presentvalueofcurrentservicecostfortheyear	415
Interestcost	170
Interestincome	(130)
Expenserecognisedinprofitorloss	455
Actuariallosses	120
Returnonplanassets	(105)
Expenserecognisedinothercomprehensiveincome	15

Definedbenefitliability:

	£000
Presentvalueofdefinedbenefitobligationatendofyear	2,760
Fairvalueofplanassetsatendofyear	2,165
DBliabilityinstatementoffinancialposition	595

Thedefinedbenefitexpenseforthe yearis£470,000intotal,butemployercontributionswereonly£450,000.Thisiswhythedefinedbenefitliability(i.e.deficit)hasincreasedby £20,000duringtheyear,from£575,000to£595,000.

Disclosuresrelatingtodefinedbenefitplans

IAS19makesextensivedisclosurerequirementswithregardtodefinedbenefitplans.The main disclosures required are as follows:

(a) Informationwhichexplainsthecharacteristicsofeachoftheentity'sdefinedbenefit plans and the risks associated with that plan:

  (i) thenatureofthebenefitsprovidedbytheplan
  (ii) adescriptionoftheregulatoryframeworkwithinwhichtheplanoperates
  (iii) adescriptionofanyotherentity'sresponsibilitiesforgovernanceoftheplan
  (iv) adescriptionoftheriskstowhichtheentityisexposedbecauseoftheplan.

(b) Informationwhichidentifiesandexplainstheamountsintheentity'sfinancial statements which relate to defined benefit plans:

  (i) a reconciliation between the opening and closing balances of the defined benefit liability(orasset),showingseparatereconciliationsfortheplanassetsandfor the present value of the defined benefit obligation
  (ii) an analysis of the fair value of the plan assets into classes which distinguish the nature and risks of those assets, subdividing each class into assets which have a quotedpriceinanactivemarket andthosethat donot
  (iii) the fair value of the entity's own financial instruments held as plan assets and thefairvalueofanyplanassetsconsistingofpropertyoccupiedbytheentityor other assets used by the entity
  (iv) the significant actuarial assumptions used to determine the present value of the defined benefit obligation.

(c) Information which describes how the entity's defined benefit plans may affect theamount, timinganduncertaintyof its futurecashflows:

  (i) asensitivityanalysisforeachsignificantactuarialassumptionusedtodetermine the present value of the defined benefit obligation, showing how the obligation wouldhavebeenaffectedbychangesineachassumption
  (ii) adescriptionoffundingarrangementsthataffectfuturecontributions
  (iii) theexpectedcontributionstotheplanforthenextannualaccountingperiod
  (iv) informationaboutthematurityprofileofthedefinedbenefitobligation,suchas a maturity analysis of benefit payments.

Otherlong-termemployeebenefits

"Otherlong-termemployeebenefits"includeitemssuchas:

(a) long-termpaidabsencessuchaslong-serviceleaveandsabbaticalleave

(b) long-termdisabilitybenefits

(c) profit-sharingandbonuspayments

aslongasthesearenotexpectedtobesettledwhollybeforetwelvemonthsaftertheendof theperiodinwhichtheemployeesrendertherelatedservices.

The accounting treatment of these benefits is similar to the treatment required for defined benefitpost-employmentplans.Theemployer'sfinancialstatementsforanaccounting period should recognise:

(a) a liability equal to the present value at the end of the period of the accumulated long-termbenefitstowhichemployeesareentitledinreturnfortheirservicestodate,less thefairvalueofanyassetsoutofwhichthisobligationistobesettled

(b) an expense, equal to the extra amount of such benefits that employees have earned in returnfortheirservicesduringthecurrentperiod(thecurrentservicecost)adjusted forinterestcost,interestincome,returnonassetsandactuarialgains/losses.

IAS19 requires that the whole of the above expense should be taken into account when calculating the employer's profit or loss, with none of it recognised in other comprehensive income. However, as is the case for short-term employee benefits and post-employment benefits, the requirement to recognise an expense may be over-ruled by another standardwhichrequiresorpermitsthecostofthebenefitstobeincludedinthecostofanasset.

IAS19doesnotcontainanyspecificdisclosurerequirementswithregardtootherlong-term employee benefits. However, certain other standards (e.g. IAS1 and IAS24) require a numberofdisclosuresrelatingtoemployeebenefits(seeearlierinthischapter).

Terminationbenefits

TerminationbenefitsaredefinedbyIAS19as"*employeebenefitsprovidedinexchangeforthe terminationofanemployee'semployment…*".Thesemayarisebecauseanentity decides to terminate an employee's employment or because of an employee's decision toacceptanofferofbenefitsinexchangefortheterminationofemployment.

IAS19 requires that an entity should recognise a liability and an expense for termination benefits at the earlier of the following dates:

(a) whentheentitycannolongerwithdrawtheofferofthosebenefits

(b) whentheentityrecognisescostsforarestructuringthatiswithinthescopeofIAS37 (seeChapter12)andwhichinvolvesthepaymentofterminationbenefits.

Terminationbenefitsthatareexpectedtobesettledwhollybeforetwelvemonthsafterthe endoftheperiodinwhichtheyarerecognisedshouldbemeasuredinthesamewayas short-termbenefits(i.e.onanundiscountedbasis).Otherwise,terminationbenefitsshould bemeasuredinthesamewayasotherlong-termemployeebenefits.

IAS19 does not contain any specific disclosure requirements with regard to termination
benefits.However,asmentionedabove,certainotherstandards(e.g.IAS1andIAS24) requireanumberofdisclosuresrelatingtoemployeebenefits.

Share-basedpayments

TheobjectiveofIFRS2*Share-basedPayment*istoprescribetheaccountingtreatmentof payments made by an entity either:

(a) intheformofshares(includingshareoptions),or

(b) incash,wheretheamountofcashpayabledependsuponthecompany'sshareprice.

Share-based payments could be made in exchange for any goods or services received by an entitybuttheemphasisinthischapterisonshare-basedpaymentsmadetoemployees.

In this situation, it is important to distinguish between the date on which an entity and an employee agree to a share-based payment arrangement (the "grant date") and the date onwhichtheemployeebecomesentitledtoreceivethepaymentconcerned(the"vesting date"). The employee will normally have to satisfy certain "vesting conditions" during the intervening period (the "vesting period") to be eligible for the payment. The main require- mentsofIFRS2inrelationtoshare-basedpaymentstoemployeesareasfollows:

(a) In the case of payments which take the form of equity instruments (i.e. shares or share options) the entity should measure the fair value of each equity instrument at the grant date.Oncemade,thismeasurementisfixedandisnotadjustedtoreflectanychanges insharevalues(orshareoptionvalues)duringthevestingperiod.

(b) Itisthenpresumedthattheemployeesconcernedwillrenderservicestotheentity duringthevestingperiodinordertoearntheirshare-basedpayments.Thereforethe cost of providing such payments is written off as an expense over that period, with a correspondingincreaseinequity.Thiswillinvolvetheuseofanequityaccount entitled "shares to be issued" or something similar.

(c) Estimatesofthenumberofequityinstrumentstobeissuedonthevestingdatemayvaryduringthevestingperiodasemployeessatisfy(orfailtosatisfy)thevesting conditions. Such changes are accounted for prospectively in accordance with IAS8 *AccountingPolicies,ChangesinAccountingEstimatesandErrors*(seeChapter4).

(d) Any remaining balance on the "shares to be issued" account after vesting has occurred must remain in equity (but may be transferred to another component of equity). This

wouldoccurifemployeeswhosatisfythevestingconditionsandreceiveshare options then decide not to exercise those options.

(e) In the case of share-based payments which are to be settled in cash, the entity should measurethisliabilityatfairvalueatthegrantdateandthenre-measurethefairvalue oftheliabilityateachreportingdateduringthevestingperiod.Anychangesinthis fair value during an accounting period are recognised in the calculation of the entity's profit or loss for that period.

(f) Asisthecaseforequity-settledshare-basedpayments,thecostofprovidingcash-settledshare-basedpaymentsiswrittenoffasanexpenseoverthevestingperiod.

EXAMPLE3

On1January2019,acompanywhichpreparesaccountsto31Decembergrants5,000shareoption seachtotwelveofitsseniorемployees.Thefairvalueofoneshareoptionat1January2019is£9.Th especifiedvestingdateis31December2021andthegrantisconditionalupontheachievementofc ertainperformancetargetsbythatdate.

On31December2019,itisestimatedthatalltwelveoftheemployeeswillachievetheirperformanc etargetsbythevestingdate.However,by31December2020thisestimatehasfallentoelevenempl oyeesandinfactonlytenoftheemployeesactuallyachievetheirtargetsby31December2021.

Showhowthesetransactionsshouldbetreatedinthecompany'sfinancialstatements.

Solution

At31December2019,thetotalcostoftheoptionsisexpectedtobe£540,000(12×5,000 × £9).Onethirdofthevestingperiodhasexpiredby31December2019.Soanexpenseof £180,000(1/3rdof£540,000)shouldberecognisedinthecompany'sfinancialstatementsfortheyearto31December2019andequityshouldbeincreasedby£180,000.

At31December2020,thetotalcostoftheoptionsisexpectedtobe£495,000(11×5,000 × £9).Twothirdsofthevestingperiodhasnowexpiredsotheexpensetodateis£330,000(2/3rdsof £495,000).Anexpenseof£180,000wasrecognisedinthepreviousyearsoafurtherexpenseof£150,000(£330,000–£180,000)shouldberecognisedinthefinancialstatementsfortheyearto31December2020andequityincreasesby£150,000.

At31December2021,thefinalcostoftheoptionschemeiscalculatedas£450,000(10×5,000×£9). Previouslyrecognisedexpensesare£330,000soanexpenseof£120,000(£450,000–£330,000) shouldberecognisedinthefinancialstatementsfortheyearto31December2021andequityshoul dbeincreasedby£120,000.

Theamountof£450,000showninequityfortheshareoptionswillbetransferredtosharecapital(a ndpossiblysharepremium)whentheoptionsareexercisedbythesuccessfulemployees.Ifanyoft heseemployeesdecidenottoexercisetheiroptions,anyremainingbalanceinthe"sharestobeissu ed"accountmustremaininequity(butmaybetransferredtoanothercomponentofequity).

Disclosuresrelatingtoshare-basedpayments

IFRS2 makes extensive disclosure requirements. In summary, an entity which undertakesshare-based payment transactions should disclose information that enables the users of the financial statements to understand:

(a) thenatureandextentofanyshare-basedpaymentarrangementsthatexistedduring the accounting period

(b) howthefairvalueofequityinstrumentsgrantedduringtheperiodwasdetermined

(c) theeffectofshare-basedpaymenttransactionsontheentity'sprofitorlossforthe periodanditsfinancialpositionattheendoftheperiod.

Summary

- Short-termemployee benefits are employee benefits (other than termination benefits)thatareexpectedtobesettledwhollybeforetwelvemonthsaftertheendofthe period inwhichtheyareearned.Theyarerecognisedasanexpenseinthatperiod.
- Anemployershouldrecognisealiabilityfortheexpectedamountpayableinrelation toemployees'unusedentitlementtoaccumulatingshort-termpaidabsences.
- Post-employmentbenefitsconsistlargelyofpensions.Apensionschemeorplanmay beadefinedcontributionplanoradefinedbenefitplan.
- A defined contribution plan is one where the employer's contributions are fixed. The employer'sfinancialstatementsshouldshowanexpenseequaltotheagreedamount of contributions for the period.
- Adefinedbenefitplanisonewheretheemployerisobligedtoprovideanagreed level of post-employment benefits. It is necessary to make actuarial estimates of the accumulated post-employment benefits which employees have earned to date and the extraamountofsuchbenefitsthatemployeeshaveearnedduringthecurrentperiod.
- Actuarialgainsorlosseswithregardtothedefinedbenefitobligationmaybecaused byexperienceadjustmentsorbychangesinactuarialassumptions.
- The defined benefit expense for an accounting period is basically equal to the present value of the extra benefits that employees have earned during that period. But this is adjustedtoreflectinterestcost,interestincomeandemployeecontributions.
- Actuarial gains or losses and the return on plan assets (excluding interest income) are shown in other comprehensive income.
- The defined benefit liability at the end of an accounting period is equal to the present valueofthedefinedbenefitobligationlessthefairvalueoftheplanassets.

- The accounting treatment of other long-term employee benefits (e.g. long-term paid absences)issimilartothetreatmentrequiredfordefinedbenefitplans.
- Termination benefits should be recognised as a liability and as an expense when the employer can no longer withdraw the offer of those benefits, or when the employer providesforrestructuringcostswhichinvolvethepaymentofterminationbenefits.
- IFRS2*Share-basedPayment*prescribestheaccountingtreatmentofpaymentswhich take the form of shares, share options or amounts of cash which depend upon acompany's share price.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

14.1 List the four main categories of employee benefits which are identified by international standard IAS19 and give examples of each category.

14.2 Acompanyhas10,000employees.Eachemployeeisentitledtotwentydaysofpaid holiday percalendaryear.Up to five days of this entitlementmay be carried forward and taken in the following year but cannot be carried forward any further. Employees are not paid for any holidays which they fail to take.

As at 31 December 2019, a total of 9,130 employees had used their full holiday entitle- ment for 2019. The remaining employees are carrying forward an average of three days peremployee.Basedonpastexperience,itisexpectedthattheseemployeeswilleachu se an average of two of these three days before the end of 2020.

Each day of paid holiday costs the company an average of £150. Calculate the liability whichshouldappearinthecompany'sstatementoffinancialpositionat31December 2019 with regard to paid holiday entitlement.

14.3 (a)Distinguishbetweendefinedcontributionpensionplansanddefinedbenefit pension plans.

(b) Acompany'sagreedcontributionstoadefinedcontributionplanfor2019are £350,000. Of this sum, the company had paid £320,000 by the end of the year. It is becoming clearthatthe pension fund assetswillbe insufficientto finance the expected level of employee benefits and that the company would have to increase its annual contributions by 50% if employee expectations were to be met.

Calculatetheexpensewhichshouldbeshowninthestatementofcomprehensive income for the year to 31 December 2019 in relation to this plan.Also calculate the amount of the liability which should appear in the statement of financial position.

(c) Explainwhyaccountingforadefinedbenefitplanismuchmoredifficultthan accounting for a defined contribution plan.

14.4 (a) Withregardtodefinedbenefitpensionplans,explaineachofthefollowingterms:

(i) definedbenefitobligation (ii)currentservicecost
(iii)interestcost (iv)actuarialgainsandlosses.

(b) Identify the main components of the defined benefitexpense which should be shown in an employer's statement of comprehensive income.

(c) Identify the main components of the defined benefit liability which should appearin the employer's statement of financial position.

14.5 Northerley plc prepares accounts to 31 December each year and has operated a defined benefit pension scheme for many years. At 31 December 2018, the present value of the defined benefit obligation was calculated to be £22.5m and the fair value of plan assets was £21.9m. The following information relates to the year to 31 December 2019:

(a) The present value of the current service cost for the year is £3.7m. This is before deducting employee contributions.

(b) Interestcostandinterestincomefortheyearhavebeencalculatedat£1.8mand £2.1mrespectively.

(c) Thereturnonplanassets(beforedeductinginterestincome)was£2.9m.

(d) Northerley plc made contributions of £3.8m into the plan. Employees contributed a further £1.5m.

(e) Theplanpaidoutbenefitstopastemployeesamountingto£1.9m.

(f) At31December2019,thepresentvalueofthedefinedbenefitobligation is£27.4m and the fair value of plan assets is £28.2m.

Calculatethedefinedbenefitexpensewhichshouldappearinthecompany'sstatemen tof comprehensive income for the year to 31 December 2019 and the defined benefit assetor liability which should appear in the statement of financial position at that date. Also reconcile the expense for the year to the employer contributions made during the year.

***14.6** Prentiss plc operates a defined benefit pension plan and prepares financial statements to 31 March each year. The financial statements for the year to 31 March 2019 showed that the present value of the defined benefit obligation on 31 March 2019 was £140m and the fair value of the plan assets on that date was £147m. The following information relatesto the year to 31 March 2020:

(i) The company made contributions of £18.4m into the plan. Employee contributions were £7.3m.

(ii) Benefitspaidintheyearwere£19.6m.

(iii) Thereturnonplanassets(beforedeductinginterestincome)was£5.9m.

(iv) Thepresentvalueofthecurrentservicecostfortheyearisestimatedat£19.2m.

(v) Theinterestcostfortheyearwas£9.8mandinterestincomewas£10.3m.

At 31 March 2020, the company's actuary estimated that the present value of the defined benefit obligation was £158m. The fair value of plan assets was £159m.

Required:

(a) Identify the main difference between a defined benefit pension plan and a defined contribution pension plan.

(b) Explain the terms "defined benefit obligation" and "current service cost" in relation to defined benefit pension plans. Also explain why the amounts of these items can only be estimated.

(c) Explaintheterms"interestcost"and"actuarialgainsandlosses".

(d) Calculatethedefinedbenefitexpensewhichshouldbeshowninthecompany's statementofcomprehensiveincomefortheyearto31March 2020.Explainwhythe amount of this expense is not equal to the £18.4m contributed by the company during the year.

(e) Calculatethedefinedbenefitassetorliabilitywhichshouldbeshowninthe company's statement of financial position at 31 March 2020. Reconcile this amount to the equivalent amount at 31 March 2019.

***14.7** On 1 January 2019, a company which prepares accounts to 31 December grants "share appreciationrights"to30ofitsemployees.Byvirtueoftheserights,theemployees concernedwillbecomeentitledtoacashpaymenton31December2021oncondition thattheyarestillemployeesofthecompanyatthatdate.The amountofthiscash paymentwilldependupontheoverallincreaseinthecompany'ssharepriceoverthethre e years between 1 January 2019 and 31 December 2021.

On 31 December2019,the company estimatesthat29oftheemployeeswillremain with the company until 31 December 2021. The fair value of the share appreciation rights at 31 December 2019 is £2,400 per employee.

On 31 December2020,the company estimatesthat26 ofthe employeeswillremain with the company until 31 December 2021. The fair value of the share appreciation rights at 31 December 2020 is £3,000 per employee.

On 31 December 2021, 24 of the employees are still employed by the company. The fair value of the share appreciation rights on that date is £2,150 per employee.

Showhowthesetransactionsshouldbetreatedinthecompany'sfinancialstatements.

Chapter15

Taxationinfinancialstatements

Introduction

Thischapterisconcernedwiththetreatmentoftaxationinfinancialstatements.The applicablestandardisIAS12*IncomeTaxes*,whichsetsoutrulesfortheaccountingtreatmentof"currenttax"and"deferredtax".Bothofthesetermsaredefinedinthischapter and the requirements of IAS12 are explained.

ItisimportanttoappreciatethatIAS12issolelyconcernedwithaccountingfortaxation andis*not*concernedwiththeactualcalculationoftaxliabilities.Thetaxsystemdiffers widely between countries and it would be beyond the scope of international standards (and beyondthescopeofthisbook)totrytoexplainhowanentity'staxliabilityforan accounting period is calculated. IAS12 assumes throughout that the tax calculations have already been done and that the problem now is how to account for taxation in the financial statements of the entity concerned.

Despite its title, IAS12 deals with any taxes payable on the profits of an entity, no matterwhat those taxes might be called in different countries. For example, the corporation tax payableontheprofitsofUKcompaniesfallswithinthescopeofIAS12.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- define the term "current tax" and account for current tax in accordance with therequirements of IAS12 *IncomeTaxes*
- definetheterm"temporarydifferences" anddistinguishbetweentaxabletemporary differences and deductible temporary differences
- explainthemeaningofthe"taxbase"ofanassetorliability
- calculate the deferred tax assets and liabilities arising from deductible and taxabletemporary differences
- accountfordeferredtaxinaccordancewiththerequirementsofIAS12.

Currenttax

IAS12definescurrenttaxas"*theamountofincometaxespayable(recoverable)inrespectoftthetaxableprofit(taxloss)foraperiod*". As mentioned earlier, the term "income taxes" referstoanytaxwhichispayableonanentity'sprofits,regardlessofthenamegivento thattaxinthecountryconcerned.ThemainrequirementsofIAS12withregardtocurrent tax may be summarised as follows:

(a) Theamountofcurrenttaxforanaccountingperiodshouldgenerallyberecognisedas an expense (or as income in the case of tax recoverable) and should be included in the calculation of profit or loss. IAS1 requires that the tax expense should be presented separatelyinthestatementofcomprehensiveincome(seeChapter3).However:

(i) Any current tax that arises from an item which is recognised in "othercomprehensiveincome"inthestatementofcomprehensiveincomeshould also berecognisedinothercomprehensiveincome.Examplesofsuchitemsinclude:

– revaluation surpluses arising in relation to property, plant and equipment or intangible assets (see Chapters 5 and 6)

– certainforeignexchangedifferences(seeChapter21).

(ii) Any current tax that arises from an item which is recognised directly in thestatement of changes in equity should also be recognised in the statement ofchanges in equity. One example of such an item is an adjustment to the opening balance of retained earnings resulting from the retrospective application of an accountingpolicyorthecorrectionofapriorperioderror(seeChapter4).

(b) Any current tax that remains unpaid at the end of the period should be recognised as a liability. If the amount already paid exceeds the amount due, the excess should be recognised as an asset. The benefit relating to a tax loss that can be carried back torecovercurrenttaxofapreviousperiodshouldalsoberecognisedasanasset.

Current tax assets and liabilities should not be offset in the statement of financial positionunlessthereisalegallyenforceablerighttosetofftheamountsconcerned andtheentityintendstodoso.Thiswouldnotapplyif(forexample)theentityowed taxinonecountryandwasduetoarefundoftaxfromanothercountry.

(c) Currenttaxshouldbemeasuredusingtaxratesandtaxlaws"*thathavebeenenactedorsubstantivelyenactedbytheendofthereportingperiod*". Tax rates and tax lawswhich have been announced but not enacted by the end of the period can be treated as "substantivelyenacted"iftheirenactmentisregardedasmoreorlessaformality.

Tax rates and laws announced after the end of the reporting period are dealt with asnon-adjustingeventsinaccordancewiththerequirementsofIAS10(seeChapter12).

(d) Anyadjustmentsnecessarysoastoreflectunderestimatesoroverestimatesofcurrent taxinpreviousperiodsshouldbeincludedinthetaxexpenseforthecurrentperiod and then (if material) disclosed separately in the notes. This is in accordance with the requirements of IAS8 (see Chapter 4).

EXAMPLE1

Thefollowinginformationrelatestoacompanywhichpreparesaccountsto30Juneeachyearandisnowcompletingitsfinancialstatementsfortheyearto30June2019:

(a) Thecompanyestimatesthatcurrenttaxfortheyearto30June2019is£750,000.Thisfiguretakesintoaccountnewtaxrateswhichwereannouncedin March2019andwhichareconfidentlyexpectedtobeenactedinAugust2019.Ifthenewtaxrateswere disregarded,theamountduewouldbe£810,000.

(b) Paymentsonaccounttotalling£390,000havebeenmadeduringtheyearto30June2019inrelationtothecurrenttaxfortheyear.

(c) Currenttaxfortheyearto30June2018wasoverestimatedby£30,000.

Calculatetheamountofthecurrenttaxexpensewhichshouldbeshowninthestatementofcomprehensiveincomefortheyearto30June2019andtheamountofthecurrenttaxliabilitywhichshouldbeshowninthestatementoffinancialpositionatthatdate.

Solution

Thenewtaxratescanberegardedassubstantivelyenacted,sothatcurrenttaxfortheyearis£750,000.Butthestatementofcomprehensiveincomewillshowanetcurrenttaxexpenseofonly£720,000,soastoadjustforthepreviousyear'soverestimate.

Paymentsonaccountof£390,000reducethecurrenttaxliabilityshowninthestatementoffinancialpositionto£360,000(£750,000–£390,000).Thecurrenttaxledgeraccountfortheyearmightappearasfollows:

CurrentTax

	£000		£000
SoCI*(overestimatewrittenback)*	30	Balanceb/d	30
Bank	390	SoCI*(currenttaxfortheyear)*	750
Balancec/d	360		
	750		750
		Balanceb/d	360

Taxdeductedatsource(UK)

Fromtimetotime,UKcompaniesmayreceivecertainformsofincomenetofUKincome tax, although this is now rare. Similarly, UK companies may occasionally make certain paymentsnetofincometax.Inthesecircumstances,anyincometaxsufferedbydeduction atsourceisreclaimedfromthetaxauthoritiesandanyincometaxwithheldfrompayments isremittedtothetaxauthorities.Theoverall tax effectisnilandsothereisnoimpacton the tax expense for the year. The company's financial statements should show the relevant incomeandpayments*gross*(i.e.attheamountbeforeincometaxwasdeducted).

Deferredtax

The amount of current tax payable by an entity for an accounting period depends upon the entity'staxableprofitforthatperiod.However,thistaxableprofitwilloftenbedifferent fromtheprofitshowninthefinancialstatements(the"accountingprofit").Therearetwo main reasons for this discrepancy:

(a) **Permanentdifferences**.Someoftheincomeshowninthefinancialstatementsmay notbechargeabletotaxandsomeoftheexpensesshowninthefinancialstatements may not be deductible for tax purposes. In such cases, there will be a "permanent difference"betweentheaccountingprofitandthetaxableprofit(i.e.adifferencethat will not reverse itself in a future accounting period).

(b) **Temporarydifferences**. Some of the income or expenses shown in the financial statements for an accounting period may be dealt with for tax purposes in a different accounting period. In the UK, for example, the depreciation charges shown in thefinancial statements are disregarded for tax purposes and are replaced by standardised depreciation charges known as "capital allowances". Total depreciation charges will usuallyequaltotalcapitalallowancesovertheentirelifespanoftheentity,butthere maybeasignificantdifferencebetweendepreciationandcapitalallowancesinany one period. This is an example of a "temporary difference" (i.e. a difference that will reverse itself in a future accounting period).

Permanent differences cause no accounting problems and can be ignored. But temporary differencesmayleadtoasignificantdistortionofthereportedfiguresforprofitaftertax andsogiveamisleadingimpressionoftheentity'sperformance.Foracompany,this distortionalsoaffectstheimportantearningspershareratio(seeChapter23).Theproblem is illustrated by the following example.

EXAMPLE2

Acompanywithanissuedsharecapitalof2,000,000ordinaryshareshasthefollowingresultsforthethre eyearsto31December2020:

	2018	2019	2020
	£000	£000	£000
Profitbeforetax	1,600	1,600	1,600
Depreciationchargedintheyear	400	400	400
Depreciationfortaxpurposes	800	300	100

Assumingthattherearenootherpermanentortemporarydifferencesandthattherateoftaxis19% throughout,computethecompany'sprofitaftertaxforeachofthethreeyears.

Alsocalculatetheearningspershareratioforeachyear.(Thisratioisequaltotheprofitaftertaxdivid edbythenumberofissuedordinaryshares).

Solution

Thetaxexpenseforeachyeariscalculatedasfollows:

	2018	2019	2020
	£000	£000	£000
Profitbeforetax	1,600	1,600	1,600
Add:Depreciationchargedintheyear	400	400	400
Profitbeforedepreciation	2,000	2,000	2,000
Less:Depreciationfortaxpurposes	800	300	100
Taxableprofit	1,200	1,700	1,900
Taxexpense(19%oftaxableprofit)	228	323	361

Theprofitaftertaxcalculationforeachyearis:

Profitbeforetax	1,600	1,600	1,600
Taxexpense	228	323	361
Profitaftertax	1,372	1,277	1,239
Earningspershare	68.6p	63.85p	61.95p

Thesefiguresgivetheimpressionthatprofitaftertaxandearningspershareareonadownwardtrend(whichmaydeterinvestors)wheninfactthecompany'sprofitshavebeenidenticalineachofthethreeyears.Totaldepreciationchargesintheaccountsandtotaldepreciationchargesfortaxpurposesareboth£1,200,000buttemporarydifferenceshavecausedthereportedfiguresforprofitsaftertaxandearningspersharetobemisleading.

Accountingfordeferredtax

IAS12solvestheproblemillustratedabovebyrequiringentitiestoaccountfor"deferred tax". The broad approach is as follows:

(a) Inanaccountingperiodinwhichtemporarydifferencescausetaxableprofitstobe lower than accounting profits, the tax expense which is shown in the statement of comprehensiveincomeisincreasedbyatransfer*to*adeferredtaxaccount.

(b) Inanaccountingperiodinwhichtemporarydifferencescausetaxableprofitstobe higher than accounting profits, the tax expense which is shown in the statement of comprehensiveincomeisreducedbyatransfer*from*thedeferredtaxaccount.

IAS1 *PresentationofFinancialStatements*(see Chapter 3) requires that the balance on the deferred tax account should be shown as a non-current liability (or asset) in the entity's statement of financial position.

EXAMPLE3

ReworkExample2,showingthenecessarytransferstoandfromthecompany'sdeferredtaxaccount.Asbefore,assumethattheapplicablerateoftaxis19%inallyears.

Solution

	2018		2019		2020	
	£000		£000		£000	
Profitbeforetax		1,600		1,600		1,600
Taxexpense:						
Currenttax	228		323		361	
Deferredtax	76	304	(19)	304	(57)	304
Profitaftertax		1,296		1,296		1,296
Earningspershare		64.8p		64.8p		64.8p

Notes:

(i) In2018,taxableprofitsare£400,000lowerthanaccountingprofitsandthisiscausedbyatemporarydifference.Therefore£76,000(19%x£400,000)istransferredtoadeferredtaxaccountandisshownaspartofthetaxexpensefortheyear.

(ii) In2019,taxableprofitsare£100,000higherthanaccountingprofitsandthisiscausedbythereversalofatemporarydifference.So£19,000(19%x£100,000)istransferredbackfromthedeferredtaxaccount,reducingthetaxexpensefortheyear.

(iii) In2020,taxableprofitsare£300,000higherthanaccountingprofitsandthisiscausedbythereversalofatemporarydifference.So£57,000(19%x£300,000)istransferredbackfromthedeferredtaxaccount,againreducingthetaxexpensefortheyear.

Bytheendof2020,thetemporarydifferencewhichoccurredin2018hasbeentotallyreversed,andsothebalanceonthedeferredtaxaccountis£nil.Theoveralleffectoverthethreeyearsistoshowprofitaftertaxataconstant£1,296,000andearningspershareataconstant64.8ppershare.Thisisamuchfairerpresentationofthecompany'sresultsthanthepresentationwhichwasgiveninExample2(withoutadeferredtaxaccount).

Thetaxbaseconcept

TheapproachadoptedbyIAS12inrelationtodeferredtaxrequiresthatthe"taxbase"of each asset and liability at the end of the reporting period should be calculated and then compared with its "carrying amount" (i.e. the amount at which the item is shown in the financial statements). If the tax base of an asset or liability is not the same as its carrying amount,atemporarydifferenceexistsandadeferredtaxadjustmentisrequired.

IAS12definesthetaxbaseofanassetorliabilityas"*theamountattributedtothatassetorliabilityfortaxpurposes*". In particular:

(a) Thetaxbaseofanassetis"*theamountthatwillbedeductiblefortaxpurposesagainstany taxableeconomicbenefitsthatwillflowtoanentitywhenitrecoversthecarryingamount oftheasset.Ifthoseeconomicbenefitswillnotbetaxable,thetaxbaseoftheassetisequ altoitscarryingamount.*".

(b) Thetaxbaseofaliabilityis"*itscarryingamount,lessanyamountthatwillbedeductiblefor taxpurposesinrespectofthatliabilityinfutureperiods*".

Furthermore, IAS12 defines temporary differences as "*differencesbetweenthecarryingamountofanassetorliabilityinthestatementoffinancialp ositionanditstaxbase*". The definition continues by stating that:

(a) Taxable temporary differences are temporary differences "*thatwillresultintaxableamountsindeterminingtaxableprofit…offutureperiodswhent hecarryingamountoftheassetorliabilityisrecoveredorsettled*".Taxabletemporarydiff erencesresult in deferred tax liabilities.

(b) Deductibletemporarydifferencesaretemporarydifferences"*thatwillresultinamounts thataredeductibleindeterminingtaxableprofit…offutureperiodswhenthecarryingam ountoftheassetorliabilityisrecoveredorsettled*". Deductibletemporary differences result in deferred tax assets.

Thesedefinitions(whichmayseemverycomplexatfirst)areexplainedbelow.

Thetaxbaseofanasset

Asthe*ConceptualFramework*definitionofanassetmakesclear(seeChapter2)entities holdassetssoastogeneratefutureeconomicbenefits.Thesebenefitsmightarisethrough:

(a) sellingtheasset(e.g.inventories)

(b) usingtheasset(e.g.property,plantandequipment)

(c) realisingtheasset(e.g.tradereceivables).

In each case, the benefits obtained might or might not be taxable. If they are, the entity will usually expect the tax system to recognise that an asset has been sacrificed in order to earn thosebenefitsandsoallowadeductionwhencalculatingthetaxdue.Ifthededuction allowed is the same as the carrying amount of the asset concerned, the tax system and the accountingsystemareinharmonyandthereisnodeferredtaxproblem.Butifthe deductionallowedisnotthesameasthecarryingamountoftheasset,thedifferencewill give rise to a deferred tax adjustment. This is why IAS12 defines the tax base of an asset in terms of the amount of the deduction that will be allowed for tax purposes against theeconomic benefits generated by that asset.

If the benefits obtained from an asset are not taxable, there is no deferred tax problem. In these circumstances, the tax base of the asset is regarded as being the same as its carrying amount,sothatthereisnoneedforadeferredtaxadjustment.

EXAMPLE4

Considereachofthefollowingassetswhichappearinacompany'sstatementoffinancialposition asat31March2020.

(a) Amachinewhichcost£40,000isshownatitswrittendownvalueof£16,000.Fortaxpurposes, itswrittendownvalueis£11,200.Themachine'sresidualvalueattheendofitsusefullifeisexp ectedtobe£nil.

(b) Tradereceivablesareshownat£75,000.Therevenuetowhichtheserelatewasincludedintax ableprofitfortheyearto31March2020.

(c) Interestreceivableisshownat£3,000.Thisinteresthasbeenincludedinaccountingprofitbu twillnotbetaxeduntilitisactuallyreceived.Itwillthenbefullytaxable.

Foreachoftheseassets:

(i) Computethetaxbaseoftheassetanddeterminewhetheratemporarydifferenceexistswithr especttoit.Ifso,statewhetherthisisataxabletemporarydifferenceoradeductibletemporar ydifference.

(ii) Assumingataxrateof19%,calculatetheamountofthedeferredtaxliabilityorassetwhichsho uldbeshowninthestatementoffinancialpositioninrelationtotheasset.

Solution

ThissolutionreliesheavilyontheIAS12definitionsgivenaboveandshouldbereadwiththosedefin itionsfirmlyinmind.

(a) (i)Useofthemachineinfutureperiodswillgeneratetaxablerevenue.Deductionstotalling£1 1,200willbeallowedagainstthatrevenuefortaxpurposes,sothetaxbaseofthemachin eis£11,200.Thecarryingamountis£16,000andthisistheamountthatwillbedeductibl ewhencomputingaccountingprofitsinfutureperiodsasthemachineisused.Sinceonl y£11,200willbedeductedfortaxpurposes,thereisataxabletemporarydifferenceof£4, 800.

(ii)Thedeferredtaxliabilityis£912(19%x£4,800).

(b) Whenthereceivablesarerealised,theamountreceivedwillnotbetaxable,sothetaxbaseofth ereceivablesisthesameastheircarryingamount(i.e.£75,000).Thereisnotemporarydiffere nceandsotherearenodeferredtaximplications.

(c) (i)Whentheinterestisreceived,taxablerevenueof£3,000willoccur.Therewillbenodeductio nfromthisrevenuefortaxpurposessothetaxbaseis£nil.Thereisataxabletemporarydi fferenceof£3,000.

(ii)Thedeferredtaxliabilityis£570(19%x£3,000).

Thetaxbaseofaliability

The settlement of a liability has no effect on accounting profit and usually has no effect on taxable profit either, so liabilities tend not to cause deferred tax problems. However, the settlementofaliabilitymightinsomecasestriggeradeductionfromtaxableprofits.In thesecircumstances,theamountofthedeductionwillgiverisetoadeferredtax adjustment.ThisiswhyIAS12definesthetaxbaseofaliabilityintermsoftheamountof thedeductionthatwillbeallowedfortaxpurposeswhentheliabilityissettled.

EXAMPLE5

Considereachofthefollowingliabilitieswhichappearinacompany'sstatementoffinancialpositi onasat31March2020.

(a) Currentliabilitiesincludeaccruedexpensesof£5,000.Theseexpenseshavealreadybeende ductedwhencomputingbothaccountingprofitandtaxableprofit.

(b) Currentliabilitiesincludefurtheraccruedexpensesof£8,000.Theseexpenseshavebeende ductedwhencomputingaccountingprofitbutwillnotbedeductedfortaxpurposesuntilthey areactuallypaid.

Foreachoftheseliabilities:

(i) Computethetaxbaseoftheliabilityanddeterminewhetheratemporarydifferenceexistswit hrespecttoit.Ifso,statewhetherthisisataxabletemporarydifferenceoradeductibletempor arydifference.

(ii) Assumingataxrateof19%,calculatetheamountofthedeferredtaxliabilityorassetwhichsho uldbeshowninthestatementoffinancialpositioninrelationtotheliability.

Solution

Onceagain,thissolutionreliesheavilyontheIAS12definitionsgivenaboveandshouldbereadwith thosedefinitionsfirmlyinmind.

(a) Whentheseaccruedexpensesarepaid,thepaymentwillnotbedeductiblefortaxpurposes.T hereforetheirtaxbaseisthesameastheircarryingamount(i.e.£5,000).Thereisnotemporar ydifferenceandsotherearenodeferredtaximplications.

(b) (i)Whentheseaccruedexpensesarepaid,thepaymentwillbedeductiblefortaxpurposes.Th ereforetheirtaxbaseis£nil(£8,000–£8,000)andthereisadeductibletemporarydiffere nceof£8,000.

(ii)Thedeferredtaxassetis£1,520(19%x£8,000).

EXAMPLE6

HereisareminderofthebasicdatagiveninExample2/3earlierinthischapter:

Acompanywithanissuedsharecapitalof2,000,000ordinaryshareshasthefollowingresultsforth ethreeyearsto31December2020:

	2018	2019	2020
	£000	£000	£000
Profitbeforetax	1,600	1,600	1,600
Depreciationchargedintheyear	400	400	400
Depreciationfortaxpurposes	800	300	100

Theapplicabletaxrateis19%throughout.

Nowusethetaxbaseconcepttoreworkthisexampleandtocalculatethenecessarytransferstoan dfromthecompany'sdeferredtaxaccount.Assumethatthedepreciationchargesrelatetoanass etacquiredfor£1,200,000on1January2018anddepreciatedonthestraight-linebasisoverthreeyears,withanestimatedresidualvalueof£nil.

Solution

Attheendof2018,theassethasacarryingvalueof£800,000butitstaxbaseisonly £400,000(cost£1,200,000–depreciation£800,000fortaxpurposes).Thereisataxabletemporarydiff erenceof£400,000,givingrisetoadeferredtaxliabilityof£76,000(19%x £400,000).Settingupthisliabilityincreasesthetaxexpensefor2018by£76,000.

Attheendof2019,theasset'scarryingvalueis£400,000butitstaxbaseisonly£100,000(cost£1,20 0,000–depreciation£1,100,000fortaxpurposes).Thetaxabletemporarydifferenceis£300,000, givingrisetoadeferredtaxliabilityof£57,000(19%x£300,000).Thisis£19,000lessthantheliabilit ywhichwassetupin2018,so£19,000mustbetrans-ferredfromthedeferredtaxaccount,reducingthetaxexpensefor2019by£19,000.

Attheendof2020,theasset'scarryingvalueandtaxbaseareboth£nil.Thereisnotemporarydiffere ncesothe£57,000deferredtaxliabilityfrom2019isnolongerrequired.Transferringthis£57,000b ackfromthedeferredtaxaccountreducesthetaxexpensefor2020by£57,000.

Note:
Asexpected,theresultsobtainedbyusingthetaxbaseconceptareidenticaltothosewhichwereobtaine doriginallyinthesolutiontoExample3.

Unusedtaxlosses

Thetaxlawofthecountryinwhichanentityresidesmayallowtradingandotherlossesto becarriedforwardanddeductedfromfuturetaxableprofits,soreducingthetaxdueon those profits. In these circumstances, IAS12 states that a deferred tax asset should berecognisedtotheextentthatitisprobablethatfuturetaxableprofitswillbeavailable against which the losses can be utilised.

IAS12requirementswithregardtodeferredtax

IAS12makesanumberofdetailedrequirementswithregardtodeferredtax.Broadly,the main points are as follows:

(a) Adeferredtaxliabilitymustberecognisedforalltaxabletemporarydifferences.

(b) Adeferredtaxassetmustberecognisedforalldeductibletemporarydifferencesto the extent that it is probable that taxable profits will be available in the future against whichthesedeductibletemporarydifferencescanbeutilised.

(c) Thecarryingamountofdeferredtaxassetsmustbereviewedattheendofeach reportingperiodandreducedtotheextentthatitisnolongerprobablethattaxable profits will arise against which they can be utilised.

(d) A deferred tax asset or liability must be measured at the tax rates that are expected to applytotheperiodinwhichtheassetisrealisedortheliabilityissettled.Thesetax rates should be based upon tax rates and laws that have been enacted or substantively enactedbytheendofthereportingperiod(seeearlierinthischapter).

(e) Deferredtaxassetsandliabilitiesmustnotbediscounted,eventhoughtheymightnot be realised or settled for many years. IAS12 regards it as inappropriate to require orpermit discounting because of the uncertain timing of the reversal of each temporary difference.

(f) Transfers to or from the deferred tax account should generally be recognised in the calculation of profit or loss. However, a deferred tax transfer that arises from an item whichisrecognisedinothercomprehensiveincomeordirectlyinequityshouldalso berecognisedinothercomprehensiveincomeordirectlyinequity.

(g) Deferred tax assets and liabilities should not be offset in the statement of financialpositionunlesstheentityhasalegallyenforceablerighttodoso.

Disclosurerequirements

ThedisclosurerequirementsofIAS12areveryextensive.Abriefsummaryofthemain disclosuresthatmustbemadeinthenotestothefinancialstatementsisasfollows:

(a) Thetaxexpenseshowninthecalculationofprofitorlossfortheaccountingperiod mustbeanalysedintoitsmaincomponents.Thesemayinclude:

  (i) thecurrenttaxexpense(orincome)fortheperiod

  (ii) anyadjustmentsrelatingtounderestimatesoroverestimatesofcurrenttaxinprevi ous accounting periods

  (iii) theamountofanytransferstoorfromthedeferredtaxaccountrelatingtothe origination or reversal of temporary differences.

(b) Thefollowingmustalsobedisclosedseparately:

(i) theamountsofcurrentanddeferredtaxrelatingtoitemsthatarerecognisedin other comprehensive income or directly in equity

(ii) anexplanationoftherelationshipbetweentheaccountingprofitfortheperiod and the tax expense for the period

(iii) for each type of temporary difference, the amount of the deferred tax asset orliability recognised in the statement of financial position and the amount of the deferredtaxexpenseorincomerecognisedintheperiod.

Summary

- Currenttaxistheamountoftaxpayableorrecoverableinrespectofthetaxableprofit or loss for an accounting period. Current tax is generally shown as an expense in the statementofcomprehensiveincome.Anyamountwhichremainsunpaidattheendof thereportingperiodisshownasaliabilityinthestatementoffinancialposition.
- The current tax expense may be adjusted so as to reflect any underestimates or overestimates of current tax in previous periods.
- A temporary difference arises if an item of income or expense is recognised in the financial statements in one accounting period but is dealt with for tax purposes in a differentperiod.Temporarydifferenceswoulddistorttherepor tedfiguresforprofit aftertaxandearningspershareifdeferredtaxwerenottakenintoaccount.
- In general, transfers to the deferred tax account are made in periods in which taxable profits are lower than accounting profits. Transfers from the deferred tax account aremadeinperiodsinwhichtaxableprofitsexceedaccountingprofits.
- IAS12dealswithdeferredtaxbycomparingthetaxbaseofeachassetandliabilityat theendofthereportingperiodwithitscarryingamount.Thetaxbaseofanitemis the amount attributed to that item for tax purposes.
- Temporary differences arise if the tax base of an asset or liability is different from its carrying amount. Taxable temporary differences result in deferred tax liabilities. Deductibletaxabledifferencesresultindeferredtaxassets.
- Ingeneral,IAS12requiresthatdeferredtaxliabilitiesmustberecognisedforall taxable temporary differences. Deferred tax assets must be recognised for deductible temporarydifferencesifitisprobablethattheywillbeutilisedinthefuture.
- The tax laws and rates used when accounting for taxation should be those which have beenenactedorsubstantivelyenactedbytheendofthereportingperiod.

Exercises

PleasenotethatExercises15.8and15.9involveanumberofinternationalstandardsdealtwithinearlierchaptersofthisbook,aswellasdealingwithcurrenttaxanddeferredtax.Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

15.1 OtlayLtdpreparesaccountsto31Julyeachyear.Thecompany'sfinancialstatementsfor theyearto31July2018showedaliabilityforcurrenttaxof£120,000.Thiswasan estimate of the current tax due for the year to 31 July 2018. The following information is also available:

(a) Thecurrenttaxduefortheyearto31July2018wasfinallyagreedwiththetax authorities to be £127,000 and this sum was paid on 1 May 2019.

(b) The company estimates the amount of current tax due for the year to 31 July 2019 to be £140,000.

Prepare a current tax ledger account for the year to 31 July 2019, showing the amount of the current tax expense for that year and the amount of the current tax liability as at the end of the year.

15.2 (a) Distinguishbetweencurrenttaxanddeferredtax.

(b) Distinguishbetweenpermanentdifferencesandtemporarydifferences.

(c) Explain how temporary differences between accounting profits and taxable profits wouldaffectthetaxexpenseshowninanentity'sfinancialstatementsunless deferred tax were taken into account.

15.3 Thepre-taxprofitsofRadfernLtdforthelastthreeyears(asreportedinitsfinancial statements) have been as follows:

	£
yearto31August2018	125,000
yearto31August2019	130,000
yearto31August2020	135,000

Intheyearto31August2018,therewasataxabletemporarydifferenceof£50,000 between accounting profits and taxable profits. £10,000 of this difference was reversedin the year to 31 August 2019 and the remaining £40,000 was reversed in the year to 31 August 2020.

(a) Assumingatax rate of 19%throughout, demonstrate that if the companydidnot accountfordeferredtax,itsprofitsaftertaxwouldappeartobeonadownward trend,eventhoughpre-taxprofitsarerisingandtaxrateshaveremainedunchanged.

(b) Show the transfers that should be made to or from the deferred tax account in each year.

15.4 Explain the concept of the "tax base" of an asset or liability. Explain how this conceptthelps to identify situations in which deferred tax adjustments are required.

15.5 Considereachofthefollowingassetsandliabilitieswhichappearinacompany's statement of financial position at 30 April 2020:

(a) A motor lorry which cost £100,000 is shown at its written down value of £20,000. For tax purposes, its written down value is £30,000.

(b) Aloan payable is shown at £60,000. The repayment of the loanwill have notax consequences.

(c) Anamountreceivableisshownat£45,000.Ofthisamount,£25,000hasalready beentaxedbuttheremaining£20,000willbetaxedintheaccountingperiodin which it is received. The whole £45,000 hasalready been included in accounting profit.

(d) Anamountpayableisshownat£3,000.Thisrelatestoanexpensewhichhas alreadybeendeductedwhencomputingaccountingprofitbutwhichwillnotbe deducted for tax purposes until it is paid.

Compute the tax base of each of these assets and liabilities and identify any taxable or deductible temporary differences.

15.6 The draft statement of comprehensive income of Harrington, a public company, for the year to 31 March 2020 shows an income tax expense of £55,000. The draft statement of financial position shows a non-current liability of £280,000 for deferred tax but does not show a current tax liability.

Tax on the profit for the year to 31 March 2020 is estimated at £260,000. The figure in thedraftstatementofcomprehensiveincomeistheunderestimatefortheyearto31 March2019. The carrying amount of Harrington's net assets at 31 March 2020 is £1.4m more than their tax base on that date. The tax rate is 25%.

Required:

Restate the figures which should appear in relation to taxation in the company's financial statementsfortheyearto31March2020. *(ACCA)*

***15.7** Petersfordplcpreparesaccountsto31Decembereachyear.On1January2015,the companyacquiredanon-currentassetatacostof£256,000anddecidedtodepreciatethis asset on the straight-line basis over a five-year period, assuming a residual value of £nil.Depreciation allowed fortax purposeswith regard to thisassetin the firstfive years of ownership are as follows:

	£
yearto31December2015	102,400
yearto31December2016	38,400
yearto31December2017	28,800
yearto31December2018	21,600
yearto31December2019	16,200

The company's pre-tax profit (after charging depreciation) was £500,000 in the year to31December2015andremainedataconsistent£500,000perannumforeachofthen ext four years.

(continuedoverleaf)

There are no other non-current assets and there are no differences between taxable profit and accounting profit other than those relating to depreciation. A tax rate of 20% applies throughout.

(a) Without making use of the "tax base" concept, show the necessary transfers to and from the deferred tax account for each of the five years to 31 December 2019. Also calculate and explain the closing balance on this account at 31 December 2019.

(b) Re-workthisexerciseusingthetaxbaseconcept.

*15.8 ThefollowingtrialbalanceextractsrelatetoMostonasat30June2020:

	£000	£000
Revenue(note1)		113,500
Costofsales	88,500	
Researchanddevelopmentcosts(note2)	7,800	
Distributioncosts	3,600	
Administrativeexpenses(note4)	6,800	
Loanstockinterestanddividendpaid(notes4and7)	5,000	
Investmentincome		300
Ordinarysharesof£1each(note7)		30,000
5%Loanstock(note4)		20,000
Retainedearningsat1July2019		6,200
Revaluationsurplusat1July2019		3,000
Othercomponentsofequity(note7)		9,300
Propertyatvaluation1July2019(note3)	28,500	
Plantandequipment,atcost(note3)	27,100	
Accumulateddep'nplantandequipmentat1July2019		9,100
Investmentsatfairvalue1July2019(note5)	8,800	

Thefollowingnotesarerelevant:

1. Revenue includes a £3 million sale (made on 1 January 2020) of maturing goods. The carrying amount of these goods at the date of sale was £2 million. Moston is still in possession of the goods (but they have not been included in inventory) and has an option to repurchase them at any time in the next three years. In three years' time the goods are expected to be worth £5 million. The repurchase price will bethe originalselling price plus interestat10% per annum from the date of sale to the date of repurchase.
2. Mostoncommencedaresearchanddevelopmentprojecton1January 2020.Itspent£1millionpermonthonresearchuntil31March2020,atwhichdateth e projectpassed into the development stage. From this date it spent £1.6 million per monthuntiltheyearend(30June2020),atwhichdatedevelopmentwascomplete d.However,itwasnotuntil1May 2020thatthedirectorsofMostonwere confident that the new product would be a commercial success. Expensed research and development costs should be charged to cost of sales.
3. Moston's property is carried at fair value, which at 30 June 2020 was £29 million.
   Theremaininglifeofthepropertyatthebeginningoftheyear(1July2019)was15 years. Moston does not make an annual transfer to retained earnings in

respect of the revaluation surplus. Ignore deferred tax on the revaluation.

Plant and equipment is depreciated at 15% per annum using the reducing balance method.No depreciation hasyetbeen charged on any non-currentassetfortheyear ended 30 June 2020. All depreciation is charged to cost of sales.

4. The 5% loan stock was issued on 1 July 2019 at its nominal value of £20 million. Direct issue costs of £500,000 have been charged to administrative expenses. The loanstockwillberedeemed afterthreeyearsatapremium which givesan effective finance cost of 8% per annum. Annual interest was paid on 30 June 2020.
5. Theinvestments(holdings of ordinary shares)had a fairvalue of £9.6 million at30 June 2020. There were no acquisitions or disposals of investments during the year.
6. Aprovisionforcurrenttaxfortheyearended30June2020of£1.2millionis required,togetherwithanincreasetothedeferredtaxprovisiontobechargedto profit or loss of £800,000.
7. Moston paid a dividend of 20p per share on 30 March 2020, which was followedby an issue of 10 million ordinary shares at their market value of £1.70. The share premium on the issue was recorded in other components of equity.

Required:

PreparethefollowingfinancialstatementsforMoston:

(a) astatementofcomprehensiveincomefortheyearto30June2020

(b) astatementofchangesinequityfortheyearto30June2020. *(ACCA)*

***15.9** ThefollowingtrialbalancerelatestoQuincyasat30September2019:

	£000	£000
Revenue(note1)		213,500
Costofsales	136,800	
Distributioncosts	12,500	
Administrativeexpenses	19,000	
Loanstockinterestanddividendpaid(notes2and3)	20,700	
Investmentincome		400
Ordinarysharesof25peach		60,000
6%Loanstock(note2)		25,000
Retainedearningsat1October2018		18,500
Land,atcost(note4)	10,000	
Buildings,atcost(note4)	40,000	
Plantandequipment,atcost	83,700	
Accumulateddepreciationat1October2018:		
Buildings		8,000
Plantandequipment		33,700
Investments(note5)	17,000	
Inventoryat1October2018	24,800	
Tradereceivablesandpayables	28,500	36,700
Bank	2,900	
Currenttax(note6)	1,100	
Deferredtax(note6)		1,200

397,000	397,000

Thefollowingnotesarerelevant:

1. On1October2018, Quincysoldoneofitsproductsfor £10million(includedin revenue in the trial balance). As part of the sale agreement, Quincy is committed to theongoingservicingofthisproductuntil30September2021(i.e.threeyearsfrom the date of sale). The value of this service has been included in the selling price of
   £10 million. The estimated cost to Quincy of the servicing is £600,000 per annum and Quincy's normal gross profit margin on this type of servicing is 25%. Ignore discounting.
2. Quincyissued£25millionof6%loanstockon1October2018.Issuecostswere
   £1 million and these have been charged to administrative expenses. The loan willbe redeemed on 30 September 2021 at a premium which gives an effective interest rate on the loan of 8%.
3. Quincypaidanordinarydividendof8pencepershareduringtheyearended30 September 2019.
4. Quincy had been carrying land and buildings at depreciated cost butit decided to revalueitspropertyon1October2018tomarketvalue.Anindependentvaluer confirmed the value of the property at £60 million (land element £12 million) as at that date and the directors accepted this valuation. The buildings had a remaining life of 16 years at the date of its revaluation. Quincy will make a transfer from the revaluationreservetoretainedearningsinrespectoftherealisationofthe revaluation reserve. Ignore deferred tax on the revaluation.

   Plant and equipment is depreciated at 15% per annum using the reducing balance method.No depreciation hasyetbeen charged on any non-currentassetforthe year ended 30 September 2019. All depreciation is charged to cost of sales.
5. The investments (holdings of ordinary shares) had a fair value of £15.7 million
   asat30September2019.Therewerenoacquisitionsordisposalsoftheseinvest ments during the year ended 30 September 2019.
6. The balance on current tax represents the under/over provision of the tax liability
   fortheyearended30September2018.Aprovisionforcurrenttaxfortheyear ended30September2019of£7.4millionisrequired.At30September2019, Quincy had taxable temporary differences of £5 million, requiring a provision for deferred tax. Quincy's tax rate is 20%.

Required:

PreparethefollowingfinancialstatementsforQuincy:

(a) astatementofcomprehensiveincomefortheyearto30September2019

(b) astatementofchangesinequityfortheyearto30September2019

(c) astatementoffinancialpositionasat30September2019. *(ACCA)*

Chapter16

Statementofcashflows

Introduction

Ithasoftenbeensaidthatcashisthe"lifeblood"ofabusiness.Thisisverytrue.Without cash, a business cannot pay its employees or its suppliers and will soon fail. Therefore a financial statement which focuses on the flows of cash in and out of a business (and draws attentiontoanycashproblems)servesausefulpurpose.Thisisthefunctionofastatement ofcashflowsandIAS7*StatementofCashFlows*requiresthatallentitieswhichcomply withinternationalstandardsshouldproducesuchastatement.

Itmightbethoughtthataprofitablebusinesswouldneverrunoutofcash,butthisisnot the case. A business might report a healthy profit in its financial statements and yet suffer severecashproblems.Someofthereasonsforthisapparentparadoxareasfollows:

(a) Profitsarecomputedontheaccrualsbasis.Therefore,revenueshowninthestatement of comprehensive income might not be actually received for a considerable period oftime,especiallyifthebusinessofferslengthycredittoitscustomers.

(b) Thepurchaseofnon-currentassetshasanimmediatecashimpactbutfiltersthrough tothestatementofcomprehensiveincomeonlygradually,intheformofdepreciation.

(c) A business which builds up large inventories (perhaps in the hope of attracting more customers) usually has to pay for those inventories fairly quickly, but their cost has no impactonreportedprofituntiltheyaresoldatsometimeinthefuture.

(d) Therepaymentofaloantakescashoutofthebusinessbuthasnodirecteffecton profit.Thesameappliestothepaymentofadividend.

For reasons such as these, the size of an entity's profit is an unreliable indicator of its cash situation.Astatementofcashflowsisneededandthepurposeofthischapteristoexplain howthisstatementshouldbepreparedinaccordancewiththerequirementsofIAS7.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explainthepurposeofastatementofcashflows
- definetheterms"cash"and"cashequivalents"

- distinguishbetweenoperatingactivities,investingactivitiesandfinancingactivities
- useboththeDirect methodandtheIndirect methodfor reportingcashflows from operating activities
- prepareastatementofcashflowsinaccordancewiththerequirementsofIAS7
- preparereconciliationbetweentheamounts of cashandcashequivalents shownin the statement of cash flows and the equivalent items reported in the statement offinancial position.

Cashandcashequivalents

The main objective of IAS7 is "*torequiretheprovisionofinformationaboutthehistoricalchangesincashandcashequivalentsofanentitybymeansofastatementofcashflowswhichclassifiescashflowsduringtheperiodfromoperating,investingandfinancingactivities*". In order to understand this objective, it is necessary to examine some keydefinitionsgiveninIAS7.Twoofthemostimportantdefinitionsareasfollows:

(a) Cashcomprises"*cashonhandanddemanddeposits*".

(b) Cashequivalentsare"*short-term,highlyliquidinvestmentsthatarereadilyconvertibletoknownamountsofcashand…aresubjecttoaninsignificantriskofchangesinvalue*". An investment will usually not qualify as a cash equivalent unless it has a maturity date which is no more than three months after the date of acquisition. Equity investmentsaregenerallyexcludedfromthedefinitionbutredeemablepreference shareswithaspecifiedredemptiondateinthenearfuturemightqualify.

IAS7takestheviewthatcashequivalentsarevirtuallyindistinguishablefromcashitself andshouldthereforebetreatedascashratherthanasinvestments.Thesignificanceofthis isthatacquisitionsanddisposalsofcashequivalentsarenottreatedasinvestingactivities butsimplyasmovementsbetweenonecomponentofcashandanother.Suchmovements arenotinflowsoroutflowsofcashandsodonotappearinastatementofcashflows.

Bankoverdrafts

Insomecountries(includingtheUK)bankoverdraftsaregenerallyrepayableondemand and are an integral part of an entity's cash management. In these circumstances, bankoverdraftsareregardedasacomponentoftheentity'scashandcashequivalents.This means,ofcourse,thatthetotalofcashandcashequivalentscouldbenegative.

Bank loans which are not repayable on demand are not a component of cash and cash equivalents.Suchloansaretreatedaspartoftheentity'sfinancingactivities(seebelow).

Classificationofcashflowsbyactivity

IAS7 requires that the statement of cash flows should report cash flows "*classifiedbyoperating,investingandfinancingactivities*".Theaimofthisclassificationisto provide userswithinformationthathelpsthemtoassesstheimpactofeachoftheseactivitieson theentity'scashandcashequivalents.Thethreeclassesofactivityareexplainedbelow.

Operatingactivities

OperatingactivitiesaredefinedbyIAS7as"*theprincipalrevenue-producingactivitiesoftheentity...*".Cashinflowsandoutflowsarisingfromoperatingactiviti esinclude:

(a) cashreceiptsfromthesaleofgoodsandservices
(b) cashreceiptsfromroyalties,fees,commissionsandotherrevenue
(c) cashpaymentstosuppliersforgoodsandservices
(d) cashpaymentstoandonbehalfofemployees
(e) cashpaymentsorcashrefundsofincometaxes(seeChapter15)unlessspecifically identified with investing or financing activities.

In general, these items result from transactions or other events that are reported in thestatementofcomprehensiveincome.However,theamountswhichappearinthatstatem ent are calculated on the accruals basis, whereas the statement of cash flows simply shows the actualreceipts(inflows)andpayments(outflows)whichhaveoccurredduringtheperiod.

Investingactivities

InvestingactivitiesaredefinedbyIAS7as"*theacquisitionanddisposaloflong-termassetsandotherinvestmentsnotincludedincashequivalents*".Itisimportanttonotetha t thisclassificationcoversnotonly"investing"intheusualsense,butalsotheacquisition and disposal of long-term assets such as property, plant and equipment. Cash inflows and outflows arising from investing activities include:

(a) cashpaymentstoacquireproperty,plantandequipment,intangibleassetsandother long-term assets
(b) cashreceiptsfromthesaleofproperty,plantandequipment,intangibleassetsand other long-term assets
(c) cashpaymentstoacquireequity(e.g.shares)ordebtinstruments(e.g.loanstocksor debentures) of other entities
(d) cashreceiptsfromthesaleofequityordebtinstrumentsofotherentities
(e) cashadvancesandloansmadetootherparties
(f) cashreceiptsfromtherepaymentofadvancesandloansmadetootherparties.

Financingactivities

Financing activities are defined by IAS7 as "*activitiesthatresultinchangesinthesizeandcompositionofthecontributedequityandborrowingsoftheentity*". Cash inflows andoutflows arising from financing activities include:

(a) cashproceedsfromissuingshares
(b) cashpaymentstoownerstoacquireorredeemtheentity'sownshares
(c) cashproceedsfromissuingdebentures,loansandotherborrowings
(d) cashrepaymentsofamountsborrowed
(e) cashpaymentsmadebyalesseeforthereductionoftheoutstandingliabilityrelating to a lease (see Chapter 9).

Asregardsleases,itshouldbenotedthatthefinancechargeelementofeachleasepayment istreatedasinterestpaid(seebelow).Butpaymentsrelatingtoshort-termleasesorleases oflow-valueassetsforwhichtheentityhaselectednottorecognisearight-of-useasset andaleaseliability(seeChapter9)shouldbeclassifiedwithinoperatingactivities.

Interest,dividendsandtaxes

IAS7requiresthatcashflowsarisingfrominterestreceived,dividendsreceived,interest paid and dividends paid should be disclosed separately in the statement of cash flows.However, there is no consensus as to the classification of these items. Interest received and dividendsreceivedareusuallyclassifiedascashinflowsarisingfrominvestingactivities butthecorrecttreatmentofinterestpaidanddividendspaidislessclear.Forinstance:

(a) Interest paid on a loan obtained for operating purposes might be classified underoperating activities. Alternatively, it could be argued that interest paid should beclassifiedunderfinancingactivitiessinceitisacostofobtainingfinance.
(b) Dividends paid might be classified under operating activities so that users may deter-mine an entity's ability to pay dividends out of operating cash flows. Alternatively, itcould be argued that dividends paid are a cost of obtaining financial resources and so should be classified under financing activities.

IAS7doesnotprescribeanyparticularclassificationfortheseitemsbutdoesrequirethat eachofthemshouldbeclassifiedinaconsistentmannerfromperiodtoperiod†.

Cash inflows and outflows arising from income taxes (see Chapter 15) must be disclosed separately and should be classified under operating activities unless specifically associatedwith investing or financing activities.

† *Inthisbook,interestpaidwillusuallybeclassifiedunderoperatingactivitiesanddividendspaidwillusuallybeclassifiedunderfinancingactivities*.

Reportingcashflowsfromoperatingactivities

A statement of cash flows begins by reporting the cash flows arising from the entity'soperatingactivities.Thesecashflowsmaybereportedusingeitherthe*direct*method or the *indirect*method:

(a) **Directmethod**. If the direct method is used, major classes of receipts and payments arising from operating activities are disclosed individually and are then aggregated togivethetotalamountofcashgeneratedfromoperations.Thechosenclassification should be applicable to the entity's business and relevant to the needs of its users. A statementofcashflowspreparedusingthedirectmethodmighttypicallydisclose:

(i) cashreceiptsfromcustomers

(ii) cashpaidtosuppliersofgoodsandservices

(iii) cashpaidtoemployees.

These figures could be obtained by conducting an analysis of the entity's accounting records for the period. Alternatively, if the information provided in the financial statementsissufficientlydetailed,itmightbepossibletoderivetherequiredfigures without conducting such an analysis. For instance, the amount of cash received from customers during the period could be derived by taking the sales figure shown in the statement of comprehensive income and then making an adjustment for opening and closing trade receivables.

(b) **Indirectmethod**.Theindirectmethodtakesasitsstartingpointtheprofitorlossfor the period (before tax) and then adjusts this profit or loss so as to calculate the total amountofcashgeneratedfromoperations.Themainadjustmentsareasfollows:

(i) Non-cashexpenseswhichhavebeendeductedwhencalculatingprofitorloss but which do not involve an outflow of cash (e.g. depreciation) are added back. Interest payable is also added back.

(ii) Non-cash income which has been included in the calculation of profit or loss but which does not involve an inflow of cash (e.g. a decrease in the allowance for doubtful trade receivables) is subtracted.

(iii) Profits or losses on the disposal of non-current assets are subtracted (profits) or addedback(losses).Theactualsaleproceedsofsuchassetsareshownlaterin thestatementofcashflowsasacashinflowfrominvestingactivities.

(iv) Itemsofincomeorexpensewhichhavebeenincludedinthecalculationofprofit or loss but which represent cash flows from investing activities or financingactivitiesaresubtracted(income)oraddedback(expenses).

(v) Finally, adjustments are required for the increases/decreases in inventories, trade receivables and trade payables between the beginning and end of the

accounting period. Similar adjustments will be required for prepaid expenses and accrued expensesifthesareshownseparatelyinthefinancialstatements.

Therequiredadjustmentsareasfollows:

	Increases	*Decreases*
Inventories	Subtract	Add
Trade receivables and prepaid expenses	Subtract	Add
Tradepayablesandaccruedexpenses	Add	
Subtract		

The effect of these adjustments is to change the basis of accounting from theaccruals basis to a cash basis. For instance, an increase in trade payables causes purchases to be higher than the amount actually paid to suppliers. Adding this increasebackontotheprofitfortheperiodshowswhattheprofitwouldhave beenifpurchaseshadbeenaccountedforonacashbasis.

A simple way of remembering the correct adjustment for each increase and decrease is to consider what would happen if the increase/decrease occurred and nothing else changed in the financial statements other than cash. For instance, a decrease in trade receivables would generate extra cash as customers paid theirdebts.Thereforeadecreaseintradereceivableshasabeneficialeffectoncas h andshouldbeaddedwhencalculatingthecashgeneratedfromoperations.

Thedirectmethodandindirectmethodwill,ofcourse,givethesame"bottomline"figure forthetotalamountofcashgeneratedbyoperationsduringtheperiod.Interestpaidand taxespaidarethendeducted(seeearlierinthischapter)togivethefinalfigureforthe entity's net cash flow from operating activities.

Both methods are illustrated below. IAS7 encourages the use of the direct method, as this providesmoredetailedinformationthantheindirectmethod.However,theindirectmethodis permittedbyIAS7andisusedextensivelyinpractice.

EXAMPLE1

Acompany'sstatementofcomprehensiveincomefortheyearto31March2020isshownbelow.T hecompany'sstatementoffinancialpositionasatthatdate(withcomparativefiguresfor2019)isa lsoshown.

Statementofcomprehensiveincomefortheyearto31March2020

	£000
Sales	752
Costofsales	(387)
Grossprofit	365
Administrativeandsellingexpenses	(225)
Interestpayable	(18)
Dividendsreceived	22
Profitbeforetax	144
Taxation	(28)

Profitaftertax	116

Statementoffinancialpositionat31March2020

		2020		2019
		£000		£000
Assets				
Non-currentassets				
Property,plantandequipment		488		470
Investments		250		250
		738		720
Currentassets				
Inventories	231		212	
Tradereceivables	140		157	
Cashatbank	15	386	-	369
		1,124		1,089
Equity				
Sharecapital		220		200
Sharepremiumaccount		70		60
Retainedearnings		531		445
		821		705
Liabilities				
Non-currentliabilities				
Long-termloans		90		130
Currentliabilities				
Tradepayables	182		176	
Accruedinterestpayable	3		-	
Taxation	28		55	
Bankoverdraft	-	213	23	254
		1,124		1,089

Thefollowinginformationisalsoavailable:

(a) Administrativeandsellingexpensesincludeemployeesalariesof£148,000andequipment depreciationof£70,000.

(b) Therewerenonon-currentassetdisposalsduringtheyearto31March2020.

(c) Adividendof£30,000waspaidinJune2019.

Required:

Preparethecompany'sstatementofcashflowsfortheyearto31March2020(usingtheindirectmethod).Alsodemonstratethatuseofthedirectmethodwouldgivethesamefigureforcashgeneratedfromoperationsasisgivenbytheindirectmethod.

Solution

Statementofcashflowsfortheyearto31March2020

	£000	£000
Cashflowsfromoperatingactivities		
Profitbeforetaxation	144	
Depreciation	70	
Interestpayable	18	
Dividendsreceived	(22)	
Increaseininventories(£231,000–£212,000)	(19)	
Decreaseintradereceivables(£140,000–£157,000)	17	
Increaseintradepayables(£182,000–£176,000)	6	
Cashgeneratedfromoperations		214
Interestpaid	(15)	
Taxationpaid	(55)	(70)
Netcashinflowfromoperatingactivities		144
Cashflowsfrominvestingactivities		
Acquisitionofproperty,plantandequipment	(88)	
Dividendsreceived	22	
Netcashoutflowfrominvestingactivities		(66)
Cashflowsfromfinancingactivities		
Proceedsfromissueofsharecapital	30	
Repaymentoflong-termborrowings	(40)	
Dividendspaid	(30)	
Netcashoutflowfromfinancingactivities		(40)
Netincreaseincashandcashequivalents		38
Cashandcashequivalentsat1April2019		(23)
Cashandcashequivalentsat31March2020		15

Notes:

(a) Interestpayablefortheyearis£18,000.But£3,000ofthisisshownasaliabilityattheyear-end.Sointerestpaidintheyearmusthavebeenonly£15,000.

(b) Thetaxexpensefortheyearis£28,000butallofthisisstillowingattheyear-end.However,thetaxliabilityof£55,000owingattheendofthepreviousyearisnolongershownasaliability.Sotaxpaidduringtheyearmusthavebeen£55,000.

(c) PPEhasincreasedby£18,000despitedepreciationof£70,000intheyear.ThereforeacquisitionsofPPEmusthavebeen£88,000.

(d) Sharecapitalandsharepremiumtogetherhaveincreasedby£30,000.So£30,000musthavebeenraisedbyanewshareissue.

(e) Long-termloanshavedecreasedby£40,000.Sotheremusthavebeenarepaymentof£40,000duringtheyear.

Directmethod:

Thedirectmethodwouldalsohavegiven£214,000asthefigureforcashgeneratedfromoperations,asfollows:

	£000	£000
Cashflowsfromoperatingactivities		
Cashreceiptsfromcustomers(W1)	769	
Cashpaidtosuppliersofgoodsandservices(W3)	(407)	
Cashpaidtoemployees	(148)	
Cashgeneratedfromoperations		214

Workings:

	£000
W1Openingtradereceivables	157
Sales	752
Closingtradereceivables	(140)
Cashreceiptsfromcustomers	769
W2Openinginventories	212
Purchases(*balancingfigure*)	406
Closinginventories	(231)
Costofsales	387
W3Openingtradepayables	176
Purchases(W2)	406
Closingtradepayables	(182)
Cashpaidtosuppliersofgoodsforresale	400
Administrativeandsellingexpenses (£225,000–£148,000–£70,000)	7
Cashpaidtosuppliersofgoodsandservices	407

EXAMPLE2

Anextractfromacompany'sstatementofcomprehensiveincomefortheyearto31May2020isshownbelow,togetherwiththecompany'sstatementoffinancialpositionatthatdate(withcomparativesforthepreviousyear).

Statementofcomprehensiveincome(extract)Yearto31May2020

	£
Profitbeforetaxation	205,600
Taxation	38,980
Profitfortheyear	166,620

Statementoffinancialpositionat31May2020

		2020		2019
	£	£	£	£
Assets				
Non-currentassets				
Property,plantandequ'tatcost	285,000		183,000	
Less:Accumulateddepreciation	151,650	133,350	95,160	87,840
Investmentsatcost		12,000		10,000
		145,350		97,840
Currentassets				
Inventories	171,220		133,330	
Tradereceivablesandprepayments	121,630		86,500	
Cashatbank	710		-	
Treasurybills	5,000	298,560	-	219,830
		443,910		317,670
Equity				
Ordinarysharecapital		100,000		100,000
Preferencesharecapital		50,000		50,000
Retainedearnings		136,610		39,990
		286,610		189,990
Liabilities				
Non-currentliabilities				
11%Loanstock		30,000		-
Currentliabilities				
Tradepayablesandaccruals	89,370		61,530	
Taxation	37,930		42,660	
Bankoverdraft	-	127,300	23,490	127,680
		443,910		317,670

Thefollowinginformationisalsoavailable:

(a) The11%loanstockwasissuedon1December2019.Thefirsthalf-year'sinterestwaspaidon31May2020.Bankinterestpaidduringtheyearwas£1,320.

(b) Dividendsreceivedduringtheyearwere£930.Dividendstotalling£70,000werepaidduringtheyear.

(c) Plantwhichhadcost£22,000wassoldinMarch2020for£7,000.Theaccumulateddepreciationonthisplantatthetimeofdisposalwas£16,230.Noinvestmentsweresoldduringtheyear.

(d) TheTreasurybillsrankascashequivalents.

Required:

Prepareastatementofcashflowsfortheyearto31May2020inaccordancewiththerequirements ofIAS7(usingtheindirectmethod).Alsoreconcilethetotalcashandcashequivalentsshownbythe statementofcashflowstotheequivalentfiguresshowninthecompany'sopeningandclosingstat ementsoffinancialposition.

Solution

Statementofcashflowsfortheyearto31May2020

	£	£
Cashflowsfromoperatingactivities		
Profitbeforetaxation	205,600	
Depreciation(£151,650–£95,160+£16,230)	72,720	
Profitondisposalofplant	(1,230)	
Interestpayable(£1,320+£1,650)	2,970	
Dividendsreceived	(930)	
Increaseininventories(£171,220–£133,330)	(37,890)	
Increaseintradereceivables(£121,630–£86,500)	(35,130)	
Increaseintradepayables(£89,370–£61,530)	27,840	
Cashgeneratedfromoperations		233,950
Interestpaid	(2,970)	
Taxationpaid(£42,660+£38,980–£37,930)	(43,710)	(46,680)
Netcashinflowfromoperatingactivities		187,270
Cashflowsfrominvestingactivities		
Acquisitionofproperty,plantandequipment (£285,000–£183,000+£22,000)	(124,000)	
Disposalofproperty,plantandequipment	7,000	
Acquisitionoflong-terminvestments	(2,000)	
Dividendsreceived	930	
Netcashoutflowfrominvestingactivities		(118,070)
Cashflowsfromfinancingactivities		
Proceedsofloanstockissue	30,000	
Dividendspaid	(70,000)	
Netcashoutflowfromfinancingactivities		(40,000)
Netincreaseincashandcashequivalents		29,200
Cashandcashequivalentsat1June2019		(23,490)
Cashandcashequivalentsat31May2020(£710+£5,000)		5,710

Disclosures

IAS7 requires entities to disclose the components of their cash and cash equivalents and to present a reconciliation of these amounts in the statement of cash flows with the equivalent items reported in the statement of financial position.

Furtherdisclosures must be provided that enable users to evaluate changes in the entity's liabilitiesarisingfromfinancingactivities(e.g.loans).Thisrequirementmaybesatisfied byprovidingareconciliationbetweentheopeningandclosingbalancesofsuchliabilities.

IAS7alsoencourages(butdoesnotrequire)thedisclosureofadditionalinformationthat isrelevanttoanunderstandingoftheentity'sfinancialpositionandliquidity,suchas:

(a) theamountofanyundrawnborrowingfacilitiesthatmaybeavailabletofinance futureoperatingactivitiesandtosettlecapitalcommitments

(b) ananalysisofthecashflowsarisingfromtheoperating,investingandfinancing activities of each reportable segment, where "reportable segments" are defined in accordancewiththerequirementsofIFRS8*OperatingSegments*(seeChapter24).

Summary

- A statement of cash flows analyses cash inflows and outflows during an accountingperiodandcanbeusedtoassesstheentity'sabilitytogeneratethecashitnee ds.
- IAS7defines"cash"ascashonhandanddemanddeposits.Bankoverdraftsare usually treated as negative cash. Cash equivalents are highly liquid short-term invest- ments that may be treated as if they were cash.
- Cashflowsareclassifiedbyoperating,investingandfinancingactivities.
- Operating activities comprise an entity's main revenue-producing activities. Investing activities consist mainly of the acquisition and disposal of long-term assets. Financing activitiesincludeshareissues,shareredemption,borrowingsandloanrepayments.
- The amount of cash generated from operations can be reported using either the direct method or the indirect method.
- Thedirectmethoddisclosesmajorclassesofcashreceiptsandpaymentsindividually.
- Theindirectmethodmakesanumberofadjustmentstotheentity'spre-taxprofitsoas to calculate the total cash generated from operations.
- IAS7 requires that the components of an entity's total cash and cash equivalents are disclosed. The amounts in the statement of cash flows should be reconciled to the equivalent items in the statement of financial position.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

16.1 Explaineachofthefollowingtermswhicharedefinedininternationalstandard IAS7:

(a) cash
(b) cashequivalents
(c) operatingactivities
(d) investingactivities
(e) financingactivities.

16.2 (a) Distinguishbetweenthedirect methodandtheindirect methodof calculatingthe amount of cash generated from an entity's operations.
(b) Listthemainstepsintheaccountingworkrequiredifthe indirectmethodisused.

16.3 Explain the effect (if any) of each of the following transactions on an entity's profit orloss and on its cash flows:

(a) thepurchaseofnewequipmentwhichisthendepreciatedoveritsusefullife
(b) thepaymentofasupplier'sinvoice
(c) accountingforanaccruedexpenseattheendofanaccountingperiod
(d) thepaymentofadividend
(e) thepurchaseofinventoryforcash
(f) investingsparecashinahigh-interestbankaccount,repayableat7days'notice.

16.4 ThesummarisedstatementofcomprehensiveincomeofScharpLtdfortheyearto30 June2020isshownbelow,togetherwiththecompany'sstatementoffinancialposition at that date (with comparatives for the previous year).

Statementofcomprehensiveincomefortheyearto30June2020

	£
Operatingprofit	170,200
Investmentincome	7,100
Interestpayable	(6,120)
Profitbeforetaxation	171,180
Taxation	37,870
Profitfortheyear	133,310

Statementoffinancialpositionat30June2020

		2020		2019
	£	£	£	£
Assets				
Non-currentassets				
Property,plantandequ'tatcost	369,300		210,000	
Less:Accumulateddepreciation	151,650	217,650	107,340	102,660
Investmentsatcost		120,000		120,000
		337,650		222,660
Currentassets				
Inventories	86,220		97,430	
Tradereceivables	82,610		58,100	
Prepaidexpenses	7,200	176,030	7,000	162,530
		513,680		385,190
Equity				
Ordinarysharecapital		120,000		100,000
Retainedearnings		195,850		147,540
		315,850		247,540
Liabilities				
Non-currentliabilities				
Debentureloans		75,000		50,000
Currentliabilities				
Tradepayables	40,920		44,310	
Accruedexpenses	9,130		8,250	
Taxation	37,870		32,300	
Bankoverdraft	34,910	122,830	2,790	87,650
		513,680		385,190

Notes:

(i) Therewerenodisposalsofnon-currentassetsduringtheyearto30June2020.

(ii) Adividendof£85,000waspaidduringtheyear.

Required:

(a) Prepare a statement of cash flows for the year to 30 June 2020 in accordance with the requirements of IAS7 (using the indirect method).

(b) Explainwhytheinformationprovidedinthestatement of comprehensiveincome and in the statements of financial position is insufficient to allow use of the direct method in this case.

(c) Comment briefly on the significance of the information provided by the company's statement of cash flows.

16.5 ThestatementsoffinancialpositionofLochnagarLtdforthepasttwoyearsandthe company's most recent income statement are set out below.

Incomestatementfortheyearto31October2019

	£000
Revenue	22,400
Costofsales	(12,320)
Grossprofit	10,080
Gainondisposalofproperty,plantandequipment	224
Distributioncosts	(4,704)
Administrativeexpenses	(2,240)
Financecosts–interestonloans	(91)
Profitbeforetax	3,269
Taxexpense	(1,344)
Profitfortheyear	1,925

Statementsoffinancialpositionat31October

	2019		2018	
	£000	£000	£000	£000
Assets				
Non-currentassets				
Property,plantandequipment		25,171		24,100
Currentassets				
Inventories	3,696		2,464	
Tradeandotherreceivables	3,360		2,464	
Cashandcashequivalents	-	7,056	129	5,057
Totalassets		32,227		29,157
Equity				
Sharecapital		2,200		2,000
Sharepremiumaccount		800		500
Retainedearnings		24,990		23,065
		27,990		25,565
Liabilities				
Non-currentliabilities				
Bankloans		1,300		800
Currentliabilities				
Tradeandotherpayables	1,232		1,848	
Currenttaxliability	1,344		944	

Thefollowinginformationisalsoavailableinrelationtotheyearto31October2019:

(a) Thetotaldepreciationchargefortheyearwas£3,545,000.

(b) Property.plantandequipmentcosting£976,000withaccumulateddepreciationof £355,000wassoldduringtheyearataprofitof£224,000.

(c) Allsalesandpurchaseswereoncredit.Otherexpenseswerepaidforincash.

(d) Nodividendswerepaidduringtheyear.

Required:

Prepare a statement of cash flows for Lochnagar Ltd for the year to 31 October 2019, in accordancewiththerequirementsofaccountingstandardIAS7andusingtheindirect method.

(AmendedfromAAT)

16.6 Thefollowinginformationhasbeentakenfromthefinancialrecordsof Saptahplcforthe financial year ended 31 October 2019:

	£000
Tradepayables:	
asat1November2018	1,099
asat31October2019	1,040
Tradereceivables:	
asat1November2018	4,700
asat31October2019	3,290
Inventory:	
asat1November2018	790
asat31October2019	620
Cashandbank:	
asat1November2018	206
asat31October2019	88
Corporationtaxpayable:	
asat1November2018	1,140
asat31October2019	860
Overprovisionfortaxfortheyearended31October2018	420
Purchases	14,290
Wagesandsalaries	6,520
Discountsallowed	147
Depreciationfortheyear	750
Deficitonsalesofnon-currentassets	72
Otherexpensesexcludinginterestanddepreciation	4,490
Interestpaid	380
Sales	32,900
Discountsreceived	55
Netprofitbeforetax	6,136
Netprofitaftertax	5,696

Therewerenoexpensesprepaidoraccruedatthestartorendofthefinancialyear.

Required:

Prepareaclearcalculationofthenetcashfromoperatingactivitiesfortheyearto31 October 2019, using:

(a) theindirectmethod

(b) thedirectmethod.

(CIPFA)

16.7 The statement of financial position of Urbax plc at 31 July 2020 (with comparatives for the previous year) is shown below:

Statementoffinancialpositionat31July2020

		2020		2019
	£000	£000	£000	£000
Assets				
Non-currentassets				
Property,plantandequipmentatcost	490		450	
Less:Accumulateddepreciation	370	120	330	120
Investmentsatcost		19		44
		139		164
Currentassets				
Inventories	289		176	
Tradereceivables	231		106	
Less:All'cefordoubtfuldebts	26	205	4	102
Prepayments	13		12	
Cashon7-daydeposit	-		50	
Cashatbankandinhand	-	507	59	399
		646		563
Equity				
Ordinarysharecapital		230		180
Preferencesharecapital		20		20
Sharepremiumaccount		30		-
Retainedearnings		158		213
		438		413
Liabilities				
Non-currentliabilities				
Currentliabilities				
14%Debenturestock	40		-	
Tradepayables	60		55	
Accruals	9		8	
Amountowingrenon-currentassets	20		-	
Taxation	9		47	
Bankoverdraft	40	178	-	110
		646		563

Notes:

(i) Equipmentwhichhadcost£30,000duringtheyearto31July2017wassoldin February2020for£10,000.Thecompanydepreciatesequipmentat20%perannu m on cost with a full charge in the year of acquisition and none in the year of disposal. (Some of the equipment was over five years old on 31 July 2020).

(ii) Non-current asset investments which had cost £25,000 some years previously were sold during the year for £21,000.

(iii) Dividendsreceivedduringtheyearwere£5,000.Dividendstotalling£100,000wer e paid during the year.

(iv) The 14% debentures were issued many years ago and are due to be redeemed on 1 January 2021. A fresh issue of 12% debentures was made on 31 July 2020.

(v) Interest paid during the year (including debenture interest) was £8,000. All interest was paid on the due date and no interestwas accrued ateither the startor the end of the year. No interest was received during the year.

(vi) Taxation shown as a liability on 31 July 2019 was paid during the year to 31 July 2020 at the amount stated.

(vii) InJanuary2020,thecompanyissued50,000£1ordinarysharesatapremiumof 60p per share.

(viii) Thecashon7-daydepositranksasacashequivalent.

Required:

(a) Calculatethecompany'sprofitbeforetaxfortheyearto31July2020.

(b) Prepare a statement of cash flows for the year to 31 July 2020 in accordance with the requirements of IAS7 (using the indirect method).

(c) Reconcile the total cash and cash equivalents shown by the statement of cash flows to the equivalent figures shown in the opening and closing statements of financial position.

(d) Comment briefly on the significance of the information provided by the company's statement of cash flows.

*16.8 The statement of financial position of AadvaarkTrading Ltd at 30 November 2020 (with comparatives for 2019) is as follows:

Statementoffinancialpositionat30November2020

		2020		2019
	£000	£000	£000	£000
Assets				
Non-currentassets				
Property,plantandequipmentatcost orvaluation	2,470		1,790	
Less:Accumulateddepreciation	850	1,620	630	1,160
Investmentsatcost		50		100
		1,670		1,260
Currentassets				
Inventories	740		510	
Tradereceivables	1,010		640	
Short-terminvestments	-		150	
Bankbalance	-	1,750	180	1,480
		3,420		2,740
Equity				
Sharecapital		500		400
Sharepremiumaccount		140		100
Revaluationreserve		550		300
Retainedearnings		480		800
		1,670		1,600
Liabilities				
Non-currentliabilities				
Long-termloans		900		500
Currentliabilities				
Tradepayables	660		530	
Currenttaxpayable	-		110	
		3,420		2,740

Thefollowinginformationisalsoavailable:

(i) Freeholdpropertywhichwasvaluedat£500,000on30November2019wasre-valued at £750,000 on 30 November 2020.

(ii) Plantandequipmentwithanoriginalcostof£120,000andaccumulated depreciation of £80,000 was sold in February 2020 for £30,000.

(iii) One half of the non-current asset investments were sold for £70,000 in June 2020. Dividends received during the year to 30 November 2020 were £nil.

(iv) Interestpaidandpayableintheyeartotalled£70,000.

(v) There is no tax liability for the year to 30 November 2020. The tax liability for the year to 30 November 2019 was underestimated by £20,000.

(vi) Nodividendswerepaidorproposedineitheryear.

(vii) The short-term investments were sold for £150,000 in June 2020. These ranked as cash equivalents as defined by IAS7.

Required:

PrepareastatementofcashflowsforAadvaarkTradingLtdfortheyearto30November 2020,inaccordancewiththerequirementsofaccountingstandardIAS7andusingthe indirectmethod. *(CIPFA)*

*16.9 The following draft financial statements are available for Sipfalor plc for the year ended 31 May 2020:

Statementoffinancialpositionat31May2020

		2020		2019
	£	£	£	£
Assets				
Non-currentassetsatcostorvaluation		81,535,730		57,754,170
Less:Accumulateddep'n		16,677,788		12,687,297
		64,857,942		45,066,873
Currentassets				
Inventory	412,350		389,500	
Tradereceivables	558,400		467,800	
Othercurrentassets	2,560		1,540	
Cashandcashequivalents	2,702,204	3,675,514	64,640	923,480
Totalassets		68,533,456		45,990,353
Equity				
Issuedsharecapital		35,000,000		20,000,000
Sharepremium		5,500,000		1,500,000
Revaluationreserve		1,000,000		800,000
Retainedearnings		18,421,923		17,696,753
		59,921,923		39,996,753
Liabilities				
Non-currentliabilities				
Debentures	7,500,000		5,000,000	
Deferredtax	359,800	7,859,800	289,500	5,289,500
Currentliabilities				
Tradepayables	409,800		309,800	

Statementofprofitorlossfortheyearto31May2020

	£
Revenue	43,380,756
Costofsales	(25,050,812)
Grossprofit	18,329,944
Operatingexpenses	(15,833,481)
Operatingprofit	2,496,463
Interestpaid	(812,500)
Profitbeforetax	1,683,963
Taxation	(278,793)
Profitfortheyear	1,405,170

Note:

Sipfalorplcpresentsaseparatestatementofprofitorlossfortheyearandaseparatestatementofcomprehensiveincomeasabove.

Thefollowingadditionalinformationfortheyearended31May2020isavailable:

1) Dividendspaidduringtheyearwere£680,000.
2) Non-currentassetswhichhadcost£332,100andwhichhadacarryingvalueof £55,940weresoldfor£45,000.Anysurplusesordeficitsonthedisposalofnon-currentassetshavebeenincludedinthedepreciationchargefortheyear.Other movementsinnon-currentassetsareduetopurchasesofnewassetsand revaluations.
3) "Othercurrentassets"consistsofprepaidinsurance."Otherpayables"consistsof accrued wages and salaries.

Required:

PrepareastatementofcashflowsforSipfalorplcfortheyearended31May2020in accordancewithIAS7*StatementofCashFlows*usingthedirectmethod.Additionalnotes are not required. Ignore VAT.

(CIPFA)

Chapter17

Financialreportinginhyperinflationaryeconomies

Introduction

Theamountsthatappearinasetoffinancialstatementsaremeasuredinunitsofcurrency (e.g.poundsoreuros)anditisgenerallyassumedforaccountingpurposesthatthevalueof thecurrencybeingusedisstable.Forexample,itisassumedthatthevalueof£1atthe start of an accounting period is the same as the value of £1 at the end of the period. But ifpricesarechanging,thisisclearlyaninvalidassumption.Ingeneral,pricesareincreasing overtimeandthevalueofmoneyisfalling.Thisisinflation.Ignoringinflationcanleadto avarietyofaccountingproblemsandtheseproblemsareattheirworstifthecurrency beingusedisthecurrencyofahyperinflationaryeconomy.

Thepurposeofthischapteristooutlinethemainaccountingproblemswhicharecaused by inflation and to explain how standard IAS29 *FinancialReportinginHyperinflationaryEconomies*seeks to address these problems in the case where an entity is reporting in a currency which is losing value very rapidly.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explaintheterm"historicalcostaccounting"
- explainandillustratethemainweaknessesofhistoricalcostaccounting
- listthemainstrengthsofhistoricalcostaccounting
- identifythemainalternativestohistoricalcostaccounting
- explainwhatismeantbya"hyperinflationaryeconomy"
- explainthemainrequirementsofstandardIAS29.

Historicalcostaccountinganditsweaknesses

The term "historical cost accounting" (HCA) refers to the traditional method of accounting wherebyeachtransactionisrecordedatitsmonetaryamountatthetimeofthetransaction and no attempt is made to adjust recorded amounts to take account of subsequent inflation.This approach is used almost exclusively in practice, but it can be argued that the resulting HCAfinancialstatementssufferfromanumberofweaknesses.Theseinclude:

(a) profitsareoverstated
(b) depreciationchargesareinadequate
(c) gainsandlossesonmonetaryitemsarenotdisclosed
(d) holdinggainsoninventoriesarenotseparatelyidentified
(e) non-currentassetvaluesreportedinthestatementoffinancialpositionareunrealistic
(f) accountingratiosaremisleading.

Eachofthesepercievedweaknessesisexplainedbelow.

Overstatedprofits

It is clear that the main objective of preparing a statement of comprehensive income is to calculatetheamountofprofitearnedbyanentityduringanaccountingperiod.Itisless clearthatastatementofcomprehensiveincomewhichignoresinflationdoesnotreally achieve this objective. It might be helpful to define what is meant by the term "profit". The followingdefinitionisbasedupononewhichwascoinedbySirJohnHicksin1930:

> The profit for an accounting period is "*theamountwhichtheownerofabusinesscanconsumeandstillbeaswelloffattheendof theperiodasheorshewasatthestartoftheperiod*".

Anotherwayofputtingthisistosaythattheprofitforaperiodisequaltotheamount whichcouldbewithdrawnfromthebusinessduringthatperiodwhilstmaintainingits capitalintact.Thismeansthatthemeasurementofprofitdependsuponbeingableto measureandcomparethecapital(ornetassets)ofabusinessentityatthebeginningand end of an accounting period. The *ConceptualFramework*(see Chapter 2) distinguishesbetweenthreeessentiallydifferentapproachestothemeasurementofcapital:

(a) **Nominalfinancialcapitalmaintenance**. This approach measures capital in moneytermswithnoregardtochangesinthepurchasingpowerofmoney.Anentitywhic h has capital of £x at the start of a period and £y at the end of that period (with no distributionstoownersorcontributionsbyowners)isassumedtohavemadeaprofit of£y–£x.Thisis,ofcourse,thetraditionalHCAapproachtoprofitmeasurement.

(b) **Generalpurchasingpowermaintenance**. Capital is measured in terms of general purchasing power and profit is defined as the amount by which the general purchasing power of the entity has increased during an accounting period. Purchasing power is

measuredinaccordancewithchangesinanindexofgeneralprices.

(c) **Physicalcapitalmaintenance**.Capitalismeasuredintermsofpurchasingpower with regard to the specific items which the business entity needs to buy. Profit for an accountingperiodisdefinedastheincreaseinthespecificpurchasingpowerofthe entity during that period.

Intimesofinflation,itmightbearguedthatHCAfinancialstatements(whichmeasure capitalinnominalmonetaryunits)overstatetheprofitsofbusinessentities.Asimple exampleofthisproblemwasgiveninChapter2.Afurtherexampleisgivenbelow.

EXAMPLE1

XLtdstartedtradingon1July2019withcapitalof£100,000andimmediatelyboughttenidenticalit emsofinventoryfor£10,000each.Sixoftheseitemsweresoldon31Julyfor £84,000(whichwasreceivedincash).Therewerenoothertransactionsduringthemonth.

(a) Calculatetheprofitforthemonthinnominalmoneyterms.

(b) Iftheindexofgeneralpriceswas100.0on1July2019and104.0on31July2019,calculatethep rofitforthemonthintermsofgeneralpurchasingpower.

(c) Ifitwouldcost£11,000on31Julytoreplaceeachofthesolditems,calculatetheprofitforthem onthintermsofspecificpurchasingpower(i.e.thepowerofthecompanytomaintainitsphysi calcapital).

Solution

	Nominal financialcapital maintenance £	*General purchasingpower maintenance* £	*Physical capital maintenance* £
Assetsattheendofthemonth:			
Cash	84,000	84,000	84,000
Inventory(fouritems)	40,000	41,600	44,000
	124,000	125,600	128,000
Assetsrequiredattheendofthe monthtobeaswelloffasatthe beginningofthemonth:			
(a)nominalmonetaryunits	100,000		
(b)generalpurchasingpower (£100,000x104/100)		104,000	
(c)physicaloperatingcapability (£11,000x10)			110,000
Netprofitforthemonth	24,000	21,600	18,000

Notes:

(a) Innominalmonetaryterms,thecompanyis£24,000betteroffattheendofthemonththanitwasatthestartofthemonth.Thisistheprofitfigurewhichwouldbereportedin theHCAfinancialstatements.

(b) Therewas4%inflationduringJuly,so£104,000isneededattheendofthemonthtogivethesamegeneralpurchasingpoweraswasgivenby£100,000atthestartofthemonth.Thecashof£84,000isa"monetaryitem"(seebelow)andisfixedinmonetaryterms,regardlessofinflation.Theinventorycost£40,000on1Julybutassumingthatallcostshaverisenby4%inlinewithgeneralpriceinflation,itisnowworth£41,600.Thereforethecompanyhastotalassetsof£125,600on31Julyanditsprofitforthemonthintermsofgeneralpurchasingpoweris£21,600.

(c) £110,000isneededattheendofthemonthtobuythesameinventoryascouldbeboughtfor£100,000atthestartofthemonth.Thecompanyhasfourinventoryitemsremainingon31July(measuredattheircurrentcostof£44,000)andcashof £84,000.If£66,000ofthiscashwereusedtoreplenishtheinventory,therewouldstillbe£18,000left,sothecompanyhasmadeaprofitof£18,000forthemonth.

HCAfinancialstatements(usingnominalfinancialcapitalmaintenance)wouldoverstatethecompany'srealprofitforthemonth.TheHCAprofitwouldbe£24,000,butnomorethan£21,600ofthiscouldbedistributedwithoutreducingthecompany'sgeneralpurchasingpowerandnomorethan£18,000couldbedistributedwithoutreducingthecompany'spowertoreplaceitsinventory.Ifadividendof£24,000werepaid,thecompanywouldeffectivelybepayingpartofthatdividendoutofitscapital.

Inadequatedepreciationcharges

ThepurposeofdepreciationinHCAfinancialstatementsistospreadthehistoricalcostof a non-current asset (less its residual value) over the asset's useful life. However, a desirable side-effectofchargingdepreciationisthatreportedprofitsarereduced.Thisshouldactas arestraintontheamountdistributedtoownersandsomakeitmorelikelythatfundswill beavailabletoreplacenon-currentassetswhenthisbecomesnecessary.Evenso,thereis noguaranteethatsufficientfundswillbeavailableinliquidform.Butthefactthat inflationisusuallyignoredwhencalculatingdepreciationcausesthefollowingproblems:

(a) InanHCAstatementofcomprehensiveincome,salesrevenuemeasuredincurrent£sismatchedagainstdepreciationchargescalculatedinhistorical£s.Ifelderlynon-currentassetsarestillbeingdepreciatedorifinflationisrunningatahighrate,there maybeagreatdisparitybetweenthevalueofthese£sandthismustthrowdoubton the validity and usefulness of the profit figure.

(b) Thetotalamountofdepreciationchargedovertheyearsinrelationtoanassetwillbe less than its replacement cost. In effect, profits will be overstated and may be over-distributed, so causing capital depletion.

EXAMPLE2

Acompanystartstradingwithcapitalof£100,000.Thisisspentupontheacquisitionofplantwitha usefullifeoffiveyearsandnoresidualvalue.Depreciationischargedat20%perannumonhistorical cost.Allofthecompany'sprofitsarepaidoutasdividendsattheendofeachaccountingyear.Willth ecompanybeabletoreplacetheplantattheendofitsusefullife,giventhatitsreplacementcostwillb e£120,000bythen?

Solution

Attheendoffiveyears,thecompany'sstatementoffinancialpositionwillshowcapitalof £100,000andnetassetsof£100,000.Evenintheunlikelycasethatthesenetassetsareentirelyinliq uidform,thecompanywillnotbeabletoreplacetheplantwithoutraisingafurther£20,000.Ineffect, theHCAfinancialstatementshaveoverstatedthecompany'sprofitsandsothecapitalofthecomp any(measuredinspecificpurchasingpowerterms)hasbeendepletedby£20,000.

Gainsandlossesonmonetaryitemsnotdisclosed

Monetaryitemsareassetsorliabilitieswhicharefixedinmonetaryterms.Common examplesofmonetaryitemsarereceivables,payables,loansandcash.Inaperiodof inflation,anentitylosespurchasingpowerbyholdingmonetaryassetsbutgains purchasing power by holding monetary liabilities. However, these gains and losses are not revealed at all in the HCA financial statements. It can be argued that this is anothershortcomingoftheconventionalapproachtofinancialaccounting.

EXAMPLE3

Atthestartofanaccountingyear(whentheindexofgeneralpricesis100.0)acompanyborrows£50 0,000ataninterestrateof9%perannum.Thefullamountoftheloanisstilloutstandingattheendoft heyear,bywhichtimetheindexofgeneralpriceshasincreasedto106.0.

(a) HowwillthisloanbedealtwithintheHCAstatementofcomprehensiveincome?

(b) Calculatetherealcostoftheloantothecompanyfortheaccountingyear.

Solution

(a) Thestatementofcomprehensiveincomewillrecogniseanexpenseof£45,000.

(b) Iftheloanwerefixedintermsofgeneralpurchasingpower,thecompanywouldowe £530,000(£500,000x106/100)attheendoftheyear.However,astheloanisfixedinmonetary terms,thecompanystillowesonly£500,000andhasgainedpurchasingpowerof£30,000.Th erealcostoftheloanisonly£15,000(£45,000–£30,000).

Holdinggainsoninventoriesnotseparatelyidentified

During a period of inflation, any inventories held by an entity for an appreciable amount oftimewillincreaseinmonetaryvalue.Suchanincreaseisknownasa*holdinggain*.Inan HCA statement of comprehensive income, holding gains are not shown separately but are simplytreatedaspartofthegrossprofitarisingonthesaleofgoods.Ithasbeensuggested that the financial statements would be more useful if the gross profit were analysed so that holding gains were clearly identified.

EXAMPLE4

Atthestartofanaccountingperiod,acompany'sinventorycomprised1,000identicalunitseachcosting£200.Onthefinaldayoftheperiod,theseunitswereallsoldfor£300eachandafurther1,000identicalunitswereboughtfor£240each.Alltransactionswereforcash.Inventoriesareaccountedforonafirst-in,first-outbasis.

ExplainhowthesetransactionswouldbereflectedinanHCAstatementofcomprehensiveincomeandanalysethecompany'sgrossprofitfortheperiod,clearlyidentifyingtheholdinggainoninventories.

Solution

AnHCAstatementofcomprehensiveincomewouldshowsalesrevenueof£300,000matchedagainstcostofsalesof£200,000,givingagrossprofitof£100,000.However,thecompanybegantheperiodwith1,000unitsofinventoryandendedtheperiodwith1,000unitsofinventoryplusanextra£60,000incash.Thiswouldsuggestthatthecompanyhasactuallymadeagrossprofitofonly£60,000duringtheperiod,not£100,000.

Thedifferenceof£40,000isaholdinggainoninventories.Thisoccurredbecausethereplacementcostoftheinventoriesroseby£40perunitbetweentheiracquisitionandtheireventualsale.Itwouldbemoreinformativeifthereportedgrossprofitfigureof£100,000wereanalysedintoaholdinggainof£40,000andagrossprofitof£60,000.

Unrealisticnon-currentassetvalues

InasetofHCAfinancialstatements,non-currentassetsareshowninthestatementof financialpositionattheirhistoricalcost(lessdepreciationasnecessary)andanyincreases in asset values are not recognised until they are realised. In consequence, HCA financial statements often fail to show the true financial position of an entity, especially if the entity owns assets such as freehold land which have been subject to substantial increases in value since acquisition.

Furthermore,thehistoricalcostsofallthenon-currentassetsownedbyanentityare addedtogether inanHCAstatement of financial position, regardless of thefact that these costs have been incurred in different years. Adding together the £5,000 paid for a freehold propertyin1969andthe£250,000paidforasimilarpropertyin2009seemstoserveno usefulpurpose,butHCArequiresthatthesetwofiguresshouldbeaggregated.

Because of these problems, IAS16 *Property,PlantandEquipment*and IAS38 *IntangibleAssets*bothpermitentitiestoadopttherevaluationmodelandtoshownon-currentassets at their current values (see Chapters 5 and 6).

Misleadingaccountingratios

Accounting ratios (see Chapter 22) are frequently used as a tool for the analysis and inter- pretationoffinancial statements. However, thelimitationsofhistorical cost accounting suggest that it may be unwise to base economic decisions on a ratio analysis of the figures shown in a conventional set of financial statements. This point is illustrated in the simple example given below.

EXAMPLE5

Acompany'sstatementofcomprehensiveincomeshowsapre-taxprofitof£100,000.Thestatementoffinancialpositionshowsnetassetsof£500,000.Thecompany'sfinancialstatementsarepreparedonthehistoricalcostbasis.

(a) Calculatetheratioofpre-taxprofittonetassets.(Thisisaversionoftheaccountingratioknownas"returnoncapitalemployed").

(b) Whenthecompany'sfinancialstatementsareamendedtotakeaccountofinflation,ittranspiresthatthepre-taxprofitisonly£60,000andthatnetassetsareactually £1,200,000.Recalculatetheratioofpre-taxprofittonetassets.

Solution

(a) Ratioofpre-taxprofittonetassetsis£100,000/£500,000=20%.

(b) Therevisedratioofpre-taxprofittonetassetsisonly£60,000/£1,200,000=5%.Thisgivesatotallydifferentviewofthecompany'sprofitability.Itisevidentthatanyonewhoconductsaratioanalysisofconventionalfinancialstatementsshouldbeverymindfulofthelimitationsofhistoricalcostaccounting.

Strengthsofhistoricalcostaccounting

Despiteitsperceivedweaknesses,historicalcostaccountinghassomedistinctstrengths.It isacomparativelysimpleaccountingsystemthatallaccountantsunderstand.Itisalso well-established, having served the needs of users for several centuries. Furthermore, it possesses the important characteristic of objectivity, in that the historical cost of an asset is usually an objective fact. However, it must be admitted that some of this objectivity is lost when depreciation and impairment are accounted for.

Alternativestohistoricalcostaccounting

Theweaknessesofhistoricalcostaccountingaresufficientlyserioustohavefuelledthe searchforalternativeaccountingsystems.Notsurprisingly,thissearchwasatitsmost intense in the 1970s and 1980s when worldwide inflation rates were high, but the various proposalsputforwardatthattimewerecontroversialandfailedtogainlastingacceptance. Inmorerecentyears,mostdevelopedcountrieshaveexperiencedlowlevelsofinflation and the problem has become less urgent. However, the problem remains acute in countrieswith very high levels of inflation.

Proposedalternativestohistoricalcostaccountinggenerallyfallintooneoftwo categories.Thesearecurrentpurchasingpoweraccountingandcurrentcostaccounting.

(a) **Currentpurchasingpower(CPP)accounting**. CPP accounting adopts the approach referred to earlier in this chapter as general purchasing power maintenance. The basic principle is that each transaction shown in the historical cost financial statements is adjusted to reflect the change in the general purchasing power of money since the transaction took place.

CPPaccountingisfairlystraightforwardbutsuffersfromthedisadvantagethat general price indexes do not measure the effects of inflation on the specific businessentity for which financial statements are being prepared.

(b) **Currentcostaccounting(CCA)**. CCA adopts the approach referred to earlier in this chapter as physical capital maintenance. The basic principle of CCA is that assets consumedduringanaccountingperiod(e.g.inventories)areshowninthestatement of comprehensive income at their current values at the time of consumption and assets remainingattheendoftheperiodareshowninthestatementoffinancialpositionat their current values at the end of the period.

CCAtakesaccountofspecificpriceinflationbutintroducesanundesirableelement of subjectivity into the financial statements, since current values often need to be estimated.Italsorequiresarathercomplexseriesofadjustments.

International standard IAS15 *InformationReflectingtheEffectsofChangingPrices*was introduced in 1983 and required entities to make a number of disclosures with regard to the effectsofinflationontheirfinancialstatements.Thisstandardofferedachoicebetween the CPP and CCA approaches. However, IAS15 ceased to be mandatory in 1989 and was withdrawncompletelyasfrom2005.Ithasnotbeenreplacedsince.

Accounting for inflation no longer seems to be an important issue in most developed countries but there is still a pressing need for an alternative to historical cost accounting inthose countries which are subject to "hyperinflation". This has led to the development ofIAS29 *FinancialReportinginHyperinflationaryEconomies*and the rest of this chapter is devotedtoabriefexplanationofthemainfeaturesofthatstandard.

Hyperinflationaryeconomies

TherequirementsofIAS29*FinancialReportinginHyperinflationaryEconomies*applyto the financial statements of any entity whose functional currency is the currency of a hyperinflationary economy. The term "functional currency" is not defined in IAS29 but is defined in IAS21 *TheEffectsofChangesinForeignExchangeRates*as the currency of the primaryeconomicenvironmentinwhichtheentityoperates(seeChapter21).

Financialstatementsareusuallypresentedinthefunctionalcurrencyoftheentity concernedbutmayinfactbepresentedinanycurrency.Ifanentitywhosefunctional currencyisthecurrencyofahyperinflationaryeconomypresentsitsfinancialstatementsin a different "presentation currency", then the financial statements should be restated in accordancewithIAS29beforebeingtranslatedintothepresentationcurrency.

IAS29doesnotestablishanabsoluterateofinflationatwhichhyperinflationisdeemed tooccur,butsuggeststhathyperinflationischaracterisedbythefollowingindicators:

(a) Thegeneralpopulationpreferstokeepitswealthinnon-monetaryassetsorina relatively stable foreign currency.

(b) Thegeneralpopulationregardsmonetaryamountsnotintermsofthelocalcurrency butintermsofarelativelystableforeigncurrency(inwhichpricesmaybequoted).

(c) Creditsalesandpurchasestakeplaceatpricesthatcompensatefortheexpectedloss ofpurchasingpowerduringthecreditperiod,evenifthatperiodisshort.

(d) Wagesandinterestratesarelinkedtoapriceindex.

(e) Thecumulativeinflationrateoverthreeyearsisapproachingorexceeds100%.

IAS29statesthat,inahyperinflationaryeconomy,thereportingoffinancialperformance and position in the local currency without restatement is not useful. In such an economy,money loses value at such a rate that comparisons of amounts relating to events that have occurredatdifferenttimes(evenwithinthesameaccountingperiod)aremisleading.

Therestatementoffinancialstatements

The basic principle of IAS29 is that the financial statements of an entity whose functional currency is the currency of a hyperinflationary economy should be restated "*intermsofthemeasuringunitcurrentattheendofthereportingperiod*". This means that the recorded amounts of transactions and other events are adjusted to take account of the change in the general purchasing power of money between the date on which each transaction or event occurredandtheendoftheperiod.ThisisaCPPapproach.Notethefollowingpoints:

(a) The comparative information which is required by IAS1 for the previous accounting period(seeChapter3)shouldalsoberestatedintermsofthemeasuringunitcurrent at the end of the reporting period.

(b) IAS29doesnotpermittherestatedfinancialstatementstobepresentedintheformof asupplementtotheoriginal(unrestated)financialstatements.Separatepresentationo f the unrestated figures is permitted but discouraged.

(c) The gain or loss on the net monetary position (see later in this chapter) should beincludedinthecalculationofprofitorlossanddisclosedseparately.

Assumingthattheentity'sunrestatedfinancialstatementshavebeenpreparedonthe historical cost basis, the main steps involved in the preparation of the restated financial statements are as follows:

Restatedstatementoffinancialposition

(a) Amountsinthestatementoffinancialpositionthatarenotalreadyexpressedinterms ofthemeasuringunitcurrentattheendofthereportingperiodarerestatedby applyingageneralpriceindex.Itispreferablethatthesameindexisusedbyall entities whichreport inthecurrencyof thesameeconomy.

(b) Monetary items are not restated, as they are already expressed in current purchasingpowerterms.Monetaryitemsincludecash,receivablesandpayables.

(c) Some non-monetary items are carried at amounts that are current at the end of the reporting period and so are not restated. Examples include inventories carried at net realisablevalueandpropertieswhichhavebeenrevaluedattheendoftheperiod.

(d) The restated amount of a non-monetary item which is carried at historical cost (or at historical cost less accumulated depreciation) is determined in accordance with thechange in the general price index since the date on which the item was acquired. This changeisappliedtotheitem'scostandtoitsaccumulateddepreciation(ifany).

(e) If a non-monetary item is carried at a valuation, its restated amount is determined in accordancewiththechangeinthegeneralpriceindexsincethedateofthevaluation.

(f) At the*beginning*ofthefirstperiodinwhichIAS29isappliedtothefinancialstate- mentsofanentity,eachcomponentofowners'equity(apartfromretainedearnings andanyrevaluationreserve)isrestatedbyapplyingthechangeinthegeneralprice indexsincethecomponentwascontributedorotherwisearose.Revaluationreserves are eliminated entirely. Restated retained earnings are calculated as a balancing figure after all of the other adjustments have been made.

(g) Subsequently, all components of equity (including any new revaluation reserves) are restatedattheendofeachaccountingperiodbyapplyingthechangeinthegeneral priceindexsincethebeginningoftheperiod,orsincethedatethatthecomponent arose (if later).

EXAMPLE6

Acompany'sfunctionalcurrency(X)isthecurrencyofahyperinflationaryeconomy.Thefollowing assetsandliabilitiesareshowninthecompany'sunrestatedstatementoffinancialpositionasat31December2019:

(a) EquipmentaccountedforbythecostmodelThisequipmentcostX10,000on1July2017and hasacarryingamountofX6,000.

(b) AbankdepositofX7,500.Thedepositwasmadeon1January2019andtherehavebeennofurt herdepositsorwithdrawalssincethatdate.

(c) InventoryatcostX4,000.Thisinventorywasacquiredon1October2019andhasanetrealisab levalueon31December2019ofX6,250.

(d) TradereceivablesofX1,800andtradepayablesofX1,400.Allofthesereceivablesandpayabl esaroseon30November2019.

(e) LandaccountedforbytherevaluationmodelThislandwasrevaluedatX20,000on31Decem ber2019andiscarriedatthatamountinthestatementoffinancialposition.

Determinetheamountsatwhicheachoftheseassetsandliabilitiesshouldbeshowninthecompan y's*restated*statementoffinancialpositionasat31December2019.Assumevaluesofthegeneral priceindexasfollows:

1July2017	200	1January2019	320	1October2019440
30November2019	500	31December2019	550	

Solution

(a) Thisisanon-monetaryitemcarriedathistoricalcost(lessdepreciation)andshouldberestatedat(X6,000 ×550/200)=X16,500.

(b) Bankdepositsaremonetaryitemsandarenotrestated.

(c) Therestatedcostoftheinventoryis(X4,000×550/440)=X5,000.Thisislessthannetrealisabl evalue(whichisalreadyexpressedincurrentterms)sotheinventoryshouldbeshownatX5,0 00.

(d) Tradereceivablesandpayablesaremonetaryitemsandarenotrestated.

(e) Thecarryingamountofthelandisalreadyexpressedincurrenttermsandisthereforenotrest ated.

Restatedstatementofcomprehensiveincome

(a) Allitemsinthestatementofcomprehensiveincomearerestatedbyapplyingthe change in the general price index since the dates on which the items of income and expense were first recorded in the financial statements.

(b) Thegainorlossontheentity'snetmonetarypositioniscalculatedasabalancing figure,equaltothedifferenceresultingfromtherestatementofitemsinthestatement of financial position and the statement of comprehensive income. This gain or loss is includedinthecalculationofprofit or lossfor theperiod.

EXAMPLE7

Acompany'sfunctionalcurrency(Y)isthecurrencyofahyperinflationaryeconomy.Therevenuefigureshowninthecompany'sunrestatedstatementofcomprehensiveincomefortheyearto31December2019isY735,000.Thisisasfollows:

	Unrestatedrevenue (Y)	*Generalprices indexatendofmonth*
January	44,000	120
February	49,000	124
March	52,000	129
April	54,000	135
May	48,000	142
June	57,000	150
July	61,000	159
August	60,000	169
September	62,000	180
October	76,000	192
November	80,000	205
December	92,000	219
	735,000	

Assuming(forthesakeofsimplicity)thatallsalesaremadeonthelastdayofeachmonth,calculatetherevenuefigurethatshouldbeshowninthecompany's*restated*statementofcomprehensiveincomefortheyearto31December2019.

Solution

	Unrestatedrevenue (Y)	*Workings*	*Restatedrevenue (Y)*
January	44,000	44,000×(219/120)	80,300
February	49,000	49,000×(219/124)	86,540
March	52,000	52,000×(219/129)	88,279
April	54,000	54,000×(219/135)	87,600
May	48,000	48,000×(219/142)	74,028
June	57,000	57,000×(219/150)	83,220
July	61,000	61,000×(219/159)	84,019
August	60,000	60,000×(219/169)	77,751
September	62,000	62,000×(219/180)	75,433
October	76,000	76,000×(219/192)	86,687
November	80,000	80,000×(219/205)	85,463
December	92,000	92,000×(219/219)	92,000
	735,000		1,001,320

EXAMPLE8

Acompany'sfunctionalcurrency(Z)isthecurrencyofahyperinflationaryeconomy.Thecompany begantradingon1January2020.SummarisedfinancialstatementsfortheyeartO31December20 20(unrestated)areasfollows:

Statementofcomprehensiveincomefortheyearto31December2020

	Z
Salesrevenue	400,000
Expenses	310,000
Profitfortheyear	90,000

Statementoffinancialpositionasat31December2020

	Z
Assets	250,000
Sharecapital(issued1Jan2020)	50,000
Retainedearnings	90,000
	140,000
Liabilities	110,000
	250,000

Notes:

(i) Thegeneralpriceindexrosefrom100to140duringtheyear.

(ii) WhenrestatedasrequiredbyIAS29,salesrevenuefortheyearisZ510,000andrestatedexpe nsesareZ380,000.

(iii) RestatedtotalassetsatS1December2020areZ330,000.Allliabilitiesaremonetaryitemsan darethereforenotrestated.

Required:

Preparetherestatedfinancialstatementsandcalculatethegainorlossfortheyearonthecompany'snet monetaryposition.

Solution

RestatedstatementofcomprehensiveincomefortheyearO31December2020

	Z
Salesrevenue	510,000
Expenses	380,000
	130,000
Gainonthenetmonetaryposition	20,000(seenote)
Profitfortheyear	150,000

Restatedstatementoffinancialpositionasat31December2020

	Z
Assets	330,000
Sharecapital(50,000×140/100)	70,000
Retainedearnings	150,000(balancingfigure)
	220,000
Liabilities	110,000
	330,000

Note:

RetainedearningsinthestatementoffinancialpositionareZ150,000.Ifthegainorlossonthenetmonetarypositionisneglected,thestatementofcomprehensiveshowsaprofitofonlyZ130,000.Thereforethegainonthenetmonetarypositionis Z20,000.

Restatedstatementofcashflows

Allitemsinthestatementofcashflowsarerestatedintermsofthemeasuringunitcurrent at the end of the reporting period.

DisclosuresrequiredbyIAS29

An entity which has restated its historical cost financial statements in accordance with the requirements of IAS29 must disclose:

(a) the fact that the financial statements and the comparative figures for previous periodshave been restated so as to adjust for changes in the purchasing power of the entity's functionalcurrencyand(asaresult)arestatedintermsofthemeasuringunitcurrent at the end of the reporting period

(b) thefactthattheentity'soriginal(unrestated)financialstatementswerepreparedon the historical cost basis

(c) the identity and level of the price index at the end of the reporting period and the movementinthisindexduringthecurrentperiodandthepreviousperiod.

Summary

- Historicalcostaccounting(HCA)recordseachtransactionatitsmonetaryamountat thetimethatthetransactionoccursandmakesnoattempttoadjustforinflation.This is the traditional method of accounting.
- In times of inflation, it might be argued that HCA financial statements overstate anentity'sprofits.IfalloftheprofitsshowninanHCAstatementofcomprehensive incomewerewithdrawn,theentityconcernedwouldsuffercapitaldepletion.
- Monetary items are assets or liabilities which are fixed in monetary terms. An entity whichholdsmonetaryassetsduringaperiodofinflationlosespurchasingpowerand an entity which holds monetary liabilities gains purchasing power. These gains andlosses are not reported in HCA financial statements.
- ThegrossprofitshowninanHCAstatementofcomprehensiveincomeincludes holdinggainsoninventories.Thesearenotreportedseparately.
- An HCA statement of financial position does not show assets at current values and somay give a misleading impression. In some cases, this problem can be lessened by showing assets at a valuation.
- Despiteitsweaknesses,historicalcostaccountingremainsingeneraluse.HCAis fairly simple to understand and operate and is perceived as being more objective than alternative approaches.
- Alternatives to historical cost accounting include current purchasing power (CPP) accounting and current cost accounting (CCA). Neither of these has gained lasting acceptance. However, aversionof CPPaccountingis requiredbyIAS29inrelationto the financial statements of an entity whose functional currency is the currency of a hyperinflationary economy.
- IAS29*FinancialReportinginHyperinflationaryEconomies*requirestherestatement of HCA financial statements to take account of the change in the general purchasing powerofmoneybetweenthedateonwhicheachtransactionoreventoccurredand the end of the reporting period.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

17.1 (a)Distinguishbetweennominalfinancialcapitalmaintenance,generalpurchasing power maintenance and physical capital maintenance.

(b)A company began trading on 1 August with capital of £400,000, all of which was immediatelyspentonacquiringinventory.On31August,three-quartersofthis inventory was sold for £475,000 in cash. There were no other transactions during the month of August.

The index of general prices was 100.0 on 1 August and 105.0 on 31 August. The specific price index applicable to the company's inventories was 100.0 on 1 August and 107.0 on 31 August.

Calculatethecompany'sprofitforthemonthofAugustusingeachofthethree capital maintenance concepts listed in part (a) of this exercise.

17.2 On 1 January 2018, C Ltd lent £200,000 to D Ltd at an annual interest rate of 8%. No interest was paid until 31 December 2019, when the loan was repaid in full together with two years' interest (which was not compounded). The index of general prices was 100.0 on 1 January 2018 and was 112.0 on 31 December 2019. In terms of general purchasing power, calculate the overall gain made by C Ltd with respect to this loan.

17.3 (a)Explaintheterm"holdinggain"inrelationtoinventories.

(b)On the first day of an accounting period, a company acquired inventories at a costof £60,000. Two-thirds of these inventories were sold for £55,000 on the final day oftheaccountingperiod.Thespecificpriceindexapplicabletotheseinventories rose by 8% during the period.

Calculate the gross profit for the period (in nominal financial terms) and state the amount of this profit which comprises a holding gain.

17.4 (a) Explaintheterm"historicalcostaccounting".

(b) Summarisethestrengthsandweaknessesofhistoricalcostaccounting.

(c) Identifyandbrieflyexplainthetwomainalternativestohistoricalcostaccounting.

*17.5 (a) Listthemainindicatorsofahyperinflationaryeconomy,asspecifiedbyIAS29.

(b) ExplainwhyIAS29takestheviewthatconventionalfinancialstatementsarenot useful in a hyperinflationary economy.

(c) Explain how each of the following items should be dealt with when preparing the restated financialstatementsofan entity which operatesin ahyperinflationary economy:

(i) monetaryitemsinthestatementoffinancialposition

(ii) non-monetaryitemsshownathistoricalcostlessaccumulateddepreciation

(iii) non-monetaryitemsshownatavaluation

(iv) incomeandexpensesshowninthestatementofcomprehensiveincome.

Part3

CONSOLIDATEDFINANCIALSTATEMENTS

Chapter18

Groupsofcompanies(1)

Introduction

The purpose of this chapter is to introduce the concept of a "group" of companies and toexplainhowagroupstatementoffinancialpositionisprepared.Subsequentchaptersdeal withthegroupstatementofcomprehensiveincomeandotherrelatedmatters.

A group of companies consists of a parent company together with one or more subsidiary companieswhicharecontrolledbytheparentcompany.Controloverasubsidiaryis usuallyachievedbyacquiringover50%ofitsordinaryshares.Theshareholdersofa parent company have an indirect interest in the net assets and in the profits or losses of the company'ssubsidiaries.Accordingly,parentcompaniesarerequiredtoprepareandpresent asetofaccountsforthegroupasawhole,inrecognitionofthefactthataparentcompany anditssubsidiariesare,ineffect,asingleeconomicunit.Itisimportanttoappreciatethat these*groupaccounts*areintendedfortheshareholdersoftheparentcompanyonly.

The main international standards which apply to the preparation of group accounts are IFRS10 *ConsolidatedFinancialStatements*and IFRS3 *BusinessCombinations*. Thesestandards are concerned with groups in general, including groups with unincorporated subsidiaries.Inpractice,however,mostgroupsaregroupsofcompaniesandthisbook dealsonlywithgroupsinwhichtheparentandallofitssubsidiariesarecompanies.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explainwhatismeantbyasetofconsolidatedfinancialstatements
- define the terms "group", "parent", "subsidiary" and "control" in accordance withinternational standard IFRS10
- prepareagroupstatement of financial positionbothat thedateof acquisitionand subsequenttoacquisition,accountingcorrectlyforgoodwill
- prepareagroupstatement of financial positionincases wheresubsidiaries areeither wholly-ownedorpartly-owned,dealingcorrectlywithnon-controllinginterests

- eliminateintra-groupbalancesandeliminateunrealisedprofitsarisingonthetransfer of assets between group companies at more than cost.

Requirementtoprepareconsolidatedfinancialstatements

IFRS10*ConsolidatedFinancialStatements*includesthefollowingimportantdefinitions:

- Consolidatedfinancialstatementsare"*thefinancialstatementsofagroupinwhichtheassets,liabilities,equity,income,expensesandcashflowsoftheparentanditssubsidiariesarepresentedasthoseofasingleeconomicentity*".Consolidated financialstatementsareoftenreferredtoasgroupaccounts.
- Agroupis"*aparentanditssubsidiaries*".
- Aparentis"*anentitythatcontrolsoneormoreentities*".
- Asubsidiaryis"*anentitythatiscontrolledbyanotherentity*".

In general, IFRS10 requires that parent companies should prepare and present consolidated financialstatements†.Butaparentneednotpresentconsolidatedfinancialstatementsif*all*of the following conditions are satisfied:

(a) theparentcompanyisitselfeither:
  (i) awholly-ownedsubsidiary,or
  (ii) apartially-ownedsubsidiaryofanothercompany,andallofitsotherownersdo notobjecttotheparentnotpresentingconsolidatedfinancialstatements
(b) theparent'ssharesorsecuritiesarenotpubliclytraded
(c) theparent'sultimateparentcompanypresentsconsolidatedfinancialstatementsthat areavailableforpublicuseandcomplywithinternationalstandards.

A parent company which satisfies these conditions may present its own "separate financial statements" only, in accordance with IAS27 *SeparateFinancialStatements*. Investments in subsidiariesareaccountedforinthesestatementseitheratcostorinaccordancewith IFRS9*FinancialInstruments*(seeChapter11)orbytheequitymethod(seeChapter20).

† *Thereisanexceptiontotherequirementtopreparesconsolidatedfinancialstatementsinthecaseof"investmententities".Theseareentitieswhichobtainfundsfrominvestorsandinvestthesefundssolelyforreturnsfromcapitalappreciation,investmentincomeorboth.*

Definitionofcontrol

IFRS10 states that an investor controls an investee when the investor "*isexposed,orhasrights,tovariablereturnsfromitsinvolvementwiththeinvesteeandhastheabilitytoaffectthosereturnsthroughitspowerovertheinvestee*". The standard also states that an investor has power over an investee when the investor has existing rights that enable it todirectthe"relevantactivities"oftheinvestee.Anentity'srelevantactivitiesarethose which significantly affect its returns and may include:

(a) thesaleandpurchaseofgoodsandservices

(b) theselection,acquisitionordisposalofassets

(c) themanagementoffinancialassets(seeChapter11)

(d) researchanddevelopment

(e) thedeterminationofafundingstructurefortheentityandtheobtainingoffunding.

Aninvestordoesnothavepoweroveraninvesteeunlesstheinvestorhasrightsthatenable itto*direct*theinvestee'srelevantactivities.Rightswhichmaygivethispowerinclude:

(a) votingrights

(b) therighttoappointorremovemembersoftheinvestee'skeymanagementpersonnel

(c) therighttodirecttheinvesteetoenterintotransactionsfortheinvestor'sbenefit.

In straightforward cases, an investor which holds a majority of an investee's voting rights
usuallyhasthepowertodirecttheinvestee'sactivitiesandsocontrolstheinvestee.Inthe caseofcompanies,controlisnormallyassumedtoexistwhenonecompanyowns(directly or indirectly) more than 50% of the voting power of another company, unless it can be demonstrated that such ownership does not give control. Owning over 50% of a company's
votingpowernormallymeansowningover50%ofthatcompany'sordinaryshares.

Groupstatementoffinancialpositionatdateofacquisition

The preparation of a group statement of financial position is basically a matter of adding
together(linebyline)theindividualstatementsoffinancialpositionofallthecompanies in the group. This process is known as "consolidation" and the resulting financial statementmaybereferredtoasaconsolidatedstatementoffinancialposition.

Whencarryingoutaconsolidationitisnecessarytocanceloutitemswhichappearboth asanassetinthefinancialstatementsofonegroupcompanyandasaliability(orequity) in the financial statements of another group company. This ensures that the consolidated statement of financial position shows only the true assets and liabilities of the group as awhole.Themainitemswhichshouldbecancelledareasfollows:

(a) If a parent company owns 100% of the share capital of a subsidiary, the cost of theparent'sinvestmentinthatsubsidiaryshouldbecancelledoutwiththesubsidiary's share capital and reserves. This is because the purchase of 100% of a company's share capitalalsobuysentitlementto100%ofthatcompany'sreserves.Thesituationis slightlymorecomplexforpartly-ownedsubsidiaries(seelaterinthischapter).

(b) Ifonegroupcompanyowesmoneytoanother,theamountpayablewhichisshownas aliabilityinthefinancialstatementsofthefirstcompanyshouldbecancelledout with the corresponding amount receivable which is shown as an asset in the financial statementsoftheothercompany.Suchdebtsareknownas"intra-groupbalances".

Itisimportanttoappreciatethatthiscancelling-outprocessdoes*not*takeplaceinthe booksoftheindividualcompaniesconcerned.Theentireconsolidationtakesplaceonaset

of consolidation working papers and the books of the group companies are completely unaffected by this process.

EXAMPLE1

On31May2020,ALtdpays£35,000toacquireallofthesharesofBLtd.Thestatementsoffinancial positionofthetwocompaniesjustafterthistransactionareasfollows:

	ALtd	BLtd
	£	£
Assets		
Non-currentassets		
Property,plantandequipment	200,000	
27,000InvestmentinBLtd	35,000	
	235,000	
Currentassets	109,000	12,000
	344,000	39,000
Equity		
Ordinarysharecapital	250,000	30,000
Retainedearnings	58,000	5,000
	308,000	35,000
Liabilities		
Currentliabilities	36,000	4,000

Prepareaconsolidatedstatementoffinancialpositionasat31May2020.

Solution

	ALtd	BLtd	Group
	£	£	£
Assets			
Non-currentassets			
Property,plantandequipment	200,000	27,000	227,000
InvestmentinBLtd	~~35,000~~		
	235,000		
Currentassets	109,000	12,000	121,000
	344,000	39,000	348,000
Equity			
Ordinarysharecapital	250,000	~~30,000~~	250,000
Retainedearnings	58,000	~~5,000~~	58,000
	308,000	35,000	308,000
Liabilities			
Currentliabilities	36,000	4,000	40,000
	344,000	39,000	348,000

Notes:

1. The£35,000paidbyALtdhasbeencancelledoutwiththe£35,000sharecapitalandreserveso fBLtd.Thishasbeenindicatedbystrikingthroughthecancelledfigures.Thetwostatements offinancialpositionhavethenbeenconsolidated,linebyline.
2. Ineffect,theasset"InvestmentinBLtd"showntheALtdstatementoffinancialpositionhas beenreplacedintheconsolidatedstatementbytheunderlyingnetassetsofthesubsidiaryco mpany.
3. Thegroup(orconsolidated)statementoffinancialpositionisshownintherightmostcolumn ofthissolution.Theothertwocolumnsoffigureswouldnotbepresentedaspartofthestatem entbutareshownhereasworkings.
4. Thetotalsandsubtotalsthatareshowninthe"Group"columnhavebeenobtainedbyaddingto getherthefiguresinthatcolumnandnotbyaddingacrosstherows.

Goodwillarisingonconsolidation

In the above example, the amount paid by the parent company to acquire the shares of the subsidiarywas preciselyequal tothebookvalueof thesubsidiary's net assets. However, parent companies are often willing to pay more than book value to acquire a controllinginterest in a subsidiary, for two main reasons:

(a) Thefairvalueofthenetassetsshowninthesubsidiary'sfinancialstatementsmay exceed their book value.

(b) Theparentcompanymaybepayingforthesubsidiary'sgoodwill,whichisprobably notshowninthesubsidiary'sfinancialstatementsatall.

IFRS3 *BusinessCombinations*(see Chapter 6) prescribes the accounting treatment of any goodwill acquired in a business combination. This includes the situation where a parent acquirescontrolofasubsidiary.Asummaryoftherequiredtreatmentisasfollows:

(a) Eachofthesubsidiary'sassetsandliabilitiesisadjustedtoitsfairvalueonthedate that the parent company acquired the subsidiary's shares. Gains and losses caused bytheseadjustmentsareaddedtoorsubtractedfromthesubsidiary'sreserves.

(b) Iftheparenthaspaidmorethanfairvaluetoacquirethesharesofasubsidiary,the excess is "goodwill arising on consolidation" and this is shown as an asset in the consolidated statement of financial position. Goodwill should be tested annually for impairment and written down as necessary.

(c) If the parent has paid less than fair value to acquire the shares of a subsidiary, then "negativegoodwill"appearstohavearisen.Inthissituation,IFRS3requiresthatthe cost of the investment made by the parent and the fair values of the subsidiary's assetsand liabilities should be reassessed. Any negative goodwill which remains after this reassessmentisrecognisedasincomeandincreasesthegroup'sreserves.

Onceagain,itisveryimportanttoappreciatethatalloftheseadjustmentsaremadeonlyin theconsolidationworkingpapersandnotinthebooksofthecompaniesconcerned.

EXAMPLE2

On30June2020,CLtdpays£60,000toacquireallofthesharesofDLtd.Thestatementsoffinancial positionofthetwocompaniesjustafterthistransactionareasfollows:

	CLtd	DLtd
	£	£
Assets		
Non-currentassets		
Property,plantandequipment	410,000	
30,000InvestmentinDLtd	60,000	
	470,000	
Currentassets	231,000	25,000
	701,000	55,000
Equity		
Ordinarysharecapital	400,000	25,000
Retainedearnings	187,000	17,000
	587,000	42,000
Liabilities		
Currentliabilities	114,000	13,000

Thefairvalueoftheproperty,plantandequipmentofDLtdon30June2020is£40,000.Prepareaconsolid atedstatementoffinancialpositionasat30June2020.

Solution

	CLtd	DLtd	Group
	£	£	£
Assets			
Non-currentassets			
Property,plantandequipment	410,000	40,000	450,000
InvestmentinDLtd	~~60,000~~		
Goodwill			8,000
	470,000		458,000
Currentassets	231,000	25,000	256,000
	701,000	65,000	714,000

	CLtd £	DLtd £	Group £
Equity			
Ordinarysharecapital	400,000	~~25,000~~	400,000
Revaluationreserve		~~10,000~~	
Retainedearnings	187,000	~~17,000~~	187,000
	587,000	52,000	587,000
Liabilities			
Currentliabilities	114,000	13,000	127,000
	701,000	65,000	714,000

Notes:

1. Intheconsolidationworkingpapers,DLtd'sproperty,plantandequipmentisrevaluedat£40,000and£10,000iscreditedtoarevaluationreserve.
2. ThepricepaidbyCLtd(£60,000)iscancelledagainstthesharecapitalandreservesofDLtd(£52,000)leavingadifferenceof£8,000whichisshownasgoodwillintheconsolidatedstatementoffinancialposition.Thecancelledfigureshavebeenstruckthroughandthetwostatementsoffinancialpositionhavethenbeenconsolidated.
3. NoneoftheseadjustmentshaveanyeffectonthebooksofeitherCLtdorDLtd.Thetotalsandsubtotalsshowninthe"Group"columnhavebeenobtainedbyaddingtogetherthefiguresinthatcolumnandnotbyaddingacrosstherows.

Groupstatementoffinancialpositioninsubsequentyears

When preparing a consolidated statement of financial position in years subsequent to the acquisitionofasubsidiary,theretainedearningsofthesubsidiarywillalmostcertainly havechangedsincethedateofacquisition.Suchchangesaredealtwithasfollows:

(a) Apost-acquisition*increase*intheretainedearningsofasubsidiaryrepresentsan increase in the value of the investment made by the parent company. This increase in valuebelongsultimatelytotheshareholdersoftheparentcompanyandshould therefore be added to group retained earnings.

(b) Similarly,anypost-acquisition*decrease*intheretainedearningsofasubsidiary should be subtracted from group retained earnings.

Post-acquisitionchangesinanyofasubsidiary'sotherreservesaredealtwithinthesame way. For instance, a post-acquisition increase in the revaluation reserve of a subsidiary isadded to group revaluation reserves. Note also that:

(c) Animpairmentlossinrelationtogoodwill(seeabove)isaccountedforbyreducing boththegoodwillfigureandgroupretainedearningsbytheamountoftheloss.

(d) Ifafairvalueadjustmentwasmadewhenasubsidiarywasacquiredandthisrelated todepreciablenon-currentassets,depreciationchargesinsubsequentaccounting

periodsshouldbebaseduponthefairvaluesofthoseassets.Ifthefairvalueadjust- ment has not been reflected in the subsidiary's own financial statements, it will be necessarytore-calculatethecarryingamountofthesubsidiary'snon-currentassets andthiswillaffectgroupnon-currentassetsandgroupretainedearnings.

EXAMPLE3

On1January2017,ELtdpaid£70,000toacquireallofthesharesofFLtd.Onthatdate,theretainedearningsofFLtdwere£14,000andallofitsassetsandliabilitieswereshowninthebooksattheirfairvalues.ThestatementsoffinancialpositionofELtdandFLtdasat31December2019(i.e.threeyearslater)areasfollows:

	ELtd	FLtd
	£	£
Assets		
Non-currentassets		
Property,plantandequipment	620,000	
47,000InvestmentinFLtd	70,000	
	690,000	
Currentassets	285,000	37,000
	975,000	84,000
Equity		
Ordinarysharecapital	500,000	40,000
Retainedearnings	393,000	26,000
	893,000	66,000
Liabilities		
Currentliabilities	82,000	18,000

ThesharecapitalofFLtdhasnotchangedsince1January2017.Goodwillarisingonconsolidationhassufferedanimpairmentlossof30%sinceacquisition.Prepareaconsolidatedstatementoffinancialpositionasat31December2019.

Solution

Theapproachadoptedinthesolutionstopreviousexamplesinthischapterhasbeentoshowthefinancialstatementsofparentandsubsidiaryside-by-side,thentostrikethroughitemswhichshouldbecancelledoutandconsolidatetheitemswhichremain.Althoughthisapproachisusefulforsimpleconsolidations,itbecomesunwieldyasthecomplexityofproblemsincreases.Amorepracticableapproachistoprepareworkingsforkeyfiguressuchasgoodwillandgroupretainedearningsandthentowriteoutthegroupstatementoffinancialpositionshowinganyremainingworkingsin-line.Thisistheapproachadoptedinthissolutionandintheremainingsolutionsinthischapter.

Groupstatementoffinancialpositionasat31December2019

	£
Assets	
Non-currentassets	
Property,plantandequipment(£620,000+£47,000)	667,000
Goodwill(W1)	11,200
	678,200
Currentassets(£285,000+£37,000)	322,000
	1,000,200
Equity	
Ordinarysharecapital	500,000
Retainedearnings(W2)	400,200
	900,200
Liabilities	
Currentliabilities(£82,000+£18,000)	100,000
	1,000,200

Workings:

W1.Goodwill

	£	£
Pricepaidbyparent		70,000
Subsidiary'ssharecapitalat1January2017	40,000	
Subsidiary'sretainedearningsat1January2017	14,000	54,000
Goodwillat1January2017		16,000
Less:Impairment(30%)		4,800
Goodwillat31December2019		11,200

W2.Groupretainedearnings

	£	£
Parent'sretainedearningsat31December2019		393,000
Subsidiary'sretainedearningsat31December2019	26,000	
Less:Subsidiary'sretainedearningsat1January2017	14,000	12,000
		405,000
Less:Goodwillimpairment		4,800

Partly-ownedsubsidiaries

If a parent company does not own 100%of a subsidiary's share capital, the subsidiary ispartly-ownedandtheremainderofitssharesareheldbynon-controllingshareholders.In these circumstances, IFRS10 requires that the group statement of financial position should include*all*ofthesubsidiary'sassetsand*all*ofitsliabilities(exactlyasifthesubsidiary were wholly-owned) but should then identify separately the amount of the subsidiary's net assetswhichisattributabletothenon-controllingshareholders.Thisamountisreferredto by IFRS10 as the "non-controlling interest".

Non-controllinginterestsshouldbepresentedintheequitysectionofthegroupstatement offinancialposition,butseparatelyfromtheequityoftheparentcompany'sshareholders.

EXAMPLE4

ThestatementsoffinancialpositionofGLtdandHLtdat31March2020areasfollows:

	GLtd	HLtd
	£	£
Assets		
Non-currentassets		
Property,plantandequipment	527,000	
39,000InvestmentinHLtd	48,000	
	575,000	
Currentassets	326,000	31,000
	901,000	70,000
Equity		
Ordinarysharecapital	600,000	32,000
Retainedearnings	148,000	22,000
	748,000	54,000
Liabilities		
Currentliabilities	153,000	16,000

On1April2016,GLtdhadpaid£48,000toacquire75%ofthesharesinHLtd.Onthatdate,theretained earningsofHLtdwere£10,000andthefairvalueofthecompany'snon-currentassetswas£8,000morethantheirbookvalue.Thisrevaluationhasnotbeenreflectedinthe booksofHLtd.

HLtdhasissuednosharessincebeingacquiredbyGLtd.Goodwillarisingonconsolidationhassuff eredanimpairmentlossof40%sinceacquisition.Prepareaconsolidatedstatementoffinancialp ositionasat31March2020.

(Anydepreciationconsequencesofthefairvalueadjustmentmaybeignored.)

Solution

Groupstatementoffinancialpositionasat31March2020

	£
Assets	
Non-currentassets	
Property,plantandequipment(£527,000+£39,000+£8,000)	
574,000Goodwill(W1)	6,300
	580,300
Currentassets(£326,000+£31,000)	357,000
	937,300
Equity	
Ordinarysharecapital	600,000
Retainedearnings(W2)	152,800
	752,800
Non-controllinginterest(W3)	15,500
	768,300
Liabilities	
Currentliabilities(£153,000+£16,000)	169,000
	937,300

Workings:

W1.Goodwill

	£	£
Pricepaidbyparent		48,000
Subsidiary'sequityat1April2016(£32,000+£10,000)		
42,000Fairvalueadjustment	8,000	
	75%x50,000	37,500
Goodwillat1April2016		10,500
Less:Impairment(40%)		4,200
Goodwillat31March2020		6,300

W2.Groupretainedearnings

	£	£
Parent'sretainedearningsat31March2020		148,000
Subsidiary'sretainedearningsat31March2020	22,000	
Less:Subsidiary'sretainedearningsat1April2016	10,000	
	75%x12,000	9,000
		157,000
Less:Goodwillimpairment		4,200
Groupretainedearningsat31March2020		152,800

W3.Non-controllinginterest

	£	£
Subsidiary'ssharecapitalat31March2020	32,000	
Subsidiary'sretainedearningsat31March2020	22,000	
Fairvalueadjustment	8,000	
	25%x62,000	15,500
Non-controllinginterestat31March2020		15,500

Measurementofthenon-controllinginterestatfairvalue

Whenpreparinggroupaccounts,IFRS3*BusinessCombinations*allowsparentcompaniesto measurenon-controllinginterestsineitheroftwoways.Theseareasfollows:

(a) Non-controlling interests may be measured by calculating the non-controlling share- holders' proportion of the subsidiary's identifiable net assets. Identifiable assets do not includegoodwill(seeChapter6)sothismeansthatanygoodwillwhichbelongsto thenon-controllingshareholdersisnotincludedinthenon-controllinginterest.

(b) Onacquisition,non-controllinginterestsmaybemeasured"*atfairvalue*".Anyexcess of this fair value over the non-controlling shareholders' proportion of the subsidiary's identifiable net assets on the acquisition date is recognised as goodwill in the group statementoffinancialposition.Thisapproachhastwomainconsequences:

   (i) Thegoodwillfigureshowninthegroupstatementoffinancialpositiononthe dateofacquisitionwillbeequalto100%ofthesubsidiary'sgoodwill.

   (ii) Anygoodwillimpairmentlosseswhichoccurafteracquisitionarededucted partlyfromgroupreservesandpartlyfromthenon-controllinginterest.

However, method (a) is most frequently used in practice, since it avoids the difficulty of measuringthefair valueof the non-controllinginterest.

EXAMPLE5

InExample4(seeabove)GLtddecidedthatthenon-controllinginterestinHLtdonthedateofacquisitionshouldbemeasuredatfairvalue.Thiswasdet erminedbyGLtdtobe £16,000.Explainhowthegroupstatementoffinancialpositionasat31March2020wouldbeaffect edbythisaccountingpolicy.

Solution

Thenon-controllingshareholders'proportionoftheidentifiablenetassetsofHLtdonthedateofacquisition was£12,500(25%x(£32,000+£10,000+£8,000)).Sothegoodwillattributabletothenon-

controlling interest must have been £3,500 (£16,000 – £12,500).

Goodwillhasnowsuffered40%impairment,soonly£2,100(£3,500x60%)remainsat31March20
20.Thegroupstatementoffinancialpositionatthatdatewillshowgoodwillof
£8,400(£6,300+£2,100)andnon-controllinginterestof£17,600(£15,500+£2,100).

Preferenceshares

A company's reserves belong entirely to the ordinary shareholders. If the company werewoundup,thepreferenceshareholders(ifany)wouldbeentitledtoreceiveonlyassets equaltothenominalvalueoftheirpreferenceshares.Thisfactmustbeborneinmind whenpreparingaconsolidatedstatementoffinancialpositionifoneormoreofthe subsidiary companies has issued preference shares.

EXAMPLE6

On30September2017,JLtdpaid£40,000toacquire60%oftheordinarysharesand25%ofthepref erencesharesofKLtd.Onthatdate,theretainedearningsofKLtdwere
£4,000andallofitsassetsandliabilitieswereshownatfairvalues.Thestatementsoffinancialposi tionofJLtdandKLtdasat30September2020areasfollows:

	JLtd	KLtd
	£	£
Assets		
Non-currentassets		
Property,plantandequipment	438,000	
52,000InvestmentinKLtd	40,000	
	478,000	
Currentassets	432,000	36,000
	910,000	88,000
Equity		
Ordinarysharecapital	600,000	50,000
Preferencesharecapital		10,000
Retainedearnings	119,000	9,000
	719,000	69,000
Liabilities		
Currentliabilities	191,000	19,000

KLtdhasissuednosharessincebeingacquiredbyJLtd.Goodwillhassufferedanimpairmentloss of20%sinceacquisition.Non-
controllinginterestsaretobemeasuredattheappropriateproportionofthesubsidiary'sidentifiab lenetassets.

Prepareaconsolidatedstatementoffinancialpositionasat30September2020.

Solution

Groupstatementoffinancialpositionasat30September2020

	£
Assets	
Non-currentassets	
Property,plantandequipment(£438,000+£52,000)	
490,000Goodwill(W1)	4,080
	494,080
Currentassets(£432,000+£36,000)	468,000
	−962,080
Equity	
Ordinarysharecapital	600,000
Retainedearnings(W2)	120,980
	−720,980
Non-controllinginterest(W3)	31,100
	−752,080
Liabilities	
Currentliabilities(£191,000+£19,000)	210,000
	962,080

Workings:

W1.Goodwill

	£	£
Pricepaidbyparent		40,000
Subsidiary'sordinarysharesat30September2017	50,000	
Subsidiary'sreservesat30September2017	4,000	
	60%x54,000	(32,400)
Parent's25%stakeinsubsidiary'spreferenceshares		(2,500)
Goodwillat30September2017		5,100
Less:Impairment(20%)		1,020
Goodwillat30September2020		4,080

W2.Groupretainedearnings

	£	£
Parent'sretainedearningsat30September2020		119,000
Subsidiary'sretainedearningsat30September2020	9,000	
Less:Subsidiary'sretainedearningsat30September2017	4,000	
	60%x5,000	3,000
		−122,000

Less:Goodwillimpairment	1,020
Groupretainedearningsat30September2020	120,980

W3.Non-controllinginterest

	£	£
Subsidiary'sordinarysharesat30September2020	50,000	
Subsidiary'sretainedearningsat30September2020	9,000	
	40%x59,000	23,600
NCI's75%stakeinsubsidiary'spreferenceshares		7,500
Non-controllinginterestat30September2020		31,100

Eliminationofintra-groupbalances

Intra-groupbalancesarecancelledoutwhenpreparingaconsolidatedstatementof financialposition.Suchbalancesmayariseinanyofthefollowingcircumstances:

(a) Onegroupcompanymaylendmoneytoanothergroupcompany.Inthiscase,the loan will appear as an asset in the lending company's financial statements and as aliabilityintheborrowingcompany'sfinancial statements.

(b) Onegroupcompanymaybuyitemsoncreditfromanothergroupcompany,sothat there is a trade receivable in the financial statements of the supplier company and a correspondingtradepayableinthefinancialstatementsofthecustomercompany.

(c) A "current account" may be used to record movements of goods, services and money betweentwogroupcompanies.Thebalanceonthis accountwillbeanassetforoneof the companies and a liability for the other company.

Ifitemsareintransit fromonecompanytoanother, it maybethat therelevant asset and liability are not equal in amount. In this case it will be necessary to show the in-transititemsasanassetintheconsolidatedstatementoffinancialposition.

EXAMPLE7

LLtdistheparentcompanyofMLtdandacurrentaccountisusedtorecordtransactionsbetweenth ecompanies.On31May2020,thebalanceonthisaccountappearedasanassetof£26,750inthebo oksofLLtdandasaliabilityof£14,600inthebooksofMLtd.

Thisdiscrepancyiscausedbythefactthat MLtdsentapaymentof£12,150toLLtdon30May2020. LLtddidnotreceivethepaymentuntil3June2020.Explainhowthismatterwillbedealtwithintheco nsolidatedstatementoffinancialpositionat31May2020.

Solution

Thetwocurrentaccountbalanceswillbecancelledagainsteachother,leavinganetdebitbalanceo f£12,150.Thisbalancerepresentscashintransitandwillbeshownasanassetintheconsolidateds tatementoffinancialposition.

Unrealisedprofits

Theassetsshownintheindividual financial statementsofagroupcompanymayinclude assets acquired from another company in the group. If such assets have been transferred betweenthetwocompaniesatapriceinexcessoforiginalcost,thentheirvaluation includes an element of *unrealisedprofit*and this must be eliminated when the consolidated statement of financial position is prepared. If this were not done, a group could artificially increase the values of its assets simply by transferring them from one group company toanother at inflated prices. Note that:

(a) IFRS10requiresthatprofitsorlossesonintra-grouptransactionsmustbeeliminated infullonconsolidation,irrespectiveofwhetherthesubsidiarycompaniesinvolved are wholly-owned or partly-owned.

(b) If an asset is sold from parent to subsidiary, any unrealised profit on the transaction is entirelyattributabletothegroupandissubtractedfromgroupretainedearnings.

(c) If an asset is sold from subsidiary to parent, any unrealised profit on the transaction is allocated proportionately between group retained earnings and the non-controllinginterest (if any).

Thissituationcommonlyariseswheninventoriesaretransferredbetweengroupmembers at prices which exceed original cost.

EXAMPLE8

PLtdowns80%ofthesharecapitalofQLtd.TheinventoriesofQLtdon31December2019includego odsboughtfromPLtdfor£15,000.ThesegoodshadcostPLtd£10,000.

(a) Explainhowthesegoodsshouldbedealtwithintheconsolidatedstatementoffinancialpositi onat31December2019.

(b) ExplainhowthetreatmentwoulddifferifthegoodshadbeensoldbyQLtdtoPLtd.

Solution

(a) Theunrealisedprofitof£5,000issubtractedfromgroupinventoriesandalsofromgroupretai nedearnings.Itmightbethoughtthat20%ofthisprofithasinfactbeenrealised,since20%ofth egoodsarenoweffectivelyownedbythenon-controllingshareholders,whoarenotpartofthegroup.ButIFRS10requiresthatthefull£5,00 0shouldbeeliminated.

(b) Theunrealisedprofitof£5,000issubtractedfromgroupinventories.Groupretainedearning sarereducedby£4,000(80%)andthenon-controllinginterestisreducedbytheremaining£1,000(20%).

Reportingperiodandaccountingpolicies

In general, the financial statements of a parent company and its subsidiaries should all bedrawn up to the same date. If the reporting period of a parent is different from that of a subsidiary, the subsidiary should prepare additional financial statements for consolidation
purposes,usingthesamereportingperiodasitsparent.Ifthisisimpracticable,the financialstatementsofthesubsidiaryshouldbeadjustedbeforeconsolidationtoreflect anysignificanttransactionsoreventsthatoccurbetweentheendofthesubsidiary's reportingperiodandtheendoftheparent'sreportingperiod.Inanycase,IFRS10requires thatthedifferencebetweentheendofthereportingperiodofasubsidiaryandthatofits parent should not exceed three months.

Furthermore,consolidatedfinancialstatementsshouldbepreparedusinguniform accountingpolicies.Ifagroupcompanyusesdifferentaccountingpoliciesfromthose adopted in the consolidated financial statements, its own financial statements should be adjustedinlinewiththegroup'saccountingpoliciesbeforeconsolidationtakesplace.

Disclosurerequirements

InternationalstandardIFRS12*DisclosureofInterestsinOtherEntities*requiresanentity todiscloseinformationthatenablestheusersofitsfinancialstatementstoevaluate:

(a) thenatureofitsinterestsinotherentitiesandtherisksassociatedwiththoseinterests

(b) theeffectsofthoseinterestsontheentity'sfinancialposition,financialperformance and cash flows.

Inparticular, theentityshoulddisclosethesignificant judgements andassumptions it has madeindeterminingthenatureofitsinterestinanotherentity(e.g.indeterminingwhether ornotithascontroloveranentity)andshouldthenprovideinformationaboutitsinterests insubsidiaries,jointarrangementsandassociates(seeChapter20).

With regard to its subsidiaries, IFRS12 requires an entity to disclose information which enables users to understand the composition of the group and the interest that any non- controlling interests have in the group's activities.

Summary

- Aparentcompanycontrolsitssubsidiaries.Controlusuallyaccompaniesownership of over 50% of a company's ordinary shares.
- A parent company together with its subsidiaries is known as a group. The parentcompany must prepare and present consolidated financial statements which show the financialperformanceandpositionofthegroupasawhole.

- A group statement of financial position is prepared by consolidating the statements of financial positionof all the groupcompanies (line by line) andcancellingout intra- group items. A group statement of financial position may also be referred to as a consolidated statement of financial position.
- Goodwillarisingonconsolidationmustbetestedforimpairmentannually.
- Theconsolidatedstatementoffinancialpositionshouldshowtheextenttowhichthe netassetsofthegroupareattributabletoanon-controllinginterest.
- IFRS3 allows non-controlling interests to be measured as the non-controlling share- holders' proportion of the subsidiary's identifiable net assets. Alternatively, non- controllinginterestsmaybemeasuredonthedateofacquisitionatfairvalue.
- Agroup'sinterestinthepost-acquisitionincreaseordecreaseintheretainedearnings ofasubsidiaryareaddedtoorsubtractedfromconsolidatedretainedearnings.
- Intra-group balances are cancelled out when preparing a consolidated statement of financialposition.Anyunrealisedprofitonassetstransferredbetweengroup companies is eliminated in full on consolidation.

Exercises

Unlessstatedotherwise,itisassumedthroughouttheseexercisesthatnon-controllinginterestsaretobemeasuredattheappropriateproportionofthesubsidiary'sidentifiablenetassets.Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

18.1 At the start of business on 1 January 2020, the statements of financial position of A1 Ltd and A2 Ltd were as follows:

	A1Ltd	A2Ltd
	£000	£000
Assets		
Non-currentassets	510	125
Currentassets	325	75
	835	200
Equity		
Ordinarysharecapital	500	100
Retainedearnings	185	60
	685	160
Liabilities		
Currentliabilities	150	40
	835	200

On 1 January 2020, A1 Ltd acquired 100% of the share capital of A2 Ltd for £225,000. The fair value of A2 Ltd's non-current assets on that date was £150,000. All other assets and liabilities were shown at fair value in the company's statement of financial position. There were no other transactions on 1 January 2020.

Required:

(a) Prepare a consolidated statement of financial position as at the close of business on 1 January 2020, assuming that the purchase consideration of £225,000 was paid in cash.

(b) Prepare a consolidated statement of financial position as at the close of business on 1 January 2020, now assuming that the purchase consideration of £225,000 was settled by means of an issue of 150,000 £1 ordinary shares in A1 Ltd at a premium of 50p per share.

18.2 On 31 December 2019, A3 Ltd paid £550,000 to acquire 80% of the ordinary share capital of A4 Ltd. The statements of financial position of the two companies just after this transaction were as follows:

	A3 Ltd	A4 Ltd
	£000	£000
Assets		
Non-current assets		
Property, plant and equipment	3,700	320
Investment in A4 Ltd	550	
	4,250	
Current assets	2,750	250
	7,000	570
Equity		
Ordinary share capital	2,000	100
Retained earnings	3,550	280
	5,550	380
Liabilities		
Current liabilities	1,450	190
	7,000	570

The fair value of the property, plant and equipment of A4 Ltd on 31 December 2019 was £440,000. All other assets and liabilities were shown at fair value.

Required:

Prepare a consolidated statement of financial position as at 31 December 2019.

18.3 Thestatements of financial positionof AALtdandBBLtdas at 30April2020areas follows:

	AALtd	BBLtd
	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment	2,265	345
InvestmentinBBLtd	800	
	3,065	
Currentassets	2,124	466
	5,189	811
Equity		
Ordinarysharecapital	3,000	350
Retainedearnings	1,029	223
	4,029	573
Liabilities		
Currentliabilities	1,160	238
	5,189	811

Thefollowinginformationisrelevant:

(i) AA Ltd acquired the entire share capital of BB Ltd on 30 April 2016. There have been no changes in the share capital of BB Ltd since then.

(ii) On 30 April 2016, the fair value of BB Ltd's non-current assets was £500,000, as compared with their book value on that date of £320,000. This revaluation has not been reflected in the books of BB Ltd.

(iii) On30April2016,theretainedearningsofBBLtdwere£195,000.

(iv) Goodwill arising on consolidation has suffered an impairment loss of 100% since the date of acquisition.

(v) IfBBLtdhadrevalueditsnon-currentassetsat£500,000on30April2016,the company's financial statements for each of the four years to 30 April 2020 would have been charged with additional depreciation of £10,000.

Required:

(a) Prepare a consolidated statement of financial position as at 30 April 2020, ignoring the depreciation consequences of the fair value adjustment.

(b) Modify this consolidated statement so as to account for additional depreciation in relation to the non-current assets of BB Ltd.

18.4 ThestatementsoffinancialpositionofTTLtdandUULtdasat31May2020areas follows:

	TTLtd	UULtd
	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment	6,910	1,640
InvestmentinUULtd	1,400	
	8,310	
Currentassets	3,110	1,120
	11,420	2,760
Equity		
Ordinarysharecapital	4,000	500
Retainedearnings	5,380	1,550
	9,380	2,050
Liabilities		
Currentliabilities	2,040	710
	11,420	2,760

Thefollowinginformationisavailable:

(i) TT Ltd acquired 70% of the share capital of UU Ltd on 31 May 2012. There have been no changes in the share capital of UU Ltd since that date.

(ii) On 31 May 2012, the fair value of the non-current assets of UU Ltd was £150,000 higher than their book value on that date. This valuation has not been reflected in the books of UU Ltd.

(iii) On31May2012,theretainedearningsofUULtdwere£850,000.

(iv) Goodwillhassufferednoimpairmentsince31May2012.

(v) Anydepreciationconsequencesofthefairvalueadjustmentmaybeignored.

Required:

(a) Prepare a consolidated statement of financial position as at 31 May 2020, assuming thatthenon-controllinginterestinUULtdistobemeasuredattheappropriate proportion of that company's identifiable net assets.

(b) Explain how this consolidated statement would be modified if the non-controlling interest in UU Ltd on acquisitionwas measured at fair value and this fair value was determined by TT Ltd to be £530,000.

18.5 Klarke plc acquired a subsidiary, Cameroon Ltd, on 1 October 2019. The statements of financialpositionofKlarkeplcandCameroonLtdasat30September2020areas follows:

	Klarke	Cameroon
	£000	£000
Assets		
Non-currentassets		
Property, plant and equipment	53,181	
36,762 Investment in Cameroon Ltd	29,000	
	82,181	
Currentassets	28,484	10,337
	110,665	47,099
Equity		
Ordinarysharecapital	20,000	5,000
Sharepremiumaccount	10,000	2,000
Retainedearnings	34,225	28,370
	64,225	35,370
Liabilities		
Non-currentliabilities		
Long-termloan	35,000	8,000
Currentliabilities	11,440	3,729

(i) ThesharecapitalofCameroonLtdconsistsofordinarysharesof£1each.There havebeennochangestothebalancesofsharecapitalandsharepremiumduringt he year. No dividends were paid or proposed by Cameroon Ltd during the year.

(ii) Klarkeplcacquired3,000,000sharesinCameroonLtdon1October2019.

(iii) At1October2019,theretainedearningsofCameroonLtdwere£24,700,000.

(iv) Thefairvalueofthenon-currentassetsofCameroonLtdat1October2019was £37,000,000.Thebookvalueofthenon-currentassetsat1October2019was £33,000,000. The revaluation has not been recorded in the books of Cameroon Ltd (ignoreanyeffectonthedepreciationfortheyear).Therewerenootherdifference s betweenthebookvalueandthefairvalueoftheotherassetsandliabilitiesof Cameroon Ltd at the date of acquisition.

(v) The directorshave concluded thatgoodwillon the acquisition ofCameroon Ltd has been impaired during the year. They estimate that the impairment loss amounts to 20% of the goodwill.

Required:

CalculatethefollowingfiguresrelatingtotheacquisitionofCameroonLtdthatwill appear in the consolidated statement of financial position of Klarke plc at 30 September 2020:

(a) thenon-controllinginterest

(b) thegoodwillarisingonacquisition

(c) theconsolidatedretainedearningsofthegroup.

(AmendedfromAAT)

***18.6** The statements of financial position of CC Ltd and its two subsidiaries DD Ltd and EE Ltd as at 31 December 2019 are as follows:

	CCLtd		DDLtd		EELtd	
	£000		£000		£000	
Assets						
Non-currentassets						
Propertyandequipment		4,761		521		411
InvestmentinDDLtd		600				
InvestmentinEELtd		575				
		5,936				
Currentassets						
Inventories	1,532		222		187	
Tradereceivables	1,947		258		202	
Cashatbank	239	3,718	30	510	13	402
		9,654		1,031		813
Equity						
Ordinarysharecapital		5,000		500		300
Revaluationreserve		2,500		-		100
Retainedearnings		547		320		250
		8,047		820		650
Liabilities						
Currentliabilities						
Tradepayables		1,607		211		163
		9,654		1,031		813

Thefollowinginformationisavailable:

(a) CC Ltd acquired 60% of the shares of DD Ltd on 1 January 2018, when DD Ltdhad retained earnings of £280,000. The fair value of the property and equipment of DDLtdonthatdatewas£30,000morethanbookvalue.Thisvaluationhasnotbeen reflected in the books of DD Ltd.

(b) CC Ltd acquired 90% of the shares of EE Ltd on 1 January 2019, when EE Ltd had a revaluation reserve of £60,000 and retained earnings of £230,000. The fair value of EE Ltd's assets and liabilities on that date was equal to their book value.

(c) NeitherDDLtdnorEELtdhaveissuedanysharessincebeingacquiredbyCCLtd.

(d) GoodwillarisingonconsolidationinrelationtoDDLtdhassufferedanimpairment loss of 50% since the date of acquisition. The impairment loss for EE Ltd is 25%.

(e) Thefollowingintra-groupbalancesexiston31December2019:

- DDLtdowesCCLtd£15,000
- EELtdowesCCLtd£25,000
- EELtdowesDDLtd£8,000.

Allofthesebalancesareincludedintradereceivablesandpayables.

(f) Goods purchased for £8,000 from CC Ltd are included in DD Ltd's inventory at 31 December 2019. CC Ltd had invoiced these goods to DD Ltd at cost plus 60%.

(g) Any depreciation consequences of the fair value adjustment relating to the property and equipment of DD Ltd may be ignored.

Required:

Prepareaconsolidatedstatementoffinancialpositionasat31December2019.

*18.7 The following are the statements of financial position of two companies at 31 October2020, the end of their most recent financial years:

	Multaplc	Tuliplc
	£m	£m
Assets		
Non-currentassets		
Property,plantandequipment	425	288
Investments,atcost	147	13
	572	301
Currentassets		
Inventories	88	73
Tradereceivables	147	106
Othercurrentassets	37	22
Cashandcashequivalents	36	15
	308	216
Totalassets	880	517

(continued)

	£m	£m
Equity		
Ordinarysharecapital(£1shares)	300	150
10%Preferencesharecapital(£1shares)	-	45
Retainedearnings	157	90
	457	285
Liabilities		
Non-currentliabilities	150	82
Currentliabilities		
Tradepayables	184	56
Currenttaxpayable	89	69
Bankoverdraft	-	25
	273	150
Totalliabilities	423	232
Totalequityandliabilities	880	517

Thefollowingadditionalinformationisavailable:

1) On 1 November 2018 Multa plc purchased 90,000,000 ordinary shares in Tuli plc paying a total of £120,000,000. The reserves of Tuli plc on 1 November 2018 were £30,000,000.Itwasagreedthatalltheassetsandliabilitiesof Tuliplcwerereported in itsfinancialstatementsatfairvaluesasat1 November2018.Since then thedirectors of Multaplcfeel that the amount paidfor as goodwill uponthe acquisition has been impaired by £3,000,000.
2) Duringtheyearended31October2020MultaplcsoldinventorytoTuliplcfor £25,000,000. Multa plc earned a uniform margin of 40% on these sales. During the year ended 31 October 2020 Tuli plc resold 80% of this inventory. On 31 October 2020Tuliplchadunpaidinvoicestotalling£18,000,000payabletoMultaplcin respect of these purchases.
3) Each ordinary share in Tuli plc carries one vote and there are no other voting rights in the company.

Required:

(a) CalculatetheamountpaidasgoodwillontheacquisitionofTuliplcon1 November 2018.

(b) Preparewithfullsupportiveworkingstheconsolidatedstatementoffinancial position of Multa plc as at 31 October 2020.

(CIPFA)

Chapter19

Groupsofcompanies(2)

Introduction

Thepreviouschapterofthisbookintroducedtheconceptofagroupofcompaniesand dealtwiththegroupstatementoffinancialposition.Thissecondchapterongroupsdeals with the group statement of comprehensive income and the group statement of changes in equity.Thechapterbeginsbyexplainingthebasicadjustmentsthatareusuallyrequired whenpreparingthesegroup(or"consolidated")financialstatements.Theseinclude:

(a) theeliminationofintra-groupitemsandunrealisedprofits

(b) accountingfortheimpairmentofgoodwill

(c) accountingforprofitswhichareattributabletoanon-controllinginterest.

This chapter then goes on to explain how a group statement of comprehensive income is preparedwhenasubsidiaryisacquiredpartofthewaythroughtheaccountingperiod.

As stated in Chapter 18, the applicable standards are IFRS10 *ConsolidatedFinancialStatements*andIFRS3*BusinessCombinations*.Althoughthesestandardsapplytogroups ingeneral,includinggroupswithunincorporatedsubsidiaries,thischapterdealswith groups of companies only.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explainthepurposeofagroupstatementofcomprehensiveincome
- prepareagroupstatementofcomprehensiveincome,eliminatingintra-groupitemsin accordance with the requirements of IFRS10
- accountcorrectlyforanon-controllinginterestintheprofitsofasubsidiary
- prepareagroupstatementofchangesinequity
- prepareagroupstatement of comprehensiveincomeinthesituationwhereaparent

companyhasacquiredasubsidiarypartofthewaythroughtheaccountingperiod.

Thegroupstatementofcomprehensiveincome

The main purpose of a group (or "consolidated") statement of comprehensive income is to reporttheprofitorlossofthegroupasawhole.IFRS10requiresthatsuchastatement should be prepared and presented in recognition of the fact that a parent company and its subsidiaries are, in effect, a single economic entity.

Agroupstatement ofcomprehensiveincomeispreparedbyaddingtogether(linebyline) the individual statements of comprehensive income of all of the companies in the group, cancellingoutanyintra-groupitems.Notethefollowingpoints:

(a) Any intra-group sales are included in the sales revenue of the selling company and thecost of sales of the buying company. Therefore, intra-group sales are deducted fromgroupsalesrevenueandfromgroupcostofsaleswhenpreparingthegroupstatement of comprehensive income. This ensures that the group financial statements show only salestoexternalcustomersandthecostofgoodsacquiredfromexternalsuppliers.

(b) As explained in Chapter 18, any unrealised profit on inventories is deducted from the inventories figure shown in the group statement of financial position. A reduction in closing inventory causes an increase in cost of sales, so the group's cost of sales figure mustbe*increased*bytheamountofanyunrealisedprofit.

(c) Otherintra-groupitemsthatmayarise(andwhichmustbecancelledout)include interestpayablebyonegroupmembertoanotherandmanagementexpensescharged by one group member to another.

(d) Any dividends paid by a subsidiary to its parent company (shown in the subsidiary's statement of changes in equity) are cancelled against the dividends received which are shownintheparent'sstatementofcomprehensiveincome.

(e) If goodwill has suffered an impairment loss during the period, this loss is shown as an expense in the group statement of comprehensive income. It may also be necessary to makeadepreciationadjustmentifasubsidiary'sdepreciableassetswerenotshownat fairvaluewhenthesubsidiarywasacquired(seeChapter18).

(f) If a group includes any partly-owned subsidiaries, part of the group's profit after tax is attributable to the non-controlling interest. This amount is deducted in the groupstatementofcomprehensiveincome,leavingtheprofitattributabletothegroup.

Thegroupstatementofchangesinequity

Thepurposeofagroupstatementofchangesinequityistoshowhoweachcomponentof thegroup'sequity(showninthegroupstatementoffinancialposition)haschangedduring the accounting period. In general, there is one column for the parent's share capital and one

columnforeachofthegroup'sreserves.Thesecolumnsaretotalledtoshowtheequity which belongs to the parent's shareholders. There is then a further column for the non-controllinginterestandafinalcolumnwhichshowsthetotalequityofthegroup.

EXAMPLE1

On1July2017,RLtdacquired70%oftheordinaryshareCapitalofSLtd.Therearenopreferenceshares.TheretainedearningsofSLtdon1July2017were£2,000.Statementsofcomprehensiveincomefortheyearto30June2020areasfollows:

	RLtd	SLtd
	£	£
Salesrevenue	624,000	109,000
Costofsales	267,400	65,300
Grossprofit	356,600	43,700
Distributioncosts	(71,370)	(5,100)
Administrativeexpenses	(101,430)	(10,500)
Operatingprofit	183,800	28,100
DividendreceivedfromSLtd	14,000	
Profitbeforetax	197,800	28,100
Taxation	38,200	5,600
Profitfortheyear	159,600	22,500

Thefollowingfiguresaretakenfromtheretainedearningscolumnofthestatementofchangesinequityof RLtdandSLtdfortheyearto30June2020:

	RLtd	SLtd
	£	£
Balanceat30June2019	54,900	7,000
Profitfortheyear	159,600	22,500
Dividendspaid	(120,000)	(20,000)
Balanceat30June2020	94,500	9,500

Thefollowinginformationisalsoavailable:

(a) Duringtheyear,RLtdsoldgoodstoSLtdfor£8,000.Thesegoodshadcost RLtd £5,000.Attheyearend,one-halfofthegoodswerestillheldbySLtd.

(b) Goodwillarisingonconsolidationhassufferednoimpairmentlosses.

Prepareaconsolidatedstatementofcomprehensiveincomefortheyearto30June2020.Alsoprepareanextractfromtheconsolidatedstatementofchangesinequity,showingthechangesinthegroup'sretainedearningsduringtheyear.

Solution

Intra-groupsalesof£8,000andtheunrealisedprofitof£1,500(50%x£3,000)mustbeeliminatedwhenpreparingthegroupstatementofcomprehensiveincome.Theintra-groupdividendof£14,000(70%x£20,000)mustalsobeeliminated.

Non-controllingshareholdersown30%ofthesharesinSLtd.Sotheprofitattributabletothenon-controllinginterestis30%of£22,500=£6,750.

Groupstatementofcomprehensiveincomefortheyearto30June2020

	£
Salesrevenue(£624,000+£109,000–£8,000)	
725,000Costofsales(£267,400+£65,300–£8,000+£1,500)	326,200
Grossprofit	398,800
Distributioncosts(£71,370+£5,100)	(76,470)
Administrativeexpenses(£101,430+£10,500)	(111,930)
Profitbeforetax	210,400
Taxation(£38,200+£5,600)	43,800
Profitfortheyear	166,600
Attributabletonon-controllinginterest(30%x£22,500)	6,750
Attributabletothegroup	159,850

Groupstatementofchangesinequityfortheyearto30June2020(extract)

	Retainedearnings
	£
Balanceat30June2019(W1)	58,400
Profitfortheyear	159,850
Dividendspaid	(120,000)
Balanceat30June2020(W2)	98,250

Workings:

W1.Groupretainedearningsat30June2019

	£	£
Parent'sretainedearningsat30June2019		54,900
Subsidiary'sretainedearningsat30June2019	7,000	
Less:Subsidiary'sretainedearningsat1July2017	2,000	
	70%x5,000	3,500
Groupretainedearningsat30June2019†		58,400

†*Itisassumedthattherewerenounrealisedprofitsat30June2019*

W2.Groupretainedearningsat30June2020

	£	£
Parent'sretainedearningsat30June2020		94,500
Subsidiary'sretainedearningsat30June2020	9,500	
Less:Subsidiary'sretainedearningsat1July2017	2,000	
	70%x7,500	5,250
Less:Unrealisedprofit		(1,500)
Groupretainedearningsat30June2020		98,250

EXAMPLE2

On1January2019,VLtdpaid£92,000toacquire80%ofthesharecapitalofWLtd.Thefinancialstatements ofVLtdandWLtdfortheyearto31December2019areasfollows:

Statementsofcomprehensiveincomefortheyearto31December2019

	VLtd	WLtd
	£000	£000
Salesrevenue	870	340
Costofsales	370	160
Grossprofit	500	180
Operatingexpenses	(305)	(105)
DividendreceivedfromWLtd	20	-
Profitbeforetax	215	75
Taxation	43	15
Profitfortheyear	172	60

Statementsofchangesinequityfortheyearto31December2019

	VLtd			WLtd		
	Share capital	*Retained earnings*	*Total*	*Share capital*	*Retained earnings*	*Total*
	£000	£000	£000	£000	£000	£000
Balanceat1/1/2019	200	240	440	50	30	80
Profitfortheyear		172	172		60	60
Dividendspaid		(90)	(90)		(25)	(25)
Balanceat31/12/2019	200	322	522	50	65	115

Statementsoffinancialpositionasat31December2019

	VLtd	WLtd
	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment	360	120
InvestmentinWLtd	92	
Currentassets	150	40
	602	160
Equity		
Ordinarysharecapital	200	50
Retainedearnings	322	65
	522	115
Liabilities		
Currentliabilities	80	45
	602	160

Thefollowinginformationisalsoavailable:

(a) AlloftheassetsandliabilitiesofWLtdwerecarriedatfairvalueon1January2019.

(b) Goodwillarisingonconsolidationhassufferedanimpairmentlossof25%.

(c) Therewerenointra-groupsalesduringtheyear.

(d) Non-controllinginterestsinthestatementoffinancialpositionaretobemeasuredattheappropriateproportionofthesubsidiary'sidentifiablenetassets.

Prepareagroupstatementofcomprehensiveincomeandstatementofchangesinequityfortheyearto31December2019.Alsoprepareagroupstatementoffinancialpositionasatthatdate.

Solution

Theconsolidatedfinancialstatementsareasfollows:

Groupstatementofcomprehensiveincomefortheyearto31December2019

	£000
Salesrevenue(870+340)	1,210
Costofsales(370+160)	530
Grossprofit	680
Operatingexpenses(305+105)	
(410)Impairmentofgoodwill(W1)	(7)
Profitbeforetax	263
Taxation(43+15)	58
Profitfortheyear	205
Attributabletonon-controllinginterest(20%x60)	12
Attributabletothegroup	193

Groupstatementofchangesinequityfortheyearto31December2019

	Share capital	*Retained earnings*	*Total*	*Non-controlling interest*	*Total equity*
	£000	£000	£000	£000	£000
Balanceat1/1/2019	200	240	440	-	440
Acquisitionofsubsidiary				16	16
Profitfortheyear		193	193	12	205
Dividendspaid		(90)	(90)	(5)	(95)
Balanceat31/12/2019	200	343	543	23	566

Note:

ThetotalequityofWLtdwhenitwasacquiredbyVLtdwas£80,000.Thenon-controllingshareholdersown20%ofthesharesofWLtd.Thereforethenon-controllinginterestthatwascreatedwhenWLtdwasacquiredwas£16,000(20%x£80,000).

Groupstatementoffinancialpositionasat31December2019

	£000
Assets	
Non-currentassets	
Property,plantandequipment(360+120)	480
Goodwill(W1)	21
Currentassets(150+40)	190
	691
Equity	
Ordinarysharecapital	200
Retainedearnings(W2)	343
	543
Non-controllinginterest(20%x(50+65))	23
	566
Liabilities	
Currentliabilities(80+45)	125
	691

Workings:

W1.Goodwill

	£000	£000
Pricepaidbyparent		92
Subsidiary'ssharecapitalat1January2019	50	
Subsidiary'sretainedearningsat1January2019	30	
	80%x80	64
Goodwillat1January2019		28
Less:Impairment(25%)		7
Goodwillat31December2019		21

W2.Groupretainedearnings

	£000	£000
Parent'sretainedearningsat31December2019		322
Subsidiary'sretainedearningsat31December2019	65	
Less:Subsidiary'sretainedearningsat1January2019	30	
	80%x35	28
		350
Less:Goodwillimpairment		7
Groupretainedearningsat31December2019		343

Subsidiaryacquiredpartwaythroughanaccountingperiod

If a subsidiary is acquired part of the way through the accounting period for which group accountsarebeingprepared,itisnecessarytoapportionthesubsidiary'sprofitforthat period into its pre-acquisition and post-acquisition components. The group's share of the subsidiary'spre-acquisitionprofitiscancelledoutinthecalculationofthegoodwillarising onconsolidation.Thegroup'sshareofthesubsidiary'spost-acquisitionprofitisincludedin the consolidated statement of comprehensive income.

There are no new principles here. This treatment of a subsidiary's profits in the year of acquisitionissimplyafurtherapplicationoftherequirementtoexcludepre-acquisition profitsfromtheconsolidatedstatementofcomprehensiveincome.

Theapportionmentofasubsidiary'sprofitsintheyearofacquisitionisnormallydoneon atimebasis.However,adifferentapproachmaybenecessaryifthesubsidiary'sbusiness isaffectedbyseasonalorotherfactorssothatastraightforwardtimeapportionmentwould not be appropriate.

EXAMPLE3

YLtdacquired75%oftheordinarysharecapitalofZLtdon1April2020.Therearenopreferenceshar es.Bothcompaniesprepareaccountsto30Septembereachyear.Theirstatementsofcomprehen siveincomefortheyearto30September2020areasfollows:

	YLtd	ZLtd
	£	£
Salesrevenue	317,500	96,000
Costofsales	149,500	31,200
Grossprofit	168,000	64,800
Distributioncosts	(36,300)	(4,800)
Administrativeexpenses	(59,400)	(20,400)
Profitbeforetax	72,300	39,600
Taxation	14,000	7,500
Profitfortheyear	58,300	32,100

MovementsintheretainedearningsofYLtdandZLtdfortheyearto30September2020areasfollo ws:

	YLtd	ZLtd
	£	£
Balanceat30September2019	112,600	77,700
Profitfortheyear	58,300	32,100
Balanceat30September2020	170,900	109,800

Thefollowinginformationisalsoavailable:

(a) Two-thirdsofthesales,costofsalesanddistributioncostsofZLtdoccurinthesecondhalfoftheaccountingyear.Administrativeexpensesarespreadevenlyovertheyear.£5,600ofZLtd'staxliabilityrelatestothesecondhalfoftheyear.

(b) Goodwillarisingonconsolidationhassufferednoimpairmentlosses.

Prepareaconsolidatedstatementofcomprehensiveincomefortheyearto30September2020anddcalculatethegroup'sretainedearningsasatthatdate.

Solution

Beforeconsolidation,theZLtdstatementofcomprehensiveincomeshouldbeapportionedintoitspre-acquisitionandpost-acquisitioncomponents,asfollows:

	1/10/19to31/3/20	*1/4/20to30/9/20*
	£	£
Salesrevenue(1:2)	32,000	64,000
Costofsales(1:2)	10,400	20,800
Grossprofit	21,600	43,200
Distributioncosts(1:2)	(1,600)	(3,200)
Administrativeexpenses(1:1)	(10,200)	(10,200)
Profitbeforetax	9,800	29,800
Taxation	1,900	5,600
Profitfortheyear	7,900	24,200

Theconsolidatedstatementofcomprehensiveincomeisasfollows:

	£
Salesrevenue(£317,500+£64,000)	381,500
Costofsales(£149,500+£20,800)	170,300
Grossprofit	211,200
Distributioncosts(£36,300+£3,200)	(39,500)
Administrativeexpenses(£59,400+£10,200)	(69,600)
Profitbeforetax	102,100
Taxation(£14,000+£5,600)	19,600
Profitfortheyear	82,500
Attributabletonon-controllinginterest(25%x£24,200)	6,050
Attributabletothegroup	76,450

Theretainedearningscolumnoftheconsolidatedstatementofchangesinequityfortheyearto30September2020willshowthefollowing:

	Group £
Balanceat30September2019	112,600
Profitfortheyear	76,450
Balanceat30September2020	189,050

Notes:

1. Theprofitattributabletothenon-controllinginterestis25%ofthepost-acquisitionprofitsofZLtd(i.e.25%x£24,200=£6,050).
2. At30September2019,thegroupretainedearningsaresimplythe£112,600retainedearningsofYLtd.
3. Sinceacquisition,theretainedearningsofZLtdhaveincreasedby£24,200.Groupretainedearningsat30September2020aretheretainedearningsofYLtd(£170,900)plus75%of£24,200(£18,150).Thisgivesatotalof£189,050.

Summary

- Aconsolidatedstatementofcomprehensiveincomeshowstheprofitorlossofthe group as a whole and is prepared by adding together (line by line) the individual statementsofcomprehensiveincomeofallofthecompaniesinthegroup,cancelling out any intra-group items.
- The main intra-group items that should be cancelled out are intra-group sales, interestandmanagementexpenses.Anyunrealisedprofitoninventoriesshouldbeadded to the group cost of sales figure.
- Any dividends paid by a subsidiary to its parent company are cancelled against the dividendsreceivedshownintheparent'sstatementofcomprehensiveincome.
- Impairmentlossesongoodwillareshownasanexpenseintheconsolidatedstatement of comprehensive income. A depreciation adjustment may be needed if a subsidiary's depreciableassetswerenotshownatfairvaluewhenthesubsidiarywasacquired.
- Any part of a subsidiary's profit that is attributable to the non-controlling interest is deductedintheconsolidatedstatementofcomprehensiveincome.
- Aconsolidatedstatementofchangesinequityshowshoweachcomponentofthe group's equity has changed during the period. In general, there is one column for the parent's share capital and one column for each of the group's reserves. There is also a column showing changes in the non-controlling interest.
- If a subsidiary is acquired part-way through an accounting period, its profit for thatperiodmustbeapportionedintoitspre-acquisitionandpost-acquisitioncomponents.

Exercises

Intheseexercises,itmaybeassumedthateachcompany'sothercomprehensiveincomefortheyearis£nil.Itmayalsobeassumedthatnon-controllinginterestsinthestatementoffinancialpositionaretobemeasuredattheappropriateproportionofthesubsidiary'sidentifiablenetassets.Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

19.1 PP Ltd acquired 65% of the ordinary share capital of QQ Ltd on 1 January 2019. There areno preferenceshares.Thestatementsofcomprehensiveincomeofthetwo companies for the year to 31 December 2019 are as follows:

	PPLtd	QQLtd
	£	£
Salesrevenue	345,450	186,350
Costofsales	125,700	71,990
Grossprofit	219,750	114,360
Operatingexpenses	56,330	37,800
Profitbeforetax	163,420	76,560
Taxation	32,000	14,660
Profitfortheyear	131,420	61,900

Required:

Prepare a consolidated statement of comprehensive income for the year to 31 December 2019.

19.2 FF Ltd acquired 80% of the ordinary share capital of GG Ltd on 1 April 2016. On that date, the retained earnings of GG Ltd were £18,260. There are no preference shares. The statementsofcomprehensiveincomeofFFLtdandGGLtdfortheyearto31March 2020 are as follows:

	FFLtd	GGLtd
	£	£
Salesrevenue	359,800	154,600
Costofsales	102,600	55,550
Grossprofit	257,200	99,050
Operatingexpenses	118,480	19,300
Operatingprofit	138,720	79,750
Dividendsreceived	28,000	-
Profitbeforetax	166,720	79,750
Taxation	32,000	16,000
Profitfortheyear	134,720	63,750

The statement of changes in equity for FF Ltd and GG Ltd show the following retained earnings figures for the year to 31 March 2020:

	FFLtd	GGLtd
	£	£
Balanceat31March2019	66,090	41,110
Profitfortheyear	134,720	63,750
Dividendspaid	(90,000)	(35,000)
Balanceat31March2020	110,810	69,860

On 4 March 2020, FF Ltd sold goods to GG Ltd for £10,000. These goods had cost FF Ltd£6,000.One-quarterofthemwereincludedinGGLtd'sinventoryat31March2020.

Required:

(a) Prepareaconsolidatedstatementofcomprehensiveincomefortheyearto31March 2020, assuming that there are no impairment losses in relation to goodwill.

(b) Prepareanextractfrom theconsolidatedstatementofchangesinequityfortheyear to 31 March 2020, showing the changes in the group's retained earnings.

19.3 On 1 March 2020, YY Ltd acquired 85% of the ordinary share capital of ZZ Ltd. There arenopreferenceshares.Bothcompaniespreparefinancialstatementsto31October each year. Transactions between the two companies during the year to 31 October 2020 were as follows:

(a) On 31 January 2020, YY Ltd sold goods costing £2,000 to ZZ Ltd for £3,500. Allof these goods had been sold by ZZ Ltd by the end of the accounting year.

(b) On 30 September 2020, YY Ltd sold goods costing £4,000 to ZZ Ltd for £7,000. None of these goods had been sold by ZZ Ltd by the end of the accounting year.

There was a goodwill impairment loss of £10,000 during the period from 1 March 2020 to 31 October 2020. The statements of comprehensive income of the two companies for the year to 31 October 2020 are as follows:

	YYLtd	ZZLtd
	£	£
Salesrevenue	150,000	84,000
Costofsales	60,000	27,000
Grossprofit	90,000	57,000
Operatingexpenses	25,800	18,600
Profitbeforetax	64,200	38,400
Taxation	12,000	7,200
Profitfortheyear	52,200	31,200

Allincomeandexpensesaccruedevenlythroughtheyear.

Required:

Prepareaconsolidatedstatementofcomprehensiveincomefortheyearto31October 2020.

19.4 TheManagingDirectorofWraymandplchasaskedyoutopreparethestatementof comprehensiveincomeforthegroup.Thecompanyhasonesubsidiaryundertaking, Blonk Ltd. The statements of comprehensive income of the two companies for the year ended 31 March 2020 are set out below.

StatementsofcomprehensiveincomefortheyeartO31March2020

	Wraymand	Blonk
	£000	£000
Salesrevenue	38,462	12,544
Costofsales	(22,693)	(5,268)
Grossprofit	15,769	7,276
DividendfromBlonkLtd	580	
	16,349	
Distributioncosts	(6,403)	(2,851)
Administrativeexpenses	(3,987)	(2,466)
Profitfromoperations	5,959	1,959
Financecosts	(562)	(180)
Profitbeforetax	5,397	1,779
Taxation	(1,511)	(623)

Furtherinformation:

(i) Wraymand plc acquired 75% of the ordinary share capital of Blonk Ltd on 1 April 2019.

(ii) Duringtheyear,BlonkLtdsoldgoodswhichhadcost£1,100,000toWraymandplc for £1,600,000. All of the goods had been sold by Wraymand plc by the end of the year.

Required:

DraftaconsolidatedstatementofcomprehensiveincomeforWraymandplcandits subsidiaryfortheyearended31March2020. *(AmendedfromAAT)*

*19.5 The financial statements of JJ Ltd and KK Ltd for the year to 30 June 2020 are shownbelow:

Statementsofcomprehensiveincomefortheyearto30June2020

	JJLtd	KKLtd
	£000	£000
Salesrevenue	21,545	5,328
Costofsales	13,335	3,552
Grossprofit	8,210	1,776
Operatingexpenses	4,087	640
Operatingprofit	4,123	1,136
DividendsreceivedfromKKLtd	377	-
Profitbeforetax	4,500	1,136
Taxation	850	220
Profitfortheyear	3,650	916

Statementsoffinancialpositionasat30June2020

	JJLtd		KKLtd	
	£000		£000	
Assets				
Non-currentassets				
Property,plantandequipment		5,961		2,667
InvestmentinKKLtd		3,153		
		9,114		
Currentassets				
Inventories	2,215		1,052	
Tradereceivables	1,823		829	
Cashatbank	101	4,139	5	1,886
		13,253		4,553
Equity				
Ordinarysharecapital		7,000		2,500
Preferencesharecapital		800		400
Retainedearnings		2,599		508
		10,399		3,408
Liabilities				
Currentliabilities				
Tradepayables	2,004		925	
Taxation	850	2,854	220	1,145

Statementsofchangesinequityfortheyearto30June2020

	JJLtd			KKLtd		
	Share capital	*Retained earnings*	*Total*	*Share capital*	*Retained earnings*	*Total*
	£000	£000	£000	£000	£000	£000
Balanceb/f	7,800	829	8,629	2,900	112	3,012
Profitfortheyear		3,650	3,650		916	916
Dividends-ord.		(1,800)	(1,800)		(500)	(500)
Dividends-pref.		(80)	(80)		(20)	(20)
Balancec/f	7,800	2,599	10,399	2,900	508	3,408

Thefollowinginformationisalsoavailable:

1. On 1 July 2016, JJ Ltd paid £3,153,000 to acquire 75% of the ordinary shares and 10% of the preference shares of KK Ltd. On that date, the retained earnings of KK Ltd were £704,000.
2. The fair value of the non-current assets of KK Ltd on 1 July 2016 exceeded their carrying amount by £600,000. This valuation has not been reflected in the books of KK Ltd.
3. KKLtdhasissuednosharessincebeingacquiredbyJJLtd.
4. Goodwill had suffered impairment losses of 30% by 30 June 2019 and there was a further impairment loss during the year to 30 June 2020. This further impairment loss is equal to 10% of the amount originally paid for goodwill.
5. JJ Ltd sells goods to KK Ltd at cost plus 60%. During the year to 30 June 2020, these sales totalled £2,400,000, of which £216,000 was still owing to JJ Ltd at the end of the year. The inventory of KK Ltd at 30 June 2020 includes goods bought from JJ Ltd for £512,000.
6. Anydepreciationconsequencesofthefairvalueadjustmentmaybeignored.

Required:

(a) Prepare a consolidated statement of comprehensive income for the year to 30 June 2020.

(b) Prepareaconsolidatedstatementofchangesinequityfortheyearto30June2020.

(c) Prepareaconsolidatedstatementoffinancialpositionasat30June2020.

(d) Explain how each of these financial statements would differ if the intra-group sales described above were from KK Ltd to JJ Ltd (rather than from JJ Ltd to KK Ltd).

(e) Explain how the consolidated financial statements would differ if the depreciation consequencesofthefairvalueadjustmentwerenotignored.Itmaybeassumedth at thefinancialstatementsofKKLtdforeachofthefouryearsto30June2020would have been charged with additional depreciation of £40,000 if the company had revalued its non-current assets to their fair value on 1 July 2016.

Chapter20

Associatesandjointarrangements

Introduction

If one company is able to exercise control over another company, then a parent-subsidiary relationship exists between the two companies and the parent must prepare consolidated financial statements in accordance with IFRS10 (see Chapter 18). Control is generallyachievedthroughownershipofover50%oftheothercompany'sordinaryshares.

However,acompanywhichownssharesinanothercompanymightnotownenough shares to be able to exercise control over that other company's activities. There are threedistinct possibilities:

(a) Theinvestor companymight ownonlyasmall number of sharesintheinvestee company, insufficient to give the investor any significant influence over the investee's activities.Inthiscase,theinvestmentisaccountedforintheinvestorcompany's financialstatementsinaccordancewithIFRS9*FinancialInstruments*(Chapter11).

(b) Theinvestorcompanymightownenoughsharesintheinvesteecompanytobeable toexercisesignificant influenceover its activities, but not enoughtoexercisecontrol overthoseactivities.Inthiscase,theinvesteecompanyisknownasan"associate" andtheinvestmentisaccountedforinaccordancewithIAS28*InvestmentsinAssociatesandJointVentures*.

(c) The investor company together with other investors might be able to exercise jointcontrol over the investee company. This type of arrangement is known as a "joint arrangement"andtherequiredaccountingtreatmentisprescribedbyeitherIFRS11 *JointArrangements*orIAS28*InvestmentsinAssociatesandJointVentures*.

The purpose of this chapter is to explain the main requirements of standards IAS28 and IFRS11.Thesestandardsapplytoentitiesingeneral(includingunincorporatedentities)butitis assumedthroughoutthischapterthatalloftheentitiesconcernedarecompanies.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- definetheterms"associate"and"significantinfluence"inaccordancewithIAS28
- explaintheequitymethodofaccountingandapplythismethodwhenaccountingfor an investment in an associate
- definetheterms"jointarrangement"and"jointcontrol"inaccordancewithIFRS11
- distinguishbetweenajointoperationandajointventure
- accountcorrectlyforaninterestinajointoperationorajointventure
- outlinethemainrequirements of IFRS12*DisclosureofInterestsinOtherEntities*in relation to associates and joint arrangements.

Associatesandsignificantinfluence

IAS28*InvestmentsinAssociatesandJointVentures*includesthefollowingdefinitions:

- Anassociateis"*anentityoverwhichtheinvestorhassignificantinfluence*".
- Significant influence is "*thepowertoparticipateinthefinancialandoperatingpolicydecisionsoftheinvesteebu tisnotcontrolorjointcontrolofthosepolicies*".

Whenaninvestorcompanyholds(directlyorindirectly)atleast20%ofthevotingpower of an investee company, significant influence is presumed to exist unless it can be clearly demonstrated that this is not the case. Holding at least 20% of a company's voting power normallymeansowningatleast20%ofthatcompany'sordinaryshares.

IAS28alsostatesthatsignificantinfluenceispresumed*not*toexistiftheinvestorholds less than 20% of the voting power of the investee, unless such influence can be clearly demonstrated.Theexistenceofsignificantinfluenceisusuallyevidencedinoneormoreof the following ways:

(a) representationontheboardofdirectorswhichgovernstheinvesteecompany
(b) participationinpolicy-makingprocessesoftheinvestee,includingparticipationindecisions about dividends or other distributions
(c) materialtransactionsbetweentheinvestorandtheinvestee
(d) interchangeofmanagerialpersonnel
(e) provisionofessentialtechnicalinformation.

Aninvestorcompanylosessignificantinfluenceoveraninvesteecompanywhenitloses thepowertoparticipateintheinvestee'sfinancialandoperatingpolicies.Thisgenerally occurswhentheinvestornolongerholdsatleast20%oftheinvestee'svotingpower.

Theequitymethod

IAS28requiresthataninvestmentinanassociateshouldnormallybeaccountedforusing the "equity method". The equity method is defined as "*amethodofaccountingwherebytheinvestmentisinitiallyrecognisedatcostandadjustedthereafterforthepost-acquisitionchangeintheinvestor'sshareoftheinvestee'snetassets*".Thedefinitiongoesontostate thattheprofitorlossoftheinvestorshouldincludetheinvestor'sshareoftheprofitorloss oftheinvestee.Afullerexplanationoftheequitymethod,togetherwithanumberof worked examples, is given below.

Theequitymethodofaccountingforassociatesshouldnormallybeusedwhetherornot the investor company is also a parent company which presents consolidated financial statements.However,aparentcompanywhichsatisfiescertainconditionsisnotrequired toapplytheequitymethod.Theseconditionsareverysimilartothosewhichexempta parentcompanyfrompreparingconsolidatedfinancialstatements(seeChapter18)and most commonly apply to parent companies which are themselves subsidiaries of other companiesandwhosesharesorsecuritiesarenotpubliclytraded.

Aparentcompanywhichisexemptfromapplyingtheequitymethodwillgenerally prepare its own "separate financial statements", in which investments in associates may be showneitheratcostorinaccordancewithIFRS9*FinancialInstruments*(seeChapter11).

Applicationoftheequitymethod

Under the equity method of accounting, the investment made by the investing company is recorded initially at cost. This will include goodwill if the cost of the investment is greaterthantheinvestor'sshareofthefairvalueoftheinvestee'sidentifiablenetassets.However, anygoodwillincludedinthecostofaninvestmentaccountedforbytheequitymethodisnotseparatelyrecognised.Norisitseparatelytestedforimpairment.Buttheamountpaid forgoodwillmustbedeterminedincasethereisanynegativegoodwill.Negativegoodwill isrecognisedasincomeintheinvestor'sstatementofcomprehensiveincomeandisadded tothecarryingamountoftheinvestmentintheinvestor'sstatementoffinancialposition.

Insubsequentyears,therequiredaccountingtreatmentisasfollows:

(a) Theinvestor'sshareoftheinvestee'sprofit(orloss)fortheyearisrecognisedas income (or as an expense) in the investor's statement of comprehensive income and is eitheraddedtoorsubtractedfromthecarryingamountoftheinvestmentinthe investor's statement of financial position.

(b) The investor's share of the investee's "other comprehensive income" for the year is recognisedasothercomprehensiveincomeintheinvestor'sstatementofcomprehensive income and is either added to (if positive) or subtracted from (if negative) thecarrying amount of the investment.

(c) Anydividendsreceivedfromtheinvesteearesubtractedfromthecarryingamountof the investment.

Itisimportanttograspthedifferencebetweentheequitymethodwhichisusedinrelation to associates and the acquisition method which is used in relation to subsidiaries. With the equity method, only *theinvestor'sshare*of an associate's profit or loss is shown in theinvestor's financial statements (or consolidated financial statements) and this is shown as a single figure. With the acquisition method, *all*of a subsidiary's revenues and expenses are incorporatedlinebylineintotheconsolidatedstatementofcomprehensiveincomeand thentheprofitattributabletothenon-controllinginterest(ifany)issubtracted.

Similarly,undertheequitymethod,aninvestmentinanassociateisshowninthe investor'sfinancialstatements(orconsolidatedfinancialstatements)asasinglenon-current asset. With the acquisition method, all of a subsidiary's assets and liabilities are incorporated line by line into the consolidated statement of financial position. Any non- controlling interest is then shown in equity.

EXAMPLE1

Asphaplcistheparentofagroupofcompanies.On1January2019,Asphaplcacquired25%oftheor dinarysharecapitalofBexxaLtdatacostof£100,000.Thiswaspreciselyequalto25%ofthefairvalu eoftheidentifiablenetassetsofBexxaLtdonthatdate.Duringtheyearto31December2019,Bexxa Ltd:

(a) madeaprofitaftertaxof£42,000,and

(b) paidanordinarydividendof£27,000.

ExplainhowthesetransactionsshouldbereflectedintheconsolidatedfinancialstatementsofAs phaplcfortheyearto31December2019.

Solution

Initsconsolidatedstatementofcomprehensiveincome,Asphaplcwillrecognise"shareofprofito fassociates"as£10,500(25%x£42,000).IAS1suggeststhatthisamountshouldbeshownjustbef orethegroup'spre-taxprofit.

Theinvestmentisrecognisedinitiallyatcost.Thegroup'sshareoftheassociate'sprofitisadded andthedividendreceivedof£6,750(25%x£27,000)issubtracted.Thereforetheconsolidatedstat ementoffinancialpositionwillshow"investmentsinassociates"as £103,750(£100,000+£10,500–£6,750).Thisisshownasanon-currentasset.

Ineffect,thecarryingamountoftheinvestmenthasbeenincreasedbytheinvestor's25%shareof theincreaseintheassociate'sretainedearningsfortheyear.

EXAMPLE2

Gannaxplcistheparentofseveralwhollyownedsubsidiaries.On1July2019,Gannaxplcacquired30%oftheordinarysharesofDeltarLtdat acostof£70,000.DeltarLtdhadretainedearningsof£50,000onthatdateandallofitsassetsandlia bilitieswerecarriedatfairvalue.DeltarLtdhasissuednosharesduringtheyearto30June2020.

ThedraftconsolidatedfinancialstatementsofGannaxplcfortheyearto30June2020(beforeappl yingtheequitymethod)andthefinancialstatementsofDeltarLtdforthatyearareasfollows:

Statementsofcomprehensiveincomefort heyearto30June2020

	Gannaxplcand subsidiaries	DeltarLtd
	£000	£000
Salesrevenue	930	320
Costofsales	340	170
Grossprofit	590	150
Operatingexpenses	215	113
Operatingprofit	375	37
DividendreceivedfromDeltarLtd	6	-
Profitbeforetax	381	37
Taxation	75	7
Profitfortheyear	306	30

Note:Othercomprehensiveincomewas£nilineachcase.

Statementsoffinancialpositionas at30June2020

	Gannaxplcand DeltarLtdsubsidiaries	
	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment	510	155
InvestmentinDeltarLtd,atcost	70	
	580	
Currentassets	225	40
	805	195
Equity		
Ordinarysharecapital	300	100
Retainedearnings	390	60
	690	160
Liabilities		
Currentliabilities	115	35
	805	195

Statementofchangesinequity(retainedearningsonly)fortheyearto30June2020

	Gannaxplcandsubsidiaries	DeltarLtd
	£000	£000
Balanceat30June2019	204	50
Profitfortheyear	306	30
	510	80
Dividendspaid	120	20
Balanceat30June2020	390	60

Prepareaconsolidatedstatementofcomprehensiveincomefortheyearto30June2020andaconsolidatedstatementoffinancialpositionasatthatdate.Alsoprepareanextractfromtheconsolidatedstatementofchangesinequity,showingthechangesinthegroup'sretainedearningsintheyear.

Solution

DeltarLtdisanassociateofGannaxplc.Thecostoftheinvestmentwas£70,000andthefairvalueof30%ofthenetassetsofDeltarLtdon1July2019was30%x£150,000=£45,000.Therefore thereisgoodwillof£25,000.Thisisnotshownseparately,butitwasnecessarytodothiscalculationsoastobesurethattherewasnonegativegoodwill.

Theinvestmentinassociatesat30June2020is£70,000+(30%x£30,000)–£6,000=£73,000.Thedividendreceivedof£6,000shouldberemovedfromthegroupstatementofcomprehensiveincomeandreplacedbythegroup's£9,000shareoftheassociate'sprofitfortheyear.Thegroupretainedearningsfigurerisesby£3,000inconsequence.Thefinalconsolidatedfinancialstatementsareasfollows:

Statementofcomprehensiveincomefortheyearto30June2020

	£000
Salesrevenue	930
Costofsales	340
Grossprofit	590
Operatingexpenses	215
Operatingprofit	375
Shareofprofitofassociates	9
Profitbeforetax	384
Taxation	75
Profitfortheyear	309

Statementoffinancialpositionasat30June2020

	£000
Assets	
Non-currentassets	
Property,plantandequipment	510
Investmentsinassociates	73
	583
Currentassets	225
	808
Equity	
Ordinarysharecapital	300
Retainedearnings	393
	693
Liabilities	
Currentliabilities	115
	808

Statementofchangesinequity(retainedearningsonly)fortheyearto30June2020

	£000
Balanceat30June2019	204
Profitfortheyear	309
	513
Dividendspaid	120
Balanceat30June2020	393

Note:

Theeffectsofapplyingtheequitymethodareasfollows:

(i) Inthestatementofcomprehensiveincome,thedividendreceivedfromtheassociatehasbeenreplacedbytheinvestor'sshareoftheassociate'sprofitsfortheyear.

(ii) Inthestatementoffinancialposition,thecarryingamountoftheinvestmenthasbeenincreasedbytheinvestor'sshareoftheassociate'sretainedearningsfortheyear.

Upstreamanddownstreamtransactions

"Upstream" and "downstream" transactions are transactions between an investor and an associate.Anexampleofanupstreamtransactionisthesaleofgoodsbytheassociateto theinvestor.Anexampleofadownstreamtransactionisthesaleofgoodsbytheinvestor to the associate. IAS28 requires that any unrealised profits resulting from such transactions shouldbeeliminatedtotheextentoftheinvestor'sinterestintheassociate.Thisdiffers fromthe IFRS10 requirement that unrealised profits on intra-group transactions should befullyeliminated,whetherornotthesubsidiaryconcernediswholly-owned.

Accounting entries which may be used to eliminate the unrealised profits resulting from upstreamand downstreamtransactions are as follows:

(a) **Upstream**.Intheinvestor'sfinancialstatements,theunrealisedprofitissubtracted from the investor's share of profit from associates. This automatically reduces the investmentinassociatesfigureshowninthestatementoffinancialposition.

(b) **Downstream**. In the investor's financial statements, the unrealised profit is subtracted from gross profit (usually by increasing cost of sales) and is also subtracted from the investmentinassociatesfigureshowninthestatementoffinancialposition.

The unrealised profits which are eliminated as above should be recognised if and when the goods concerned are sold on to a third party.

EXAMPLE3

Aninvestorcompanyhasa25%interestinanassociate.Duringtheyearto31December2019,thein vestorboughtgoodsfromtheassociateonwhichtheassociateearnedaprofitof£10,000.One-halfofthesegoodsremainedunsoldbytheinvestorattheyearend.

(a) Calculatetheunrealisedprofitonthistransactionandexplainhowthisiseliminatedfromthei nvestor'sfinancialstatements.

(b) Explainhowtherequiredaccountingtreatmentwoulddifferifthegoodshadbeensoldbythei nvestortotheassociateratherthantheotherwayaround.

Solution

(a) Theunrealisedprofitis£1,250(25%x50%x£10,000).Intheinvestor'sfinancialstatements,s hareofprofitfromassociatesisreducedby£1,250andinvestmentinassociatesisalsoreduc edby£1,250.

(b) Intheinvestor'sfinancialstatements,thecostofsalesfigureisincreasedby£1,250andinves tmentinassociatesisreducedby£1,250.

Lossesofanassociate

Asstatedearlierinthischapter,theinvestor'sshareofanassociate'slossisrecognisedas anexpenseintheinvestor'sfinancialstatementsandissubtractedfromthecarrying amountoftheinvestment.However,iftheinvestor'sshareofanassociate'slossisgreater than the carrying amount of the investment, that amount is reduced to zero and the investor shouldnormallyrecognisenofurtherlosses.Butfurtherlossesarerecognisedifthe investorhasincurredlegalorconstructiveobligationsonbehalfoftheassociate.This situationmightoccuriftheinvestorhasguaranteedtheassociate'sdebts.

Ifthecarryingamountoftheinvestmentisreducedtozerobuttheassociatethen eventually returns to profit, the investor should not resume recognition of its share of the associate's profits until after those profits have cancelled out the losses which were not recognisedwhilstthecarryingamountoftheinvestmentwaszero.

Impairmentlosses

Anygoodwillwhichisincludedinthecarryingamountofaninvestmentinanassociateis not separately recognised and is not separately tested for impairment. However, the entire carrying amount of the investment should be tested for impairment whenever there is an indication that impairment may have occurred. As usual, an impairment test involves
comparingthecarryingamountoftheinvestmentwiththehigherofitsvalueinuseandits fair value less costs of disposal (see Chapter 7).

Reportingperiodsandaccountingpolicies

IAS28makesruleswithregardtoreportingperiodsandaccountingpoliciesthataresimilar totheirIFRS10counterparts(seeChapter18).Insummary:

(a) Ifthereportingperiodofaninvestorandanassociateardifferent,theassociate shouldprepareadditionalfinancialstatementsfortheuseoftheinvestor,usingthe samereportingperiodastheinvestor.Ifthisisimpracticable,thefinancialstatements of the associate should be adjusted to take account of any significant transactions
oreventswhichoccurbetweentheendoftheassociate'sreportingperiodandtheendof the investor's reporting period. In any case, the difference between the end of the associate'sreportingperiodandthatoftheinvestorshouldnotexceedthreemonths.

(b) Theinvestor'sfinancialstatementsshouldbepreparedusinguniformaccounting policies. If an associate uses different accounting policies from those adopted by the investor, its financial statements should be adjusted to conform with the investor's accounting policies before the equity method is applied.

Jointarrangements

A "joint arrangement" exists if two or more parties exercise joint control over a business enterprise.IFRS11*JointArrangements*includesthefollowingdefinitions:

- Ajointarrangementis"*anarrangementofwhichtwoormorepartieshavejointcontrol*".
- Joint control is "*thecontractuallyagreedsharingofcontrolofanarrangement,whichexistsonlywhend ecisionsabouttherelevantactivitiesrequiretheunanimousconsentofthepartiesshari ngcontrol*".

Theimportantcharacteristicofajointarrangementthatdistinguishesitfromasubsidiary or associate is that there is a contractual agreement to share control. Without such an agreement,jointcontrolcannotexistandtheactivityconcernedisnotajointarrangement.

Although IFRS11 refers to entities in general, not only to companies, it is assumed in this chapterthatallofthepartiestoajointarrangementarecompanies.

Typesofjointarrangement

IFRS11identifiestwotypesofjointarrangementandprescribestheaccountingtreatment for each. These are as follows:

(a) **Jointoperations**.Ajointoperationis"*ajointarrangementwherebythepartiesthathavej ointcontrolofthearrangementhaverightstotheassets,andobligationsfortheliabilities, relatingtothearrangement*".Forexample,thepartiestoajointarrange- mentcouldagreetomanufactureaproducttogether,eachpartybeingresponsiblefor aspecifictaskandwitheachpartyusingitsownassetsandincurringitsown liabilities.Theagreementbetweenthese"jointoperators"wouldspecifythewayin whichtherevenueandexpensesoftheoperationshouldbesharedbetweenthem.

A joint arrangement that is notstructured as a "separate vehicle" (a business entitywhichisseparatefromthepartiestothearrangement)mustbeajointoperation.

(b) **Jointventures**. A joint venture is "*ajointarrangementwherebythepartiesthathavejointcontrolofthearrangementhaver ightstothenetassetsofthearrangement*". For example,thepartiestoajointarrangementmightestablishaseparatebusinessentity overwhichthepartieshavejointcontrolandwhichhasitsownassetsandliabilities. In this case, the assets and liabilities of the arrangement would belong to the separate entityandnottothepartiesthemselves.However,the"jointventurers"wouldeach have an interest in the net assets of the arrangement, generally by virtue of theirownership of shares in the separate entity concerned.

In most cases, a joint arrangement that isstructured as a separate vehicle would be regarded as a joint venture.

Accountingforajointarrangement

IFRS11specifiestherequiredaccountingtreatmentofeachtypeofjointarrangement.The requirements are broadly as follows:

(a) **Jointoperations**.Ajointoperationraisesnospecialaccountingproblems.Ingeneral terms,thefinancialstatementsofeachjointoperatorshouldrecognise:
   (i) itsassetsthatarebeingusedinthejointoperation,includingitsshareofany assets that are held jointly
   (ii) itsliabilitiesthatrelatetothejointoperation,includingitsshareofanyliabilities that are incurred jointly
   (iii) itsshareoftherevenuearisingfromthejointoperation
   (iv) itsshareoftheexpensesarisingfromthejointoperation.

   Thereisnoneedtopreparefinancialstatementsforthejointoperationitself.

(b) **Jointventures**. A joint venturer should recognise its interest in a joint venture as an investment in its own financial statements. This investment should normally beaccountedforbytheequitymethod(seeabove).Inthiscase,itwillalsobenecessary topreparefinancial statementsfor thejoint ventureitself.

Disclosurerequirements

IFRS12*DisclosureofInterestsinOtherEntities*(seeChapter18)requiresanentityto disclosethesignificantjudgementsandassumptionsithasmadeindeterminingthenature ofitsinterestinotherentities(e.g.significantinfluenceorjointcontrol)andthetypeof anyjointarrangementtowhichitisaparty.Theentityshouldalsodiscloseinformation whichenablestheusersofitsfinancialstatementstoevaluate:

(a) thenature, extent andfinancial effects ofits interests inassociates andits interests in joint arrangements
(b) the nature of (and changes in) any risks associated with its interests in associates andjoint arrangements.

Summary

- An associate is an entity over which the investor has significant influence. This will usuallybethecaseiftheinvestorownsatleast20%oftheinvestee'svotingpower.
- An investment in an associate should be accounted for by the equity method. The investment is initially recognised at cost and is then adjusted for the post-acquisition change in the investor's share of the associate's net assets. The investor's statement of comprehensiveincomeshowstheinvestor'sshareoftheassociate'sprofitorloss.
- Unrealised profits resulting from upstream and downstream transactions between an investorandanassociateshouldbeeliminatedtotheextentoftheinvestor'sinterest in the associate.
- Ajointarrangementexistsifinvestorsexercisejointcontroloverabusinessenterprise.IFRS11distinguishesbetweenjointoperationsandjointventures.
- In general terms, a joint operation is a joint arrangement in which the parties to the arrangement use their own assets and incur their own liabilities in relation to the arrangement. Each party recognises these assets and liabilities in its own financial statements,togetherwithitsshareoftheoperation'srevenueandexpenses.
- A joint venture is normally a separate business entity that is jointly controlled by the partiestothearrangement.Financialstatementsarepreparedforthisentityandeach jointventureraccountsforitsinvestmentintheentitybyusingtheequitymethod.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

20.1 (a)Explainwhatismeantbytheterms"associate"and"significantinfluence".

(b)Explaintheequitymethodofaccountingwhichisusedtoaccountforaninvestmentinanassociate.Alsoexplainhow thisdiffersfrom theconsolidationapproach which is used in relation to subsidiaries.

20.2 (a)Explainwhatismeantbytheterm "jointarrangement".

(b)Distinguishbetweenjointoperationsandjointventures.Outlinetheaccounting treatment prescribed for each of these by standard IFRS11.

20.3 The statements of financial position of M Ltd, P Ltd and Q Ltd as at 31 July 2020 are as follows:

	MLtd	PLtd	QLtd
	£000	£000	£000
Assets			
Non-currentassets			
Property,plantandequipment	2,570	370	280
InvestmentinPLtd	410		
InvestmentinQLtd	100		
	3,080		
Currentassets	1,150	220	170
	4,230	590	450
Equity			
Ordinarysharecapital	1,000	100	80
Retainedearnings	2,420	380	280
	3,420	480	360
Liabilities			
Currentliabilities	810	110	90
	4,230	590	450

Thefollowinginformationisavailable:

(a) On31July2017,MLtdpaid£410,000toacquire90%ofthesharecapitalofPLtd.Th eretainedearningsofPLtdonthatdatewere£220,000.Thecompany's issued share capital has not changed since M Ltd acquired its holding. On 31 July 2017,thefairvalueofthenon-currentassetsofPLtdwas£80,000higherthantheir book value. This valuation has not been reflected in the books of P Ltd.

(b) On31July2019,MLtdpaid£100,000toacquire25%ofthesharecapitalofQLtd. The retained earnings of Q Ltd on that date were £240,000 and all of its assets and liabilities were carried at fair value. The company's issued share capital has not changed since M Ltd acquired its holding.

(c) Therehavebeennoimpairmentlosses.

(d) Non-controllinginterestsinsubsidiariesaretobemeasuredattheappropriate proportion of the subsidiary's identifiable net assets.

(e) Anydepreciationconsequencesofthefairvalueadjustmentrelatingtothenon-current assets of P Ltd may be ignored.

Required:

PrepareaconsolidatedstatementoffinancialpositionforMLtdasat31July2020.

20.4 On 30 September 2016, KLtd paid £140,000 to acquire 40%of the share capital of LLtd (which became its associate). Draft financial statements for these two companies for the year to 30 September 2020 are as follows:

Statementsofcomprehensiveincomefor the year to 30 September 2020

	KLtd	LLtd
	£000	£000
Operatingprofit	600	135
DividendreceivedfromLLtd	20	-
Profitbeforetax	620	135
Taxation	120	25
Profitfortheyear	500	110

Statementsoffinancialpositionas at 30 September 2020

	KLtd	LLtd
	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment	1,600	400
InvestmentinLLtd,atcost	140	
	1,740	
Currentassets	780	290
	2,520	690
Equity		
Ordinarysharecapital	1,000	200
Retainedearnings	1,210	320
	2,210	520
Liabilities		
Currentliabilities	310	170
	2,520	690

Statementofchangesinequity(retainedearningsonly) for the year to 30 September 2020

	KLtd	LLtd
	£000	£000
Balanceat30September2019	710	260
Profitfortheyear	500	110
Dividendspaid	-	(50)
Balanceat30September2020	1,210	320

Thefollowinginformationisalsoavailable:

(i) In the draft financial statements of K Ltd, the company's investment in L Ltd has been recognised at cost and the dividend received from L Ltd has been recognised asincome.Thesefinancialstatementsshowthesituationasitwouldbewithout applicationoftheequitymethod,eitherintheyearto30September2020orin previous years.

(ii) The retained earnings of L Ltd on 30 September 2016 were £100,000 and all of its assetsandliabilitieswerecarriedatfairvalue.Neithercompanyhasissuedany shares since that date.

(iii) Duringtheyearto30September2020,K Ltdboughtgoodsfrom LLtdfor£30,000 which had cost L Ltd £20,000. One-quarter of these goods were unsold by K Ltd at 30 September 2020.

Required:

PreparethefinancialstatementsofKLtdfortheyearto30September2020.

*20.5 On1October2019Pumiceacquiredthefollowingnon-currentinvestments:

(i) 80%oftheequitysharecapitalofSilvertonatacostof£13.6million
(ii) 50%ofSilverton's10%loannotesatpar
(iii) 1.6millionequitysharesinAmokatacostof£6.25each.

Draftstatementsoffinancialpositionofthethreecompaniesat31March2020are:

	Pumice	Silverton	Amok
	£000	£000	£000
Assets			
Non-currentassets			
Property,plantandequipment	20,000	8,500	16,500
Investments	26,000		1,500
	46,000	8,500	18,000
Currentassets	15,000	8,000	11,000
	61,000	16,500	29,000
Equity			
Ordinarysharesof£1each	10,000	3,000	4,000
Retainedearnings	37,000	8,000	20,000
	47,000	11,000	24,000
Liabilities			
Non-currentliabilities			
8%loannotes	4,000		
10%loannotes		2,000	
Currentliabilities	10,000	3,500	5,000
	61,000	16,500	29,000

Thefollowinginformationisrelevant:

(i) The fair values of Silverton's assets were equal to their carrying amounts with the exception of land and plant. Silverton's land had a fair value of £400,000 in excess ofitscarryingamountandplanthadafairvalueof£1.6millioninexcessofits carryingamount.Theplanthadaremaininglifeoffouryears(straight-line depreciation) at the date of acquisition.

(ii) Inthepost-acquisitionperiod,PumicesoldgoodstoSilvertonatapriceof£6 million. These goods had cost Pumice £4 million. Half of these goods were still in theinventoryofSilvertonat 31March 2020. SilvertonhadabalanceofÂ£1.5 million owing to Pumice at 31 March 2020 which agreed with Pumice's records.

(iii) Thenetprofitaftertaxfortheyearended31March2020was£2millionfor Silverton and £8 million for Amok. Assume profits accrued evenly throughout the year.

(iv) Animpairmenttestat31March2020concludedthatconsolidatedgoodwillwas impaired by £400,000 and the investment in Amok was impaired by £200,000.

(v) Nodividendswerepaidduringtheyearbyanyofthecompanies.

(vi) Non-controllinginterestsinsubsidiariesaretobemeasuredattheappropriate proportion of the subsidiary's identifiable net assets.

Required:

(a) ExplainhowtheinvestmentspurchasedbyPumiceon1October2019shouldbetr eated in its consolidated financial statements.

(b) Prepare the consolidated statement of financial position for Pumice as at 31 March 2020. *(ACCA)*

Chapter21

Relatedpartiesandchangesinforeignexchangerates

Introduction

Thischapterisconcernedwithtwofurtherinternational standardswhichmayberelevant whenpreparingthefinancialstatementsofagroupofcompanies.Thefirstoftheseis IAS24 *RelatedPartyDisclosures*, which requires entities to make certain disclosures about their relationships with other parties, including parent-subsidiary relationships. The other standard considered in this chapter is IAS21 *TheEffectsofChangesinForeignExchangeRates*.Thisstandardprescribestheaccountingtreatmentofforeigncurrencytransactions andisalsoapplicableifanentityhasaforeignoperation(e.g.aforeignsubsidiary).

Although these standards are probably of most significance for groups of companies, itshould be appreciated that their scope covers entities in general and that both of them are applicable to individual companies as well as to groups.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explainwhatismeantbya"relatedparty"
- identifytherelatedpartiesofareportingentity
- listthemaindisclosuresrequiredbyinternationalstandardIAS24
- determine an entity's functional currency and distinguish between its functionalcurrency and its presentation currency
- record foreign currency transactions in an entity's functional currency, both on initialrecognitionandsubsequently,accountingcorrectlyforexchangedifferences
- translate an entity's financial statements into a presentation currency and translate thefinancial statements of a foreign operation.

Relatedparties

The objective of IAS24 *RelatedPartyDisclosures*is to ensure that financial statementscontaincertaindisclosures.Thesedisclosuresshoulddrawattentiontotheposs ibilitythat anentity'sfinancialperformanceandpositionmayhavebeenaffectedby:

(a) theexistenceofrelatedparties,and

(b) transactionswiththoseparties.

The standard accepts that relationships with other parties (e.g. subsidiaries) are a normalfeature of business and commerce, but points out that related parties might enter into transactionsthatunrelatedpartieswouldnot.Forinstance,asubsidiarycompanywhich sellsgoodstoitsparentatcostpricewouldprobablynotsellgoodsonthosetermstoany othercustomer.Suchatransactionwouldofcourseaffecttheprofitofboththesubsidiary andtheparent.Ingeneral,transactionsbetweenrelatedpartiesmightinvolve:

(a) thetransferofassetsorliabilitiesatpriceswhichareaboveorbelowtheirtruevalue

(b) thesupplyofservicesatreducedorincreasedprices

(c) themakingofloansatinterestrateswhichdifferfrommarketrates.

Eventhemereexistenceofarelationshipwithanotherpartymightaffectanentity's financialperformanceandposition,whetherornottherearеanytransactionswiththat party. For instance, a subsidiary might be instructed by its parent to trade only with certain suppliersorperhapstoceaseallresearchanddevelopmentactivity.

In summary, the users of financial statements cannot properly assess an entity's financial performanceandpositionunlesstheyaresuppliedwithinformationabouttheentity's related parties and its transactions with those parties.

Definitionofrelatedpartyandrelatedpartytransaction

IAS24 defines a related party as "*apersonorentitythatisrelatedtotheentitythatispreparingitsfinancialstatements*". The term "reporting entity" is used to refer to the entitythatispreparingitsfinancialstatements.Theruleswhichdeterminewhetherornota personorentityisrelatedtothereportingentitymaybesummarisedasfollows:

(a) Aperson(P)oraclosememberofthatperson'sfamilyisrelatedtoareportingentity if *any*of the following conditions applies:

  (i) Phascontrolorjointcontrolofthereportingentity.

  (ii) Phassignificantinfluenceoverthereportingentity.

  (iii) Pisamemberofthekeymanagementpersonnelofeitherthereportingentityor a parent of the reporting entity.

(b) Anentity(E)isrelatedtoareportingentityif*any*ofanumberofconditionsapplies. The main conditions are as follows:

(i) EntityEandthereportingentityaremembersofthesamegroup.

(ii) EntityEisanassociateorjointventureofthereportingentity(orviceversa).

(iii) EntityEandthereportingentityarebothjointventuresofthesamethirdparty.

(iv) EntityEisanassociateofathirdentityandthereportingentityisajointventure of that same third entity (or vice versa).

(v) Entity Eis a post-employment benefit plan (a pension scheme) for the benefit ofthe employees of the reporting entity or for the benefit of the employees of any entity which is related to the reporting entity.

(vi) EntityEiscontrolledorjointlycontrolledbyapersonidentifiedin(a)above.

(vii) A person identified in (a)(i) above has significant influence over Entity E or is a memberofthekeymanagementpersonnelofEntityEorofaparentofEntityE.

(viii) EntityEprovideskeymanagementpersonnelservicestothereportingentityor to its parent.

Closemembersofaperson'sfamilyare"*thosefamilymemberswhomaybeexpectedtoinfluence, orbeinfluencedby,thatpersonintheirdealingswiththeentity*".Theyinclude:

(a) theperson'schildrenandspouseordomesticpartner

(b) childrenoftheperson'sspouseordomesticpartner

(c) dependantsofthepersonoroftheperson'sspouseordomesticpartner.

Keymanagementpersonnelare"*thosepersonshavingauthorityandresponsibilityforplanning,directingandcontrollingtheactivitiesoftheentity...includinganydirector...*".

Arelatedpartytransactionisdefinedas"*atransferofresources,servicesorobligationsbetweenareportingentityandarelatedparty,regardlessofwhetherapriceischarged*"..

Partiesthatarenotnecessarilyrelated

Thefollowingarenotnecessarilyrelatedparties,thoughitisalwaysimportanttoexamine thesubstanceofeachrelationshipandnotmerelyitslegalform:

(a) twoentitiessimplybecausetheyhaveadirectorincommon,orsomeothermember of their key management personnel in common

(b) twojointventurerssimplybecausetheysharejointcontroloverajointventure

(c) providers of finance, trade unions, public utilities and government departments or agencies,simplybyvirtueoftheirnormaldealingswithanentity

(d) a customer, supplier, franchisor, distributor or general agent with whom an entitytransacts a significant volume of business, merely by virtue of the resulting economic dependence.

DisclosuresrequiredbyIAS24

IAS24isprincipallyadisclosurestandardandthereforeitsdisclosurerequirementsare quiteextensive.Themaindisclosuresthatarerequiredareasfollows:

(a) Parent-subsidiary relationships must be disclosed whether or not there have been any transactionsbetweentheseparties.Thereportingentityshoulddisclosethenameof its parent and, if different, the name of the ultimate controlling party. These requirementsareinadditiontotherequirementsofIFRS12(seeChapter18).

(b) The reporting entity should disclose key management personnel "compensation" (i.e. employeebenefits)intotalandforeachofthefollowingcategories:

(i) short-termemployeebenefits (ii)post-employmentbenefits
(iii)otherlong-termbenefits (iv)terminationbenefits
(v)share-basedpayments.

These categories are all defined in IAS19 *EmployeeBenefits*or IFRS2 *Share-basedPayment*(see Chapter 14).

(c) Iftherehavebeentransactionswitharelatedparty,thereportingentityshould disclosethenatureoftherelationshipandprovideinformationaboutthetransactions and any outstanding balances, as necessary for an understanding of the effect of the relationshiponthefinancialstatements.Asaminimum,disclosuresshouldinclude:

(i) theamountofthetransactions
(ii) theamountofanyoutstandingbalancesandtheirtermsandconditions
(iii) any allowances for doubtful debts relating to these outstanding balances and the amountofanyexpenserecognisedduringtheperiodinrespectofbador doubtful debts due from related parties.

Thesedisclosuresshouldbemadeseparatelybythereportingentityforeachcategory ofrelatedparty(e.g.thereportingentity'sparent,subsidiaries,associates,joint ventures, key management personnel etc.).

(d) IAS24givesexamplesoftransactionsthatshouldbedisclosediftheyarewitha related party. These include:

(i) purchasesorsalesofgoods
(ii) purchasesorsalesofpropertyandotherassets
(iii) therenderingorreceivingofservices
(iv) leases
(v) loansandequitycontributions
(vi) provisionofguaranteesorcollateral
(vii) settlementofliabilitiesonbehalfofthereportingentitybytherelatedpartyor by the reporting entity of behalf of the related party.

Foreignexchangeaccounting

IAS21 *TheEffectsofChangesinForeignExchangeRates*statesthatanentitymaycarry onforeignactivitiesintwoways.Ontheonehand,theentitymayhavetransactionswhich areexpressed(or "denominated") inaforeigncurrency. Ontheother hand,theentity may haveaforeignoperation(e.g.aforeignsubsidiary).Furthermore,anentitymightpresent its financial statements in a foreign currency. The objective of IAS21 is to prescribe the accounting treatment of foreign currency transactions and foreign operations and to set outrulesforthetranslationoffinancialstatementsintoaforeigncurrency.

Thestandardprovidesanumberofdefinitions.Themostsignificantofthesedefinitions are as follows:

(a) Anentity'sfunctionalcurrencyis"*thecurrencyoftheprimaryeconomicenvironmentinwhichtheentityoperates*".

(b) Aforeigncurrencyis"*acurrencyotherthanthefunctionalcurrencyoftheentity*".

(c) Anentity'spresentationcurrencyis"*thecurrencyinwhichthefinancialstatementsarepresented*".

(d) A foreign operation is "*anentitythatisasubsidiary,associate,jointarrangementorbranchofareportingentity,theactivitiesofwhicharebasedorconductedinacountryorcurrencyotherthanthoseofthereportingentity*".

Determinationofanentity'sfunctionalcurrency

As stated above, an entity's functional currency is the currency of the primary economic environment in which it operates. This is usually the main environment in which the entity generates and expends cash. When determining its functional currency, an entity should consider the following factors:

(a) thecurrencythatmainlyinfluencessalespricesforitsgoodsandservices(whichis oftenthecurrencyinwhichthesepricesaredenominatedandsettled)

(b) the currency of the country whose competitive forces and whose regulations mainly determine the sales prices of its goods and services

(c) the currency that mainly influences labour costs, materials costs and other costs of providing goods and services (which is often the currency in which such costs are denominated and settled).

Furtherfactorswhichprovideevidenceofanentity'sfunctionalcurrencyarethecurrency in which funds from financing activities are generated (e.g. loans and share issues) and the currency in which receipts from operating activities are usually retained. If the evidence
providedbyallofthesevariousfactorsismixed,thenthemanagementoftheentityshould useitsjudgementtodeterminetheentity'sfunctionalcurrency.

If the functional currency of an entity is the currency of a hyperinflationary economy, its financial statements must be restated in accordance with IAS29

FinancialReportinginHyperinflationaryEconomies(see Chapter 17).

Reportingforeigncurrencytransactions

IAS21definesaforeigncurrencytransactionas"*atransactionthatisdenominatedorrequiressettlementinaforeigncurrency*".Thisdefinitionincludestransactionssuchas:

(a) thepurchaseorsaleofgoodswhosepriceisdenominatedinaforeigncurrency

(b) theborrowingorlendingofamountswhicharedenominatedinaforeigncurrency.

On initial recognition, a foreign currency transaction should be recorded in the entity's functionalcurrencybyapplyingthespotexchangeratebetweenthefunctionalcurrency andtheforeigncurrencyasatthedateofthetransaction.Thespotexchangerateisdefined as "*theexchangerateforimmediatedelivery*". For practical purposes, an average rate for a week or month may be used for all transactions occurring in that week or month as long as exchangeratesdonotfluctuatesignificantlyduringthattime.

Subsequently,thetreatmentofaforeigncurrencyiteminthestatementoffinancial position depends upon whether the item is a monetary item or a non-monetary item andwhetheritiscarriedathistoricalcostoratfairvalue.Monetaryitemsaredefinedas"*unitsofcurrencyheldandassetsorliabilitiestobereceivedorpaidinafixedordeterminablenumberofunitsofcurrency*".Attheendofeachreportingperiod:

(a) foreigncurrencymonetaryitemsshouldbetranslatedusingthespotexchangerateat the end of the reporting period (the "closing rate")

(b) non-monetaryforeigncurrencyitemscarriedathistoricalcostshouldbetranslatedusingthe exchangerateatthedateofthetransactionwhichgaverisetotheitem

(c) non-monetaryforeigncurrencyitemscarriedatfairvalueshouldbetranslatedusing theexchangerateatthedatethattheitem'sfairvaluewasmeasured.

AsstatedinChapter10,IAS2*Inventories*requiresthatinventoriesaremeasuredatthe lower of cost and net realisable value (NRV). The carrying amount of inventory which is measuredinaforeigncurrencyisdeterminedbytakingthelowerof:

(a) itscost,translatedattheexchangerateatthedatethatitwasacquired,and

(b) itsNRV,translatedusingtheclosingrateattheendofthereportingperiod.

Treatmentofexchangedifferences

Exchangedifferenceswhichariseonthesettlementofmonetaryitems,oronthetrans- lation of monetary items at exchange rates which are different from those used at initial recognition,shouldberecognisedasincomeorexpenseswhencalculatingtheentity's profit or loss for the period.

Ifagainorlossonanon-monetaryitemisrecognisedinthecalculationoftheentity's profit or loss (e.g. on disposal) then any exchange component of that gain or loss is also recognisedinthecalculationofprofitorloss.Butifagainorlossonanon-monetaryitem is recognised in other comprehensive income (e.g. on a revaluation) then any exchange componentofthatgainorlossisalsorecognisedinothercomprehensiveincome.

EXAMPLE1

AUKcompanypreparesfinancialstatementsto31Decemberandhasthepoundsterlingasitsfunctionalcurrency.On27November2019,thecompanybuysinventoryfor$7,440.Thecompanystillholdsthisinventoryat31December2019(whenitsnetrealisablevalueis£7,000)anddoesnotpayfortheinventoryuntil16February2020.

(a) Explainhowthistransactionshouldberecordedon27November2019.

(b) Explainhowanyitemsoutstandingon31December2019shouldbeshowninthecompany'sstatementoffinancialpositionatthatdateandhowanyexchangedifferencesshouldbedealtwithinthecompany'sfinancialstatements.

(c) Explainhowthepaymenton16February2020shouldbeaccountedfor.

(£1=$1.50on27Nov2019;£1=$1.60on31Dec2019;£1=$1.55on16Feb2020).

Solution

(a) On27November2019,thecompanyshouldrecordapurchaseof£4,960($7,440÷1.50)andatradepayableofthesameamount.

(b) On31December2019,thecostoftheinventoryisstill£4,960.ItsNRVis£7,000soitshouldbeshowninthecompany'sstatementoffinancialpositionat£4,960.Thetradepayableof$7,440shouldbeshownas£4,650($7,440÷1.60).

Thetradepayableisnow£310lessthaninitiallyrecorded(£4,960–£4,650)sothereisanexchangegainof£310whichshouldberecognisedasincomewhencalculatingthecompany'sprofitorlossfortheyear.Notethatthisisan*unrealised*gainandyetIAS21requiresthatitshouldbeincludedinthecalculationofprofitorloss.

(c) On16February2020,itcoststhecompany£4,800($7,440÷1.55)tosettlethetradepayableof£4,650.Thereisanexchangelossof£150(£4,800–£4,650)andthisshouldberecognisedasanexpenseinthe2020financialstatements.

EXAMPLE2

AUKcompanypreparesfinancialstatementsto31Marchandhasthepoundsterlingasitsfunctionalcurrency.On15July2019,thecompanybuysaninvestmentpropertyfor €660,000.Thefairvalueofthispropertyon31March2020is€687,500.

(a) Explainhowthistransactionshouldberecordedon15July2019.

(b) Explainhowtheinvestmentpropertyshouldbedealtwithinthecompany'sfinancialstatementsfortheyearto31March2020.

(c) Howwouldthesituationdifferiftheitemboughtbythecompanyon15July2019hadbeenpropertyplantandequipment(accountedforusingtherevaluationmodel)ratherthaninvestmentproperty?

(£1=€1.20on15Jul2019;£1=€1.10on31Mar2020).

Solution

(a) Thepropertyisinitiallyrecognisedatitscostof£550,000(€660,000÷1.20).

(b) Thepropertyshouldbeshowninthestatementoffinancialpositionatitsfairvalueof £625,000(€687,500÷1.10)andthecompanyshouldrecogniseagainof£75,000whencalculatingitsprofitorlossfortheyear.Thisgainconsistsofanexchangegainof£50,000inrelationtotheinitialcostoftheproperty((€660,000÷1.10)–(€660,000 ÷1.20))plusarevaluationsurplusof£25,000(€27,500÷1.10).

(c) Iftheitemhadbeenproperty,plantandequipmentaccountedforbytherevaluationmodel,thegainof£75,000(includingtheexchangegainof£50,000)wouldhavebeenrecognisedinothercomprehensiveincome(seeChapter5).

Translationtoapresentationcurrency

Althoughmostentitiespresenttheirfinancialstatementsintheirfunctionalcurrency, IAS21 allows entities to use a different presentation currency if they wish. The process of translatingfromthefunctionalcurrencytothepresentationcurrencyisasfollows:

(a) Assets and liabilities in the statement of financial position are translated at the closingrate at the end of the reporting period.

(b) Incomeandexpensesshowninthestatementofcomprehensiveincomearetranslated at the exchange rates which applied on the dates of the transactions. But an average exchangeratefortheperiodmaybeusedunlessrateshavefluctuatedsignificantly.

(c) Theresultingexchangedifferencesarerecognisedinothercomprehensiveincomeand areaccumulatedinaseparatecomponentofequity(aforeignexchangereserve).

Unfortunately,IAS21doesnotspecifythetranslationratetobeusedforequityitemssuch asacompany'ssharecapital.Obviouschoicesaretheratewhichappliedwhentheshares were originally issued (the "historical rate") and the closing rate at the end of the reporting period.Inpractice,thehistoricalrateisgenerallyregardedasmoreappropriate.

Translationofaforeignoperation

Ifanentityhasaforeignoperation(e.g.aforeignsubsidiary,associateorjointventure)it willbenecessarytotranslatethefinancialstatementsofthatoperationintothesame currency as is used in the entity's own financial statements. Only then will it be possible to includetheforeignoperationintheentity'sfinancialstatementsbyeitherconsolidation (seeChapter18)ortheequitymethod(seeChapter20).Thetranslationprocessrequired by IAS21 in these circumstances is the same as the process adopted when translating anentity'sfinancialstatementsfromafunctionalcurrencytoapresentationcurrency.

When an entity disposes of a foreign operation, the cumulative amount of the exchange differences which have been recognised in other comprehensive income in relation to that operationarereclassifiedtoprofitorloss(seeChapter3).

EXAMPLE3

On1January2020,aUKcompanyformedaforeignsubsidiaryinacountrywherethelocalcurrencyistheUtopiandollar($).Thesummarisedfinancialstatementsofthisforeignsubsidiaryfortheyear to31December2020areasfollows:

Statementofcomprehensiveincomefortheyearto31December2020

	$
Salesrevenue	810,000
Expenses	719,640
Profitfortheyear	90,360

Statementoffinancialpositionasat31December2020

	$
Assets	268,000
Sharecapital(issued1Jan2020)	100,000
Retainedearnings	90,360
	190,360
Liabilities	77,640
	268,000

Translatethesefinancialstatementsinto£sterling,assumingthat£1=$5on1Jan2020, £1=$4on31Dec2020andthattheaverageratefortheyearwas£1=$4.5.

Solution

Statementofcomprehensiveincomefortheyearto31December2020

	$	Rate	£
Salesrevenue	810,000	4.5	180,000
Expenses	719,640	4.5	159,920
Profitfortheyear	90,360		20,080
Othercomprehensiveincome	-		7,510
	90,360		27,590

Statementoffinancialpositionat31December2020

	$	Rate	£
Assets	268,000	4.0	67,000
Sharecapital	100,000	5.0	20,000
Retainedearnings	90,360		20,080
Foreignexchangereserve	-	bal.fig.	7,510
	190,360		47,590
Liabilities	77,640	4.0	19,410
	268,000		67,000

Notes:

(i) Salesandexpenseshavebeentranslatedataveragerate.Assetsandliabilitieshavebeentranslatedatclosingrate.Sharecapitalhasbeentranslatedathistoricalrate.

(ii) Thereisanexchangedifferenceof£7,510(thebalancingfigureinthestatementoffinancialposition).Thisiscreditedtoaforeignexchangereserveandrecognisedasothercomprehensiveincomeinthestatementofcomprehensiveincome.

(iii) Infuturestatementsoffinancialposition,theretainedearningsfigurewillbeequaltotheamount(in£)broughtforwardfromthepreviousyearplusanyfurtherretainedearningsarisingduringthecurrentyear(translatedattheaverageratefor thatyear).

(iv) Ineachyearfromnowon,theforeignexchangereserveinthestatementoffinancialpositionwillbeinsertedasabalancingfigure.Theamountbywhichthisreservehasincreasedordecreasedsincethepreviousyearwillberecognisedinthestatementofcomprehensiveincomeasothercomprehensiveincome.

Summary

- IAS24 requires certain disclosures with regard to an entity's related parties and its transactions with those parties.
- The list of an entity's related parties includes parents, subsidiaries, associates, joint ventures,keymanagementpersonnelandtheentity'spensionscheme.
- Parent-subsidiary relationships must be disclosed whether or not there are anytransactionsbetweentheseparties.Entitiesmustalsodisclosekeymanagement personnel benefits. If there have been transactions with related parties, the entity must providedetailsoftherelationships,thetransactionsandanyoutstandingbalances.
- Anentity'sfunctionalcurrencyisthecurrencyoftheprimaryeconomicenvironment in which it operates.
- A foreign currency transaction is one that is denominated or requires settlement in a foreigncurrency.Suchtransactionsarerecordedinitiallyattheexchangerateonthe date of the transaction.
- Monetary foreign currency items in the statement of financial position are translatedusingtheclosingrateattheendoftheperiod.Non-monetaryforeigncurrencyitems aretranslatedusingtheexchangerateonthedateoftheoriginaltransactionor(for itemsshownatfairvalue)attherateonthedatethatfairvaluewasmeasured.
- Exchange differences arising in relation to foreign currency transactions are usually recognisedasincomeorexpenseswhencalculatingtheentity'sprofitorloss.
- IAS21 contains rules for translating financial statements from the entity's functional currency to a presentation currency. These rules also apply to the translation of the financial statements of a foreign operation.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

21.1 ThefollowinginformationrelatestoZplc:

(a) Alanowns27%oftheordinarysharesofZplc.Elaineishiswife.

(b) Zplcowns60%oftheordinarysharesofYplc.

(c) Zplcowns15%oftheordinarysharesofXplc.

(d) BarbaraisadirectorofZplc.Sheowns75%oftheordinarysharesofWLtd. David is her husband. He owns 10% of the ordinary shares of V Ltd.

(e) ColinworksforZplcasamanagerbutheisnotadirector.Fionaishisdaughter.

(f) Zplchasestablishedapensionschemeforthebenefitofitsemployee

s. Identify those parties (if any) which are related to Z Plc.

21.2 Dalle Ltd is a UK company which has the pound sterling as its functional currency. The company has the following transactions in Euros (€) during the year to 31 March 2020:

1 January 2020 Equipment costing €143,750 bought on credit from X 1 February 2020 Inventory costing €48,000 bought on credit from Y28 February 2020Paid X in full for the equipment bought on 1 January
15 March 2020 Paid Y €13,200 on account for the inventory bought on 1 February 15 March 2020 Sold inventory to Z on credit for €77,000

Exchangeratesmaybeassumedasfollows:

1January2020	£1=€1.25	15March2020	£1=€1.10
1February2020	£1=€1.20	31March2020	£1=€1.00
28February2020	£1=€1.15		

The equipment bought on 1 January 2020 is carried at historical cost in the company's statement of financial position at 31 March 2020. The cost of the company's inventory at that date does not exceed its net realisable value.

(a) Explaintheaccountingtreatmentofeachoftheabovetransactions.

(b) Calculate the exchange difference for the year to 31 March 2020 and explain how this difference should be dealt with in the company's financial statements.

21.3 On 1 July 2018, a UK company formed a foreign subsidiary in a country which has the Florin(Fn)asitscurrency.Thesummarisedfinancialstatementsofthissubsidiaryfort he years to 30 June 2019 and 2020 are as follows:

StatementsofcomprehensiveincomefortheyeartO30June

	2019 Fn	2020 Fn
Salesrevenue	67,200	71,820
Expenses	40,320	41,580
Profitforthevear	26.880	30.240

Statementsoffinancialpositionas at30June

	2019	2020
	Fn	Fn
Assets	112,400	145,920
Sharecapital(issued1July2018)	60,000	60,000
Retainedearnings	26,880	57,120
	86,880	117,120
Liabilities	25,520	28,800
	112,400	145,920

Exchangeratesareasfollows:

1July2018	£1=Fn6
30June2019	£1=Fn4
30June2020	£1=Fn4.8

The average exchange rate for the year to 30 June 2019 was £1 = Fn 5 and the average exchange rate for the year to 30 June 2020 was £1 = Fn 4.5

Required:

Translate the financial statements for both years into £ sterling, in accordance with the requirements of IAS21.

***21.4** Relatedpartyrelationshipsareacommonfeatureofcommerciallife.Theobjectiveof IAS24*RelatedPartyDisclosures*istoensurethatfinancialstatementscontainthe necessarydisclosurestomakeusersawareofthepossibilitythatfinancialstatements may have been affected by the existence of related parties.

Hideaway is a public listed company that owns two subsidiary company investments. It owns100%oftheequitysharesofBenedictand55%oftheequitysharesofDepret. Duringtheyearended30September2020DepretmadeseveralsalesofgoodstoBenedict.Thesesalestotalled£15millionandhadcostDepret£14millionto manufacture. Depret made these sales on the instruction of the Board of Hideaway. It is known that one of the directors of Depret, who is not a director of Hideaway, is unhappy with the parentcompany's instruction as he believes the goods could have been sold to othercompaniesoutsidethegroupatthefarhigherpriceof£20million.Alldirectors within the group benefit from a profit sharing scheme.

Required:

(a) Describethemaincircumstancesthatgiverisetorelatedparties.

(b) Explain why the disclosure of related party relationships and transactions may be important.

(c) Describe the financial effect that Hideaway's instruction may have on the financial statements of thecompanies within the group and the implications this may haveforotherinterestedparties. *(ACCA)*

Part4

ANALYSISOFFINANCIALSTATEMENTS

Chapter22

Ratioanalysis

Introduction

So far, this book has been concerned almost exclusively with the preparation of financial statements. In this chapter, we turn our attention to the interpretation of the information contained in these statements.

The IASB *ConceptualFramework*(see Chapter 2) states that the objective of financial reporting is to provide users with information which will help them make decisions about providingresourcestoanentity.Confrontedwithasetoffinancialstatements,userswill need to analyse the information provided and draw some conclusions about the financial performanceandfinancialpositionoftheentityconcerned.

Therearesevеralwaysinwhichfinancialstatementsmightbeanalysed.Inpractice,one ofthemostimportantmethodsisthetechniqueknownas*ratioanalysis*,whichinvolves the calculation of a number of accounting ratios. The main purpose of this chapter is to introducethemostcommonly-usedaccountingratiosandtoexplainthesignificanceof eachratio.Theonlyratioaddressedbyaninternationalstandard(IAS33)istheearnings pershareratio,whichisexplainedinsomedetailinChapter23ofthisbook.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explain the role of accounting ratios in the analysis and interpretation of theinformation provided in financial statements
- defineeachofthemostcommonly-usedaccountingratios
- performaratioanalysisofasetoffinancialstatements
- explainthelimitationsofratioanalysis
- brieflyexplainthetechniqueofmultivariateratioanalysis.

Accountingratios

Anaccountingratioisameasureoftherelationshipwhichexistsbetweentwofigures shown in a set of financial statements. For example, the gross profit margin (see below) measurestherelationshipbetweengrossprofitandsales.Theusefulnessofaccounting ratiosintheanalysisandinterpretationofaccountinginformationcanbeillustratedby means of the following example.

Supposethatacompanymakesaprofitof£11millionintheyear2019,asopposedto £10 million in 2018. A shareholder seeking to assess the company's performance might ask whether the company has done better in 2019 than in 2018. The obvious answer to thisquestionis"Yes".However,thecompanymayhaveraisedsubstantialamountsofextra capitalatthestartoftheyear2019,inwhichcaseamere10%increaseinprofitmightin factrepresentadeteriorationinfinancialperformance.Theproblemisthatthetwoyears maynotbedirectlycomparableandthisproblembecomesevenworseifonebusiness entity is compared with another.

Ingeneral,theproblemsofcomparabilityarereducedoreliminatedifaccountingratios arecompared,ratherthanabsolutefigures.Intheaboveexample,theratioofprofitto capitalin2019shouldbecalculatedandcomparedwiththeequivalentfigurefor2018. Thiswillgiveamuchbetterindicationofthecompany'sperformancethancanbeobtained bycomparingtheabsoluteprofitfiguresforthetwoyears.

Ratiosasameansofcomparison

Performingaratioanalysisonasinglesetoffinancialstatementsisusuallyafairly pointlessexercise.Mostoftheratiosbecomemuchmoremeaningfulwhenusedasabasis forcomparison.Ingeneral,ratiosareusedformakingthefollowingcomparisons:

(a) **Comparingoneperiodwithanother**.Thefinancialperformanceofabusinessentity foragivenaccountingperiodanditsfinancialpositionattheendofthatperiodmay bejudgedbycalculatingasetofratiosandthencomparingtheresultswiththe equivalent ratios for the same business in previous accounting periods. This type of comparisonisoftenreferredtoasa"trendanalysis"andanyperceivedtrendsmight beextrapolatedintothefutureandusedasabasisformakingeconomicforecasts.

(b) **Comparingoneentitywithanother**. Similarly, the ratios calculated for a businessentity in a given accounting period may be compared with those calculated for other businessesinthesameperiod(thoughthiscomparisonwouldusuallybevalidonlyif all of the businesses were in the same type of trade).

Whenusedasameansofcomparison,accountingratiosareundoubtedlyavaluabletool fortheanalysisoffinancialstatements.However,ratioanalysisdoessufferfromanumber oflimitationsandtheusershouldbeawareofthesebeforebasingimportantdecisionson theresultsofsuchananalysis.Thelimitationsofratioanalysisarediscussedtowardsthe end of this chapter.

Typesofaccountingratio

Intheory,itwouldbepossibletocalculateliterallyhundredsofaccountingratiosfroma singlesetoffinancialstatements.Someoftheseratioswouldnotmeanverymuchbut many of them might serve a useful purpose. In practice, however, it is usually sufficient to calculate a fairly small number of key ratios and each of these ratios is described in thischapter. They can be classified into four main groups:

(a) **Profitabilityratios**.Theprofitabilityratiosareusedtoassesswhetherthebusiness has succeeded in making an acceptable level of profit.

(b) **Liquidityratios**.Theliquidityratiosareameasureoftheabilityofthebusinessto pay its debts as they fall due.

(c) **Efficiencyratios**.Theefficiencyratiosprovidesomeindicationoftheextentto whichtheassetsofthebusinesshavebeenefficientlyusedandmanaged.

(d) **Investmentratios**.Theinvestmentratiosaremainlyofinteresttoinvestorsor potential investors and may help these users to decide whether or not a businessrepresentsaworthwhileinvestment.However,someoftheinvestmentratios maybe of interest to other user groups.

Manyoftheaccountingratioscouldbecalculatedforanykindofbusinessentity(sole trader,partnershiporcompany)butsomeofthemarerelevantonlytocompanies.Since ratioanalysisismostfrequentlyappliedtothefinancialstatementsofcompanies,itis assumed for the remainder of this chapter that the business entity for which ratios are being calculated is a company.

Themainratiosineachoftheabovegroupsaredefinedandexplainedbelow.Towards theendofthechapterthereisacomprehensivenumericalexamplewhichillustratesthe way in which each ratio is calculated.

Profitabilityratios

Themainprofitabilityratios† are:

(a) Returnoncapitalemployed
(b) Returnonequity
(c) Grossprofitmargin
(d) Netprofitmargin.

† *Alloftheprofitabilityratiosareillustratedinthecomprehensiveexample(Quandockplc)whichis providedlaterinthischapter.*

Returnoncapitalemployed(ROCE)

This important ratio expresses a company's profit as a percentage of the amount of capital investedinthecompany.However,thereareseveraldifferentwaysofcalculatingROCE, each using a different definition of the words "profit" and "capital employed". A fairlycommon definition is as follows:

$$\text{ROCE} = \frac{\text{Profitbeforelong-terminterestand tax}}{\text{Sharecapital andreservesplusnon-current liabilities}} \times 100\%$$

ThisversionofROCEinterprets"capitalemployed"asthe*total*amountofmoneyinvested in the company in the long term, regardless of whether that money has been supplied by shareholdersorlenders.Thisamountisthencomparedwiththereturnachievedonthat capital. Note that:

(a) The numerator used in the calculation of ROCE is often referred to as PBIT. If a company's financial statements do not distinguish between short-term and long-term interest,itmaybenecessarytousethefigureforprofitbeforetotalinterestandtax. Thiswillmakelittledifferenceiftheamountofshort-terminterestisnotmaterial.

(b) SincethedenominatorusedinthecalculationofROCEisequaltothetotalassetsof thecompanylessitscurrentliabilities,thisratioissometimesreferredtoasthe*returnon netassets*.

(c) Ideally, any ROCE calculation should be based upon the *average* amount of capital employedinthecompanyduringtheperiodandthiscanbeapproximatedby averagingtheopeningandclosingcapitalfigures.However,thecalculationofROCE isoftenbaseduponclosingcapitalonly,sinceopeningcapitalmaynotbeknownfor alloftheaccountingperiodsunderreview.Thesamepointalsoappliestothe calculation of a company's return on equity (see below).

(d) If a company's capital employed is understated in the financial statements, possibly becausenon-currentassetssuchaspropertyareshownatcostratherthancurrent value, the ROCE figure will be misleadingly high. This point highlights the fact that accountingratiosareaffectedbyaccountingpolicies(seelaterinthischapter).

As stated above, ROCE can be defined as PBIT divided by net assets (where net assets are defined for this purpose as total assets less current liabilities). This view of ROCE makes it clear that the ROCE ratio can actually be broken down into two subsidiary components, as indicated by the following formula:

$$\text{ROCE} = \frac{\text{PBIT}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Netassets}}$$

The first of these components is a profitability ratio known as the "profit margin" and the second component is an efficiency ratio known as "asset turnover". Both of these ratios are explainedinmoredetaillaterinthischapter.BreakingdownROCEintoitscomponent

partsmayhelptoexplainwhyacompany'sROCEhaschangedfromoneperiodtoanother orwhyonecompany'sROCEisdifferentfromanother's.

EXAMPLE1

Thefollowinginformationhasbeenextractedfromthefinancialstatementsoftwocompaniesfor theyearto31December2019.Thecompaniesareofsimilarsizeandoperateinthesamesectorofin dustry.

	CompanyA	CompanyB
	£000	£000
Sales	14,400	13,800
Profitbeforelong-terminterestandtax	720	690
Sharecapitalandreserves	3,100	2,475
Non-currentliabilities	500	400

CalculateROCEforeachcompanyandanalyseeachcompany'sROCEfigureintoitscomponentpa rts.

Solution

	ROCE	=	*Profitmargin*	×	*Assetturnover*
CompanyA	$\frac{720}{3,600}$	=	$\frac{720}{14,400}$	×	$\frac{14,400}{3,600}$
	20%	**=**	**5%**	×	**4.0**
CompanyB	$\frac{690}{2,875}$	=	$\frac{690}{13,800}$	×	$\frac{13,800}{2,875}$
	24%	**=**	**5%**	×	**4.8**

ThesecalculationsshowthatCompanyBhasthesameprofitmarginasCompanyAbuthasabetter ROCEbecauseofitsbetterassetturnover.

Returnonequity(ROE)

This profitability ratio concentrates on the company's ordinary shareholders and comparestheircapitalwiththeamountofprofitwhichhasbeenearnedontheirbehalf.Return on equity is usually calculated as follows:

$$\text{ROE}=\frac{\text{Profitafterinterest,taxandpreferencedividend}}{\text{Ordinarysharecapitalandreserves}}\times 100\%$$

This ratio may also be classified as an investment ratio, since it can be used by investors to assessthedesirabilityofacompany'sordinaryshares.Investmentratiosarediscussedin more detail later in this chapter.

As well as comparinga company's ROCEandROEfor anaccountingperiodwiththe returnsachievedinpreviousperiodsandbyothercompanies,itmayalsobeusefulto comparetheseratioswithcurrentmarketratesofinterest.Forinstance,ifacompany's ROCEislowerthancurrentborrowingrates,thismightindicatethatthecompanywould

not benefit from making further borrowings. Similarly, if a company's ROE is higher than current savings rates, this might indicate that the company's ordinary shares are a good investment. However, such comparisons should be viewed with caution. Returns in future accounting periods may be very different from those in past periods and factors such as the degreeofriskassociatedwithvariousinvestmentsshouldalsobetakenintoaccount.

Grossprofitmargin

Thegrossprofitmarginexpressesacompany'sgrossprofitasapercentageofitssales revenue and is sometimes referred to as the *grossprofitpercentage*. Gross profit margin is calculated as follows:

$$\text{Grossprofitmargin} = \frac{\text{Grossprofit}}{\text{Sales}} \times 100\%$$

It would be very misleading to compare the gross profit margin of two totally dissimilar businesses(e.g.ajewellerandasupermarket)butacomparisonbetweentwocompaniesin thesamelineoftradeshouldbemeaningfulandmightthrowsomelightonthepricing policies adoptedbyeachof thecompanies concerned.

Netprofitmargin

The net profit margin (also referred to as simply the *profitmargin*) expresses a company'sprofitasapercentageofitssalesrevenueandiscalculatedasfollows:

$$\text{Netprofitmargin} = \frac{\text{Profit}}{\text{Sales}} \times 100\%$$

However,thereisnoconsensusastowhichprofitfigureshouldbeusedinthecalculation of this ratio. Possibilities include PBIT, profit before tax and profit after tax. Therefore it isvery important to ascertain the way in which the ratio has been calculated before basing important decisions upon it.

Ayear-on-yearcomparisonofacompany'sgrossprofitmarginandnetprofitmargin mayrevealtheextenttowhichoperatingexpensesareundercontrol.Forinstance,ifnet profitmarginhasincreasedwhilstgrossprofitmarginhasremainedstatic,thismight indicate that the company has succeeded in trimming its operating expenses. However, the validityofthisconclusionwilldependuponthewayinwhichthenetprofitmarginhas beencalculatedandtheextenttowhichthecompany'sprofithasbeenaffectedbyitems such as "other income" (see Chapter 3).

EXAMPLE2

Thefollowingdatahasbeenextractedfromacompany'sstatementofcomprehensiveincomefortheyearto31July2020(withcomparativesfor2019):

	31July2020	31July2019
	£000	£000
Salesrevenue	9,170	8,350
Costofsales	6,220	5,670
Grossprofit	2,950	2,680
Operatingexpenses	1,280	1,230
Interestpayable	nil	nil
Profitbeforetax	1,670	1,450

Calculatethegrossprofitmarginandprofitmarginforeachyear.

Solution

	31July2020	31July2019
Grossprofitmargin	$\frac{2,950}{9,170}$ =32.2%	$\frac{2,680}{8,350}$ =32.1%
Profitmargin	$\frac{1,670}{9,170}$ =18.2%	$\frac{1,450}{8,350}$ =17.4%

Thegrossprofitmarginisvirtuallyunchangedbuttheprofitmarginhasincreasedbynearlyawholepercentagepoint.Thisincreasehasbeencausedmainlybythefactthatoperatingexpensesasapercentageofsaleshavefallenfrom14.7%to14.0%.

Liquidityratios

Themainliquidityratios†are:

(a) Thecurrentratio
(b) Thequickassetsratio(or"acidtest").

† *Theliquidityratiosareillustratedinthecomprehensiveexample(Quandockplc)whichisprovidedlaterinthischapter.*

Thecurrentratio

The purpose of the current ratio is to measure a company's ability to meet its short-term financial obligations out of its current assets. The current ratiois usuallyexpressedasan actual ratio (e.g. 3:1) and is calculated as follows:

$$\text{Currentratio}=\frac{\text{Currentassets}}{\text{Currentliabilities}}$$

Whatisperceivedasanacceptablelevelofcurrentratiowillvaryfromonetypeof business entity to another. For example, a ratio of 1:1 may be perfectly adequate for a supermarket chain which has virtually no receivables and which rapidly converts itsinventoriesintocash.Ontheotherhand,aratioofatleast2:1mightbeseenasnecessary foramanufacturingcompanywhichholdsinventoriesforalongerperiodandthensells them on credit terms.

Thequickassetsratio

In many cases, a company's inventories cannot be converted into cash at short notice and therefore the current ratio (which takes all current assets into account) may give an over- optimistic view of the company's liquidity. The quick assets ratio ("quick ratio") provides a more severe test of liquidity by omitting inventories from the calculation. The ratio iscalculated as follows:

$$\text{Quickassetsratio} = \frac{\text{Currentassetslessinventories}}{\text{Currentliabilities}}$$

Althoughaquickassetsratioofatleast1:1mightbeseenasdesirable,itshouldbeborne inmindthatsomeofthecurrentliabilitiesshowninacompany'sfinancialstatementsmay not be payable immediately. For instance, the tax liability may not fall due until severalmonthsaftertheendofanaccountingperiod.Inthesecircumstances,aratiooflessth an 1:1mightbeacceptable.Notethatthequickassetsratioisalsoknownasthe*acidtest*.

EXAMPLE3

ThefollowinginformationhasbeenextractedfromthefinancialstatementsofCompanySandCo mpanyMfortheyearto31December2019.CompanySisasupermarketchainwhilstCompanyMis amanufacturer.

	CompanyS	CompanyM
	£m	£m
Currentassets:		
Inventories	970	1,750
Tradereceivables	40	1,880
Cashandbankbalances	570	290
	1,580	3,920
Currentliabilities	2,470	2,120

Calculatethecurrentratioandthequickassetsratioforeachcompany.

Solution

	CompanyS	CompanyM
Currentratio	$\frac{1,580}{2,470}$ =0.64	$\frac{3,920}{2,120}$ =1.85
Quickassetsratio	$\frac{610}{2,470}$ =0.25	$\frac{2,170}{2,120}$ =1.02

TheliquidityratiosofCompanySareverylow.However,asupermarketchaincanusuallyturnsitsinventoriesintocashfairlyquicklyandmayalsobeabletoobtainlengthycreditfromitssuppliers.Ifso,thelowratiosmaynotbeacauseforconcern.

TheliquidityratiosofCompanyMarehigherandaremoretypicalforamanufacturerwhichhasaslowerinventoryturnoverandwhichofferscredittoitscustomers.

Efficiencyratios

Themainefficiencyratios† are:

(a) Assetturnover
(b) Inventoryholdingperiod
(c) Tradereceivablescollectionperiod
(d) Tradepayablespaymentperiod.

† *Alloftheefficiencyratiosareillustratedinthecomprehensiveexample(Quandockplc)whichisprovidedlaterinthischapter.*

Assetturnover

Thisratiomeasurestheefficiencywithwhichacompany'sassetsareusedtogeneratesales revenue. The ratio is usually calculated as follows:

$$\text{Assetturnover} = \frac{\text{Sales}}{\text{Netassets}} = \frac{\text{Sales}}{\text{Capital employed}}$$

This approach to the calculation of asset turnover defines a company's net assets as its total assets less its current liabilities, so that the net assets figure is equal to the total amount of capitalemployedinthebusiness(seeROCEabove).However,alternativeversionsofthe asset turnover ratio may be calculated, in which sales are compared with (for example) the company'sassetslesstotalliabilitiesorwiththecompany'snon-currentassetsonly.

Ideally,theassetturnoverforanaccountingperiodshouldbecalculatedbyreferenceto the *average*net assets held during that period. However, it may be necessary to base the calculation upon closing net assets if the average figure is not available. Furthermore, a company's accounting policies may have a profound effect on its net assets figure and thispointshouldbeborneinmindwhencomparingtheassetturnoverofdifferentcompanies.

Inventoryholdingperiod

The inventory holding period measures the average number of days which elapse between acquiringanitemofinventoryandthensellingorusingthatitem.Thisratioiscalculated as follows:

$$\text{Inventoryholdingperiod(indays)}=\frac{\text{Averageinventory}}{\text{Cost of sales}}\times 365$$

An alternative approach is to calculate the number of times that inventory is "turned over" duringanaccountingperiod.Inthiscase,theratioiscalculatedasfollows:

$$\text{Inventoryturnover}=\frac{\text{Cost of sales}}{\text{Averageinventory}}$$

Forexample,ifacompany'saverageinventoryforanaccountingyearis£500,000andcost ofsalesfortheyearis£2million,theinventoryholdingperiodisapproximately91days and inventory is turned over four times during the year. The average inventory for an accounting period is usually approximated by averaging the opening and closing inventory figures.Ifopeninginventoryisnotknown,theremaybenooptionbuttobasethe calculation on closing inventory only.

The inventory holding period (or the inventory turnover) provides an indication of the efficiencywithwhichacompanymanagesitsinventories.Anefficientcompanywill maintain as low an inventory as possible whilst ensuring that sufficient inventory is always availabletosatisfycustomerdemand.Excessiveinventoriesshouldbeavoidedsincethese tieupthecompany'sfundsunnecessarilyandmayrequirecostlywarehousing.

Tradereceivablescollectionperiod

The trade receivables collection period measures the average number of days which elapse betweenmakingacreditsaleandreceivingpaymentfromthecustomer.Theratiois calculated as follows:

$$\text{Tradereceivablescollectionperiod(indays)}=\frac{\text{Averagetradereceivables}}{\text{Credit sales}}\times 365$$

Closingtradereceivablesaresometimessubstitutedforaveragetradereceivablesifitis not possible to derive an average figure. Any sales tax (such as VAT) included in the trade receivablesfigureshouldbeeliminatedbeforetheratioiscalculated.

Thetradereceivablescollectionperiodprovidesaninsightintothecredittermsoffered to a company's customers. An increase in this period might indicate that the company is deliberatelyofferinglongercreditsoastoattractcustomers.Alternatively,anincrease might suggest that the company's credit control system is not operating as efficiently as in previous accounting periods.

Tradepayablespaymentperiod

The trade payables payment period measures the average number of days which elapsebetweenthedateofacreditpurchaseandthedateonwhichpaymentismadetothe supplier. The ratio is calculated as follows:

$$\text{Tradepayablespaymentperiod(indays)}=\frac{\text{Averagetradepayables}}{\text{Creditpurchases}}\times 365$$

If average trade payables cannot be ascertained, the ratio might be based upon the closingfigureinstead.Ifcreditpurchasescannotbeascertained,itmightbenecessarytouse cost ofsalesasanapproximation.Anyrecoverablesalestax(suchasVAT)whichisincluded inthetradepayablesfigureshouldbeeliminatedbeforetheratioiscalculated,sincethis salestaxwillnothavebeenincludedincreditpurchases.

Asubstantialincreaseinacompany'stradepayablespaymentperiodwhencompared withpreviousperiodsmightsuggestthatthecompanyisexperiencingdifficultyinpaying itssuppliersandcouldevenbeindangerofbeingrefusedfurthercredit.

EXAMPLE4

Thefollowingfigureshavebeenextractedfromacompany'sfinancialstatementsfortheyearto31 March2020:

	£000
Sales	1,317
Purchases	832
Inventory-at1April2019	69
-at31March2020	75
Tradereceivablesat31March2020	153
Tradepayablesat31March2020	116

Allsalesandpurchasesaremadeoncreditterms.Calculatetheinventoryholdingperiod,tradereceivablescollectionperiodandtradepayablespaymentperiodfortheyear.

Solution

Costofsalesis(£69,000+£832,000–£75,000)=£826,000.Averageinventoryis£72,000buttheinformationgivenisnotsufficienttocalculateaveragefiguresfortradereceivablesortradepayables (soyear-endfigureshavebeenused).Theratiosareasfollows:

Inventoryholdingperiod	$\frac{72}{826}\times 365=32\text{days}$
Tradereceivablescollectionperiod	$\frac{153}{1{,}317}\times 365=42\text{days}$
Tradepayablespaymentperiod	$\frac{116}{832}\times 365=51\text{days}$

Investmentratios

Themaininvestmentratios† are:

(a)Earningspershare (b)Priceearningsratio (c) Dividendcover
(d)Dividendyield (e) Capitalgearingratio (f) Interestcover.

† *Alloftheinvestmentratiosareillustratedinthecomprehensiveexample(Quandockplc)whichisprovidedlaterinthischapter.*

Earningspershare(EPS)

Earningspershare(EPS)istheamountofprofitearnedduringanaccountingperiodfor eachordinaryshareinissueduringthatperiod.Thisimportantratioisfrequentlyusedas anindicatoroffinancialperformanceandiscalculatedasfollows:

$$\text{EPS(inpence)}=\frac{\text{Profitaftertaxandpreference dividends}}{\text{Numberofordinarysharesinissue}}\times 100\text{p}$$

TheimportanceattachedtotheEPSratioisattestedbythefactthatcompaniesarerequired to present their EPS figure in the statement of comprehensive income and to calculate theirEPS in accordance with international standard IAS33 *EarningsperShare*. This standard isfully explained later in this book (see Chapter 23).

Priceearnings(P/E)ratio

The P/E ratio compares earnings per share with the market price of an ordinary share and calculatesthenumberofyearswhichitwouldtaketorecoverthemarketpricepaidfora shareifearningsremainedconstantinfutureyears.Theratioiscalculatedasfollows:

$$\text{Priceearningsratio}=\frac{\text{Marketpriceperordinaryshare}}{\text{Earningsper share}}$$

It might seem obvious that shares with a low P/E ratio would be regarded as an attractive
investment.Infact,highP/Eratiosareviewedmorefavourablythanlowones.Thisis becauseEPSisameasureofpastperformancewhilstthemarketpriceofasharereflects thestockmarket'sexpectationsofthecompany's *future* performance.AhighP/Eratiois seenasanindicationthatthemarketexpectsthecompanytoperformwellinthefuture.

Dividendcover

Dividend cover measures the number of times that the ordinary dividend for an accounting periodcouldhavebeenpaidoutoftheavailableprofitsforthatperiod.Theratiois calculated as follows:

$$\text{Dividendcover}=\frac{\text{Profitafter taxandpreferencedividends}}{\text{Ordinarydividends}}$$

Alternatively,theratiomaybecalculatedbydividingearningspershare(EPS)bythe dividend per ordinary share.

Ahighdividendcoverindicatesthatthecompanyisretainingasubstantialpartofits profits.Thispolicymightnotbepopularwiththeordinaryshareholdersbutatleastthe highlevelofcovermeansthatprofitsaremorethanadequatetofundthedividendspaid. Ontheotherhand,alowdividendcovermightindicatethatthecompanyishaving difficultyinmaintaininganacceptablelevelofdividend.

Dividendyield

The dividend yield expresses the dividend per ordinary share as a percentage of the market priceper ordinaryshare. Thecalculationis as follows:

$$\text{Dividendyield} = \frac{\text{Dividendperordinaryshare}}{\text{Marketpriceperordinaryshare}} \times 100\%$$

This ratio acts as an indicator of the cash return received on the investment made by anordinary shareholder. Whilst a low dividend yield might deter an investor who views theshares primarily as a source of income, a dividend yield of even 0%might not deter aninvestor whose main concern is capital growth.

Capitalgearingratio

Thecapitalgearingratiomeasurestheextenttowhichacompany'slong-termfundshave been provided by lenders. There are several different ways of calculating this ratio, but a frequently-used method of calculation is as follows:

$$\text{Capitalgearing} = \frac{\text{Preference sharecapitalplusnon-currentliabilities}}{\text{Totalsharecapitalandreservesplusnon-current liabilities}} \times 100\%$$

The reason for regarding preference shares as a form of borrowing for this purpose is that preference shares attract a fixed rate of dividend in much the same way as a loan attracts afixedrateofinterest.Nodividendcanbepaidtotheordinaryshareholdersuntilloan interest and the preference dividend have both been paid.

Acompanywithahighcapitalgearingratioisknownasa"high-geared"companyand suchacompanyrepresentsahigh-riskinvestmentfortheordinaryshareholder.Inapoor year, the need to pay interest and preference dividends may mean that the ordinary share-holderswillreceivenodividendatall.Furthermore,ahigh-gearedcompanywhichruns intofinancialtroublemaybeunabletoobtainfurtherloansandmaybeforcedinto liquidation, in which case there may be insufficient funds to repay the ordinary shares after liabilities and the preference shares have been repaid. Conversely, a low-geared company representsacomparativelylow-riskinvestmentfortheordinaryshareholder.

The words "high" and "low" cannot be defined in absolute terms and a company's capital
gearingratiomustbejudgedincontext.Forinstance,acapitalgearingratiowhichmight beregardedasperfectlyacceptableinthecaseofasoundcompanywithsteadilyrising

profits and excellent prospects might be judged as worryingly high if it applied to a less successful company. However, as a rule of thumb, a capital gearing ratio in excess of 50% might generally be regarded as high.

EXAMPLE5

CompanyXandCompanyYeachhaveaprofitbeforeinterestandtaxof£500,000fortheyearto30June2020.Extractsfromthecompanies'statementsoffinancialpositionasat30June2020areasfollows:

	X	Y
	£000	£000
Ordinarysharecapital	800	800
Reserves	2,200	200
	3,000	1,000
Non-currentliabilities:		
10%long-termloan	1,000	3,000

Therearenopreferenceshares.Itmaybeassumedthateachcompany'staxexpensefortheyearisequalto19%oftheprofitbeforetax.

(a) Calculatethecapitalgearingratioforeachcompany.

(b) Calculatetheamountoftheprofitfortheyearto30June2020whichisavailablefordistributiontotheordinaryshareholders.

(c) Re-workpart(b)ofthisexample,nowassumingthateachcompany'sprofitbeforeinterestandtaxfortheyearto30June2020is:

(i) decreasedby20%to£400,000

(ii)increasedby20%to£600,000Commentontheresultsofthesecalculations.

Solution

(a) ThecapitalgearingratioofCompanyXis1,000/4,000=25%.ThecapitalgearingratioofCompanyYis3,000/4,000=75%.

(b)

	X	Y
	£000	£000
Profitbeforeinterestandtax	500	500
Interestpayable	100	300
Profitbeforetax	400	200
Taxationat19%	76	38
Profitaftertax	324	162

Theamountofprofitavailabletoordinaryshareholdersis£324,000inthecaseofCompanyXand£162,000inthecaseofCompanyY.

(c)

	(i)		(ii)	
	X	Y	X	Y
	£000	£000	£000	£000
Profitbeforeinterestandtax	400	400	600	600
Interestpayable	100	300	100	300
Profitbeforetax	300	100	500	300
Taxationat19%	57	19	95	57
Profitaftertax	243	81	405	243

A20%increaseordecreaseinPBITincreasesordecreasestheprofitavailabletotheordinaryshareholdersofCompanyX(lower-geared)by25%.However,theincreaseordecreaseforthesharehold ersofCompanyY(higher-geared)is50%.

Thisdemonstratesthat,forahigher-gearedcompany,anyincrease/decreaseinPBITwillcauseadisproportionatepercentageincrease/decreaseintheprofitavailabletotheordinaryshareholders.Thissuggeststhattheordinaryshareholdersofahigh-gearedcompanyaresubjecttoanincreasedlevelofrisk.

Interestcover

Interestcoverisameasureofthenumberoftimesthattheinterestpayableforan accountingperiodcouldhavebeenpaidoutoftheavailableprofits.Theratioiscalculated as follows:

$$\text{Interestcover} = \frac{\text{Profitbeforeinterestandtax}}{\text{Interestpayable}}$$

This ratio is especially significant to the providers of loans. A high figure for interest cover indicatesthatlendersareinarelativelysecurepositionandthatthecompany'sprofits could fall substantially before there was any likelihood that interest payments could not bemet.Ontheotherhand,lenders(andpotentiallenders)mightloseconfidenceinthe company if interest cover is low.

COMPREHENSIVEEXAMPLE

Quandockplcisatradingcompanywhichmakesallofitssalesandpurchasesoncreditterms.Thecompany'sfinancialstatementsfortheyearto31December2019(withcomparativefiguresfor2018)areshownbelow.

Quandockplc
Statementsofcomprehensiveincomefortheyearto31December

	2019 £000	2018 £000
Salesrevenue	7,000	6,350
Costofsales	5,660	5,130
Grossprofit	1,340	1,220
Operatingexpenses	380	400
Profitbeforeinterestandtax	960	820
Interestpayable	80	100
Profitbeforetaxation	880	720
Taxation	180	140
Profitaftertax	700	580

Statementsoffinancialpositionasat31December

		2019 £000		2018 £000
Assets				
Non-currentassets				
Property,plantandequipment		1,730		1,820
Currentassets				
Inventories(*2017£670,000*)	740		690	
Tradereceivables	820		760	
Cashatbankandinhand	560	2,120	340	1,790
		3,850		3,610
Equity				
Ordinarysharesof£1		1,000		1,000
Retainedearnings		930		630
		1,930		1,630
Liabilities				
Non-currentliabilities				
Long-termloans		800		1,000
Currentliabilities				
Tradepayables	940		840	
Taxation	180	1,120	140	980

3,850	3,610

Notes:

(i) Ordinarydividendsof£400,000werepaidduringtheyearto31December2019.Theequivalentfigurefor2018was£350,000.

(ii) Themarketpriceofthecompany'sordinaryshareswas390ppershareon31December2019and310ppershareon31December2018.

Calculateasetofaccountingratios(foreachofthetwoyears)whichmaybeusedtojudgethecompany'sprofitability,liquidity,efficiencyandinvestmentpotential.

Solution

Profitability	**2019**	**2018**
Returnoncapitalemployed	$\frac{960}{2,730} \times 100\% = 35.2\%$	$\frac{820}{2,630} \times 100\% = 31.2\%$
Returnonequity	$\frac{700}{1,930} \times 100\% = 36.3\%$	$\frac{580}{1,630} \times 100\% = 35.6\%$
Grossprofitmargin	$\frac{1,340}{7,000} \times 100\% = 19.1\%$	$\frac{1,220}{6,350} \times 100\% = 19.2\%$
Netprofitmargin	$\frac{880}{7,000} \times 100\% = 12.6\%$	$\frac{720}{6,350} \times 100\% = 11.3\%$

Theseratiosindicatethatthebusinesswasmoreprofitablein2019thanitwasin2018.ROCEandROEbothshowanimprovementandalthoughthegrossprofitmarginwasmuchthesameinbothyears,thenetprofitmarginin2019(basedonprofitbeforetax)wasbetterthanin2018.Thisismainlyduetothefactthatthecompanymanagedtoreduceitsoperatingexpensesin2019despiteincreasingitsturnover.

Liquidity	**2019**	**2018**
Currentratio	$\frac{2,120}{1,120} = 1.9\text{to}1$	$\frac{1,790}{980} = 1.8\text{to}1$
Quickassetsratio	$\frac{2,120-740}{1,120} = 1.2\text{to}1$	$\frac{1,790-690}{980} = 1.1\text{to}1$

Bothoftheseratiosshowanimprovementin2019andthecompanydoesnotseemtohaveanyliquidityproblems,despitehavingrepaid£200,000ofloansin2019.

Efficiency	**2019**	**2018**
Assetturnover	$\frac{7,000}{2,730} = 2.56$	$\frac{6,350}{2,630} = 2.41$
Inventoryholdingperiod	$\frac{715}{5,660} \times 365 = 46\text{days}$	$\frac{680}{5,130} \times 365 = 48\text{days}$

Receivablescollectionperiod	$\frac{820}{7,000}$	
Payablespaymentperiod	$\frac{940}{5,710}\times365=43$days	$\frac{760}{6,350}\times365=44$days
	$\times365=60$days	$\frac{840}{5,150}\times365=60$days

Theassetturnoverratioindicatesthatthecompanyhasmademoreefficientuseofitsnetassetsin2019thanin2018.Theinventoryholdingperiod(basedonaverageinventoryineachyear)showsaslightreductionin2019whichmayindicateamoreefficientinventorycontrolpolicy.Thetradereceivablescollectionperiodandthetradepayablespaymentperiodin2019arebothbroadlysimilartotheir2018equivalents.

Notes:

(i) Purchasesin2018were£5,130,000–£670,000+£690,000=£5,150,000.(ii) Purchasesin2019were£5,660,000–£690,000+£740,000=£5,710,000.

Investment	2019	2018
Earningspershare	$\frac{700}{1,000}=70$p	$\frac{580}{1,000}=58$p
Priceearningsratio	$\frac{390}{70}=5.6$	$\frac{310}{58}=5.3$
Dividendcover	$\frac{700}{400}=1.8$	$\frac{580}{350}=1.7$
Dividendyield	$\frac{40}{390}\times100\%=10.3\%$	$\frac{35}{310}\times100\%=11.3\%$
Capitalgearingratio	$\frac{800}{2,730}\times100\%=29\%$	$\frac{1,000}{2,630}\times100\%=38\%$
Interestcover	$\frac{960}{80}=12$	$\frac{820}{100}=8.2$

Virtuallyalloftheseratiosindicatethatthecompanyisagoodinvestment.Earningspershareincreasedin2019andthestockmarket'sregardfortheshares(asindicatedbytheP/Eratio)alsoincreased.Thedividendyieldwentdownbutthedividenditselfincreasedbymorethan14%anddividendcoverwasadequate.Thecompanyisbecomingmorelow-gearedastheloansarerepaidandtheinterestcovergivesnocauseforconcern.

Limitationsofratioanalysis

Although ratio analysis is an extremely useful and powerful tool for the analysis and interpretationoffinancialstatements,itissubjecttoanumberoflimitations.Someofthe moreimportantlimitationsofratioanalysisareasfollows:

(a) **Lackofstandarddefinitions**. As mentioned earlier in this chapter, some accounting ratios may be defined in more than one way. This makes it difficult to compare ratios calculatedbydifferentaccountants,eachofwhommighthaveuseddifferent definitions for the same ratios. It is very important that users should be aware of this problemwhenbasingimportantdecisionsoninformationprovidedintheformofa ratio analysis.

(b) **Unrepresentativefiguresinthestatementoffinancialposition**. A statement of financial position shows only a snapshot of a company's financial position on a single date,whilstastatementofcomprehensiveincomecoversanentireaccountingperiod. So if the company's assets and liabilities at the end of the period are not typical of the period as a whole, any ratio which combines a figure drawn from the statement of financial position with a figure drawn fromthe statement of comprehensive incomemight produce a misleading result.

Onesolutiontothisproblemistoaveragethefiguresshownintheopeningand closing statements of financial position, but this will be of little help if the company's statementoffinancialpositionisaffectedeveryyearbyrecurringseasonalfactors.

(c) **Accountingpolicies**. A company's accounting policies with regard to such matters as depreciationandthevaluationofinventoriesmightbeverydifferenttothoseof another company. These differences in policy may have a significant impact onaccountingratiosandcanmakeitdifficulttoeffectameaningfulcomparisonbetwee n the companies concerned.

(d) **Misinterpretation**.Accountingratiosareopentomisinterpretationunlessallavailablee videnceistakenintoaccount.Forexample,areductioninacompany's gross profit margin might be interpreted as a bad sign, when in fact the company has deliberatelydroppedpricessoastoboostsales.Similarly,asmallincreaseinreturn on capital employed might be regarded as encouraging until it is discovered that most companies in the same sector have achieved a much larger increase. It is essential that ratios are judged collectively rather than singly, that a given company's ratios are comparedwiththoseofothercompaniesinthesamefieldandthatanyoneperforming aratioanalysisisawareofbackgroundfactorssuchastheoveralleconomicclimate, the rate of inflation, trends in interest rates etc.

Multivariateratioanalysis

The approach to ratio analysis considered so far in this chapter may be categorised as "univariate".Withthisapproach,eachratioisconsideredseparatelyandthenjudgements are made with regard to the company's profitability, liquidity etc. In contrast, the technique known as "multivariate" analysis combines together several key ratios to produce a singleindex number. This number can then be used to compare one company with another or to measure a company's progress over a number of accounting periods. Some proponents of multivariateanalysisalsoclaimthatthetechniqueisabletopredictcorporatefailure.

One example of multivariate analysis is the "Z-score" devised by Edward Altman in the 1960s,inwhichfiveaccountingratiosareweightedandcombinedasfollows:

Z=3.3A+1.0B+0.6C+1.2D+1.4E

where:

A = earnings before interest and tax ÷ total

assetsB = sales ÷ total assets

C = market value of equity ÷ total

liabilitiesD = working capital ÷ total

assets

E=retainedearnings÷totalassets.

TheweightingsusedintheZ-scorecalculationwerearrivedatastheresultofresearchinto therelativeimportanceofeachratiotoacompany'ssurvival.Itisclaimedthatacompany withaZ-scoreofmorethan3.0willnotfail,whilstacompanywithaZ-scoreoflessthan 1.8isverylikelytofail.

Whilst the multivariate approach is interesting, it has not replaced the more conventional univariateapproach,whichisstilladoptedbymostaccountants.

Summary

- Ratio analysis is a technique for the analysis and interpretation of the information contained in financial statements.
- Accounting ratios may be used to compare one accounting period with another for the same business entity or to compare one business entity with another. Ratio analysis is mostfrequentlyappliedtothefinancialstatementsofcompanies.
- The most commonly-used accounting ratios can be classified into four main groups.Theseareprofitabilityratios,liquidityratios,efficiencyratiosandinvestmentrat ios.
- Ratioanalysisissubjecttoanumberoflimitationswhichshouldbeborneinmind whenbasingeconomicdecisionsupontheresultsofaratioanalysis.
- Multivariateratioanalysisattemptstocombineratiostogetherintoasingleindex numberwhichmaythenbeusedtojudgeacompany'sfinancialhealth.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

22.1 ThefinancialstatementsofRLtdfortheyearto30April2020areasfollows:

RLtd
Statementofcomprehensiveincomefortheyearto30April2020

	£000
Salesrevenue	410
Costofsales	235
Grossprofit	175
Operatingexpenses	115
Profitbeforeinterestandtaxation	60
Interestpayable	15
Profitbeforetaxation	45
Taxation	10
Profitaftertaxation	35

Statementoffinancialpositionasat30April2020

	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment		208
Currentassets		
Inventories	82	
Tradereceivables	58	
Cashatbank	7	147
		355
Equity		
10%Preferencesharesof£1		10
Ordinarysharesof£1		100
Retainedearnings		19
		129
Liabilities		
Non-currentliabilities		
Long-termloans		150
Currentliabilities		
Tradepayables	45	
Payablerepurchaseofproperty,plantandequipment	21	
Taxation	10	76
		355

Note:Dividendsof£1,000(preference)and£20,000(ordinary)werepaidintheyear.

Required:

Insofar as the information given permits, calculate the following ratios for R Ltd for the year to 30 April 2020, stating any assumptions made:

(a) Returnoncapitalemployed
(b) Returnonequity
(c) Grossprofitmargin
(d) Netprofitmargin
(e) Currentratio
(f) Quickassetsratio
(g) Inventoryholdingperiod
(h) Receivablescollectionperiod
(i) Payablespaymentperiod
(j) Capitalgearingratio
(k) Interestcover
(l) Dividendcover
(m) Earningspershare.

22.2 CompanyXisanold-establishedclothingretailer.Thecompanyoperatesfromexpensivecitycentrepremises andoffers ahighstandardof customer service. The company's customers are willing to pay top prices so as to shop in comfort and many of them take advantage of the generous credit terms available.

CompanyYisarecently-establishedclothingretailer.Thecompanyoperatesfromaself-service store on the outskirts of the city and has comparatively few employees. The company's "no frills" approach appeals to customers who wish to buy clothes as cheaply aspossible.Ingeneral,customersareencouragedtopay fortheirpurchasesimmediately, but certain regular customers have a monthly account with the company.

Required:

Explain how these differences between Company X and Company Y might be reflected in their accounting ratios.

22.3 TheissuedsharecapitalofSoressonplcconsistsof1,000,000ordinarysharesof50p each and 250,000 6% preference shares of £1 each..

Intheyearto31March2020,thecompany'sprofitaftertaxwas£90,000.Dividendspaid duringtheyearcomprisedthepreferencedividendfortheyearandanordinary dividendof£55,000.Themarketpriceofthecompany'sordinaryshareson31March 2020 was 70p per share.

Required:

CalculatethefollowingratiosforSoressonplc:

(a) Earningspershare
(b) Dividendcover
(c) Dividendyield
(d) Priceearningsratio.

22.4 During the year to 31 December 2019, Tinderlake Ltd attempted to stimulate sales and increaseitsprofitsbyreducingsellingprices, holdinglargerinventoriesandgiving customerslongercredit.Allofthecompany'spurchasesandsalesareoncreditterms. Summarisedfinancialstatementsfortheyearto31December2019(withcomparative figures for 2018) are as follows:

TinderlakeLtd

Statementsofcomprehensiveincomefortheyearto31December

	2019	2018
	£000	£000
Salesrevenue	5,327	3,725
Costofsales	4,420	2,905
Grossprofit	907	820
Operatingexpenses	87	75
Profitbeforeinterestandtaxation	820	745
Interestpayable	130	20
Profitbeforetaxation	690	725
Taxation	135	145
Profitaftertaxation	555	580

Statementsoffinancialpositionasat31December

		2019		2018
		£000		£000
Assets				
Non-currentassets				
Property,plantandequipment		5,120		4,700
Currentassets				
Inventories	1,334		730	
Tradereceivables	1,278		596	
Bank	11	2,623	400	1,726
		7,743		6,426
Equity				
Ordinarysharesof£1		2,000		2,000
Retainedearnings		3,508		3,433
		5,508		5,433
Liabilities				
Non-currentliabilities				
Long-termloans		1,000		150
Currentliabilities				
Tradepayables	1,100		698	
Taxation	135	1,235	145	843
		7,743		6,426

Note:

Ordinarydividendsof£480,000werepaidduringtheyearto31December2019.

Required:

CalculatethefollowingratiosforTinderlakeLtdforeachofthetwoyearsconcerned and comment on the results of these calculations:

(a) Returnoncapitalemployed
(b) Returnonequity
(c) Grossprofitmargin
(d) Netprofitmargin
(e) Currentratio
(f) Quickassetsratio
(g) Inventoryholdingperiod
(h) Receivablescollectionperiod
(i) Capitalgearingratio.

*22.5WesternTradingplcisacompanywhichusesavarietyofcomponentpartsinits manufacturingoperations.Oneofthecompany'ssuppliershasrecentlygoneoutof businessandthereforeWesternisnowseekinganalternative(andreliable)sourceof supplyforthecomponentpartswhichwerepreviouslypurchasedfromthatsupplier.T wocompanieshavebeenidentifiedaspotentialsuppliers.Bothcompaniesprepare accountsto31DecembereachyearandWesternhasobtainedthefollowingcopiesof each company's financial statements for the year to 31 December 2019:

StatementsofcomprehensiveincomefortheyearTo31December2019

	XLtd	*YLtd*
	£000	£000
Salesrevenue	5,720	6,310
Costofsales	3,840	4,240
Grossprofit	1,880	2,070
Operatingexpenses	760	1,080
Profitbeforeinterestandtaxation	1,120	990
Interestpayable	50	350
Profitbeforetaxation	1,070	640
Taxation	320	210
Profitaftertaxation	750	430

StatementsoffinancialpositionasatDecember2019

	XLtd		*YLtd*	
	£000		£000	
Assets				
Non-currentassets		4,570		6,330
Currentassets				
Inventories	510		890	
Tradereceivables	670		1,090	
Bankbalance	340	1,520	-	1,980
		6,090		8,310

		XLtd		*YLtd*
		£000		£000
Equity				
Sharecapital		2,000		2,000
Retainedearnings		2,820		1,030
		4,820		3,030
Liabilities				
Non-currentliabilities				
Long-termloans		500		3,500
Currentliabilities				
Tradepayables	450		1,130	
Taxation	320		210	
Bankbalance	-	770	440	1,780
		6,090		8,310

Forbothcompanies,allpurchasesandsalesaremadeoncreditterms.

Required:

(a) Calculate three profitability ratios, two liquidity ratios, three efficiency ratios and one gearing ratio for X Ltd and for Y Ltd.

(b) Usetheinformationprovidedbytheseratiostoexplaintothemanagementof WesternTradingplcwhichofthetwocompaniesseemslikelytobethemore reliable source of supply.

(c) Identify any further information which should be obtained before a final decision is made. *(CIPFA)*

***22.6** Brenda is considering an investment in the ordinary shares of either Baker plc or Grant plc. Both companies operate in the same sector of industry and both prepare accounts to 30Septembereachyear.Financialstatementsfortheyearto30September2020are shown below.

Statementsofcomprehensiveincomefortheyearto30September2020

	Bakerplc	*Grantplc*
	£000	£000
Salesrevenue	15,160	12,260
Costofsales	10,720	8,680
Grossprofit	4,440	3,580
Operatingexpenses	2,160	1,620
Operatingprofitbeforeinterestandtaxation	2,280	1,960
Interestpayable	520	40
Profitbeforetaxation	1,760	1,920

Taxation	440	480
Profitaftertaxation	1,320	1,440

Statementsoffinancialpositionasat30September2020

		Bakerplc		*Grantplc*
		£000		£000
Assets				
Non-currentassets		13,120		8,480
Currentassets				
Inventories	1,580		1,260	
Tradereceivables	1,720		1,360	
Bankbalance	-	3,300	280	2,900
		16,420		11,380
Equity				
Sharecapital		6,000		6,000
Retainedearnings		3,880		3,440
		9,880		9,440
Liabilities				
Non-currentliabilities				
Long-termloans		3,500		500
Currentliabilities				
Tradepayables	1,920		960	
Taxation	440		480	
Bankbalance	680	3,040	-	1,440
		16,420		11,380

Thefollowinginformationisalsoavailable:

1. Forbothcompanies,allpurchasesandsalesaremadeoncreditterms.
2. During the year to 30 September 2020, Baker plc paid dividends of £180,000 and Grant plc paid dividends of £600,000.
3. Eachcompany'sissuedsharecapitalconsistsof6millionordinarysharesof£1 each. At theclose of business on30September 2020, the market price of an ordinary share in Baker plc was £1.65 and the market price of an ordinary share in Grant plc was £2.40.

HavingexaminedthefinancialstatementsofthetwocompaniesBrendaisinclinedto invest in the shares of Baker plc. Her reasons for this view are that Baker plc has higher turnover, higher operating profit and greater assets than Grant plc. The shares of Baker plc are also cheaper.

Required:

(a) In so far as the information given permits, compute the following ratios for Baker plc and Grant plc:

- returnoncapitalemployed
- earningspershare
- priceearningsratio
- currentratio
- quickratio(acidtest)
- tradepayablespaymentperiod
- capitalgearingratio
- dividendyield.

(b) Ratios for the two companies based upon the financial statements for the previous year (i.e. the year to 30 September 2019) were as follows:

	Bakerplc	*Grantplc*
Returnoncapitalemployed	18.5%	18.9%
Earningspershare	23p	23p
Priceearningsratio	8.5	9.5
Currentratio	1.2	2.1
Quickratio(acidtest)	0.7	1.1
Tradepayablespaymentperiod	49days	39days
Capitalgearingratio	11%	5%
Dividendyield	3%	4%

Taking into account these ratios and those which you have calculated for the yearto 30 September 2020, advise Brenda which of the two companies seems to be the better investment. Give reasons for your advice.

(c) Identify three types of further information which should be obtained before a final investment decision is made. *(CIPFA)*

Chapter23

Earningspershare

Introduction

The purpose of this chapter is to explain the main requirements of international standardIAS33 *EarningsperShare*. This standard provides a set of rules for the calculation and presentation of a company's earnings per share (EPS) figure. The aim of the standard is to improvethereliabilityofperformancecomparisonsbetweendifferentcompaniesinthe samereportingperiodandbetweendifferentreportingperiodsforthesamecompany.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explainwhyitisimportanttouseaconsistentdefinitionofearningspershare
- explainthescopeofinternationalstandardIAS33
- calculatebasicearningspershare
- dealcorrectlywithbonusissuesandrightsissues
- explaintheconceptof"dilution"andcalculatedilutedearningspershare
- outlinethepresentationanddisclosurerequirementsofIAS33.

SignificanceofEPS

The earnings per share (EPS) ratio was briefly introduced in Chapter 22 as one of a set of accounting ratios which may be used to analyse a company's financial performance andprovide a basis for performance comparisons between companies and between accounting periods.Asstatedinthatchapter,suchcomparisonsareinvalidunlesstheratiosbeing used are calculated on a consistent basis. EPS is widely used as a means of assessing a company's performance and it also feeds into the Price/Earnings ratio which is extensivelyused as an indicator of investment potential. Therefore it is especially

important that EPS shouldbecalculatedinaccordancewithaclearandconsistentsetofrules.

ToensurethatEPSfiguresarecalculatedonaconsistentbasis,IAS33prescribestheway inwhichacompany'sEPSshouldbecalculated.ThefactthatEPSistheonlyratiowhich is defined by an international standard (and has an entire standard devoted to it) is a strong indicationoftheimportancewhichisattachedtothiskeyratio.

The standard warns that EPS figures are subject to certain limitations because of thedifferentaccountingpolicieswhichcompaniesmayusewhendeterminingtheirearnings. Infact,theeffectofdifferingaccountingpoliciesisalimitationofratioanalysisgenerally (seeChapter22).However,anyattempttoimprovethecomparabilityofimportantratios iswelcomeandIAS33achievessignificantprogressinthisdirection.

ScopeofIAS33

IAS33 applies to companies whose ordinary shares are publicly traded. When the parent companyofagrouppresentsbothconsolidatedfinancialstatements(seeChapter18)as well as its own separate financial statements, the disclosures required by IAS33 may be presentedonthebasisoftheconsolidatedinformationonly.

CalculationofBasicEPS

AcompanywhichiswithinthescopeofIAS33isrequiredtocalculateandpresentits "basicearningspershare".BasicEPSforanaccountingperiodiscalculatedbydividing the profit (or loss) for that period which is attributable to the ordinary shareholders by the weightedaveragenumberofordinarysharesoutstandingduringtheperiod.Notethat:

(a) The profit attributable to the ordinary shareholders is the profit for the period after deductionoftaxandanypreferencedividends.Inthecaseofconsolidatedaccounts, theprofitattributabletonon-controllinginterestsisalsodeducted.

(b) Ingeneral,sharesare"outstanding"asfromthedateonwhichtheyareissued.

(c) IAS1(seeChapter 3) requires that comparativeinformation shouldbeprovidedin respect of the previous period for all amounts reported in the financial statements. ThereforeitisnecessarytopresentbasicEPSforthepreviousaccountingperiodas well as for the current accounting period.

Discontinuedoperations

If a company reports a profit or loss on discontinued operations (see Chapter 8) then it is necessarytocalculate*two*basicEPSfiguresfortheperiodinquestion.Oneofthese figuresisbasedonthewholeoftheprofitwhichisattributabletotheordinary shareholders. The other figure is based on the profit from continuing operations which is attributable to the ordinary shareholders.

EXAMPLE1

Acompany'ssummarisedstatementofcomprehensiveincomefortheyearto31May2020isasfollows:

	£000
Continuingoperations	
Profitbeforetax	560
Taxation	110
Profitfortheperiodfromcontinuingoperations	450
Discontinuedoperations	
Profitfortheperiodfromdiscontinuedoperations	70
Profitfortheperiod	520

Thefollowinginformationisalsoavailable:

(a) Thepre-taxprofitfortheperiodfromdiscontinuedoperationswas£85,000andtherelatedtaxexpenswas£15,000.

(b) Thecompany'sissuedsharecapitalconsistsof500,00010%preferencesharesof£1eachandonemillion£1ordinaryshares.Therewerenochangestotheissuedsharecapitalduringtheyear.

(c) Thepreferencedividendof£50,000waspaidinfullduringtheyear.Calculatebasic EPSfortheyearto31May2020.

Solution

BasicEPS(basedontheprofitattributabletotheordinaryshareholders)is:

$$\frac{£520,000-£50,000}{1,000,000} = 47p \text{ per share.}$$

BasicEPS(basedontheprofitfromcontinuingoperationsonly)is:

$$\frac{£450,000-£50,000}{1,000,000} = 40p \text{ per share.}$$

Thefigureof40ppershare,whichisbasedonthecompany'scontinuingoperations,isamorereliableindicatoroffutureperformancethanthefigureof47ppershare,whichincludesprofitsfromoperationsthathavenowbeendiscontinued.

Sharesissuedduringtheaccountingperiod

As stated above, IAS33 requires that the calculation of basic EPS should take into account"*theweightedaveragenumberofordinarysharesoutstandingduringtheperiod*". This requirementrecognisesthatacompany'sissuedordinaryshare capitalmaychangeduring an accounting period, generally as the result of a share issue. In such a case, the use of a weighted average number of shares ensures that basic EPS is fairly adjusted to reflect the amountoffreshcapitalwhichthecompanyhasraisedduringtheperiodandthelengthof timeforwhichthiscapitalhasbeenavailableforthepurposeofgeneratingearnings.

Theweightedaveragenumberofordinarysharesforanaccountingperiodiscalculated by *adding*:

(a) thenumberofordinarysharesoutstandingatthebeginningoftheperiod

(b) thenumberofordinarysharesissuedduringtheperiod,multipliedbytheappropriate time weighting factor

andthen*subtracting*:

(c) thenumberofordinarysharesboughtbackbythecompanyduringtheperiod(ifthis islegallypermissible)multipliedbytheappropriatetimeweightingfactor.

Strictlyspeaking,thetimeweightingfactorsusedinthiscalculationshouldreflectthe numberof*days*thathaveelapsedbetweenthedateoftheissueorbuy-backandtheendof theaccountingperiod.However,IAS33acceptsthatareasonableapproximationis adequateinmostcircumstances.Inthisbook,itisassumedthattimeweightingfactors should be calculated to the nearest month.

It is important to note that the above calculation assumes that shares are issued or bought backatfairvalue(i.e.atfullmarketprice).Furtheradjustmentsarerequiredifthisisnot thecase,mainlywherethecompanymakesabonusissueorrightsissue(seebelow).

EXAMPLE2

On1January2019,acompany'sissuedsharecapitalconsistedof60,000ordinary£1shares.On1 March2019,thecompanyissued30,000ordinaryshares.On1October2019,thecompanybought back10,000ordinaryshares.Boththeshareissueandthebuy-backweremadeatfullmarketprice.

Calculatetheweightedaveragenumberofordinarysharesoutstandingintheyearto31December 2019.

Solution

Theshareissueandthebuy-backoccurredtenmonthsandthreemonthsrespectivelybeforetheendoftheaccountingyear.Th ereforetheweightedaveragenumberofordinarysharesoutstandingintheyearwas:

60,000+(30,000x10/12)–(10,000x3/12)=82,500shares.

Thiscalculationrecognisesthattheextraresourcesgeneratedbythenewissuewereavailabletothecompanyforthepurposeofgeneratingearningsforonlythelasttenmonthsoftheyearand(similarly)thattheresourcesusedtofinancethebuy-backwereunavailabletothecompanyforthelastthreemonthsoftheyear.

Sincethecompanyhad60,000ordinarysharesoutstandingforthefirsttwomonthsoftheyear,90,000sharesforthenextsevenmonthsandthen80,000sharesforthefinalthreemonths,analternativewayofcalculatingtheweightedaveragenumberofordinarysharesisasfollows:

(60,000x2/12)+(90,000x7/12)+(80,000x3/12)=82,500shares.

Eithermethodofcalculationmaybeused.

EXAMPLE3

Acompany'sprofitaftertaxfortheyearto31July2020was£3.8million.Thecomparativefigurefortheyearto31July2019was£3.6million.

Thecompany'sissuedsharecapitalat1August2018consistedof4millionordinarysharesof50p.Noshareswereissuedduringtheyearto31July2019butafurther1millionordinaryshareswereissued(atfullmarketprice)on1November2019.

CalculatebasicEPSfortheyearsto31July2019and2020.

Solution

Thenumberofordinarysharesoutstandingintheyearto31July2019was4million.Theweightedaveragenumberofordinarysharesoutstandingintheyearto31July2020was:

4,000,000+(1,000,000x9/12)=4,750,000shares.

Alternatively,thismaybecalculatedas:

(4,000,000x3/12)+(5,000,000x9/12)=4,750,000shares.

Therefore:

BasicEPSfortheyearto31July2019is $\frac{£3,600,000}{4,000,000}$ =90ppershare.

BasicEPSfortheyearto31July2020is $\frac{£3,800,000}{4,750,000}$ =80ppershare.

ThisfallinbasicEPSreflectsthefactthatearningshaverisenbyonly5.55%whilstthenumberofissuedshareshasrisenby18.75%.

Note:

TheEPScalculationtakesintoaccountthe*number*ofordinarysharesoutstanding,nottheirnominalvalue.Therefore thefactthatthiscompany'sordinaryshareshaveanominalvalueof50pershareisirrelevant.

Bonusissues

IAS33 requires that the weighted average number of ordinary shares outstanding during an accountingperiodshouldbeadjustedforevents"*thathavechangedthenumberofordinarysharesoutstandingwithoutacorrespondingchangeinresources*". This is areferencetothefactthatordinarysharesmaybeissuedatapricewhichislessthantheir full market value. The main occasions on which this occurs are when a company makes abonusissue(seebelow)orarightsissue(seelaterinthischapter).

Abonusissueconsistsofanissueoffreeextrasharestoexistingshareholdersin proportion to their existing holdings. From the point of view of calculating EPS, the most importantfeatureofabonusissueisthatacompany'sresourcesdonotincreasewhensuch anissueismade.Thereforeabonusissueincreasesthenumberofsharesoutstanding withoutincreasingthecompany'scapacitytoearnprofits.

Ifabonusissuemadeduringaperiodweretreatedinthesamewayasanissueofshares at full price, the effect would be to depress the EPS figure and distort the comparison withEPSinpreviousperiods.Toresolvethisproblem,IAS33statesthatabonusissueshould betreatedasifithadoccurred"*atthebeginningoftheearliestperiodpresented*".Since mostcompaniespresentcomparativeinformationforthepreviousperiodonly,thismeans thatbonusissuesareusuallytreatedasiftheyhadoccurredatthebeginningofthe previousperiod.Itisnecessaryinthesecircumstancestorecalculateandrestate EPSfor thepreviousperiodaswellastocalculateEPSforthecurrentperiod.

EXAMPLE4

Acompany'sprofitaftertaxfortheyearto30June2020was£2.2million.Thecompar-ativefigurefortheyearto30June2019was£2million.

Thecompany'sissuedsharecapitalat1July2018consistedof800,000ordinaryshares.Noshare swereissuedduringtheyearto30June2019buta1for4bonusissuewasmadeon1March2020.

CalculatebasicEPSfortheyearto30June2020andtherestatedcomparativefigurefortheyearto30June2019.

Solution

Thebonusissueof200,000ordinarysharesistreatedasifmadeon1July2018,sothatthenumberofordinarysharesoutstandingis1millionthroughoutbothyears.Therefore:

$$\text{BasicEPSfortheyearto30June2020is}\ \frac{£2{,}200{,}000}{1{,}000{,}000} = £2.20\text{pershare.}$$

$$\text{RestatedbasicEPSfortheyearto30June2019is}\ \frac{£2{,}000{,}000}{1{,}000{,}000} = £2.00\text{pershare.}$$

Thesefiguresshowa10%increaseinbasicEPS.Thisisfair,sinceearningshaverisenby10%without anyincreaseinthecompany'sresources.

BasicEPSfortheyearto30June2019wouldhavebeenstatedoriginallyas£2.50pershare(earningsof£2milliondividedby800,000ordinaryshares).Ifthiswerenotrestatedasabove,itwouldappearthatthecompany'sfinancialperformancehaddeclinedduringtheyearto30June2020,whichisnotthecase.

EXAMPLE5

On1January2018,acompany'sissuedsharecapitalconsistedof500,000ordinaryshares.Nofurthershareswereissuedduringtheyearto31December2018butthefollowingissuestookplaceduringtheyearto31December2019:

(a) a1for5bonusissueon1February2019

(b) anissueof120,000ordinarysharesatfullmarketpriceon1December2019.

Calculatethenumberofsharestobeusedinthecalculationofrestatedbasic EPSfortheyearto31December2018.Alsocalculatetheweightedaveragenumberofordinarysharestobeusedinthecalculationofbasic EPSfortheyearto31December2019.

Solution

Thebonusissueof100,000sharesistreatedasifmadeon1January2018.Thereforethenumberofsharestobeusedinthecalculationofrestated basic EPSfortheyearto31December2018is600,000.

Theweightedaveragenumberofordinarysharesoutstandingintheyearto31December2019is:

600,000+(120,000x1/12)=610,000shares.

Alternatively,thismaybecalculatedas:

(600,000x11/12)+(720,000x1/12)=610,000shares.

Rightsissues

Likeabonusissue,arightsissueconsistsofanissueofextrasharestoexistingshare- holders in proportion to their existing shareholdings. However, rights shares are not issuedfree of charge. If a rights issue is made at full market price, it is treated in exactly the sameway as any other full-price issue when calculating basic EPS. But rights shares are oftenissuedatapricewhichis*lower*thanmarketpriceandsocontaina"bonuselement".In these circumstances, IAS33 requires that the rights issue should be separated into two components. These are:

(a) abonusissue,followedimmediatelyby

(b) anissueofsharesatfullmarketprice.

Eachofthesecomponentsisthentreatedasdescribedearlierinthischapter.

Calculatingthebonuselementofarightsissue

Thecalculationofthebonuselementofarightsissuereliesuponthefactthat(intheory) themarketpricepershareofacompany'ssharesshouldfallwhenanissueismadewithout acorrespondingincreaseinthecompany'sresources.Forinstance,a1for1bonusissue woulddoublethenumberofsharesoutstandingbutwouldnotinjectanyextraresources intothecompanyconcerned.Thereforethemarketpricepershareshouldhalvewhensuch asissueismade.Basedonthisprinciple,theproceduretobeadoptedwhenarightsissue is made at less than fair value is as follows:

(a) **Step1**. The theoretical fall in the market price of the company's shares caused by the rightsissueiscalculated.Thiscalculationtakesintoaccountthenumberofshares issuedandtheamountofextraresourcesraisedbytheissue.

(b) **Step2**. It is thennecessaryto compute thesizeof bonus issue*thatwouldhavecausedthesamefallinthemarketprice*of the company's shares as the fall which has beencaused by the rights issue.

(c) **Step3**. The bonus element of the rights issue† is equal to the number of bonus shares calculated at step 2 above. The remainder of the rights issue is treated as an issue ofshares at full market price.

Theprocedureisillustratedintheexamplesgivenbelow.

†*Analternative(andequivalent)wayofcalculatingthebonuselementofarightsissueistomultiply thenumberofordinarysharesoutstandingbeforetheissueby:*

$$\left(\frac{\textit{Marketvaluepershareimmediatelybeforetherightsissue}}{\textit{Theoreticalmarketvaluejustaftertherightsissue}}\right)_{-1}$$

ThisisinfacttheapproachsuggestedintheIAS33applicationguidance.

EXAMPLE6

Acompanywithanissuedsharecapitalof100,000ordinarysharesmakesa1for5rightsissueat£4.20pershareandthisissueisfullysubscribed(i.e.alloftherightssharesaresold).Themarketpriceofthecompany'ssharesimmediatelybeforethisissueis£6pershare.Whatisthetheoreticalmarketvaluepersharejustaftertherightsissue?

Solution

Thetotalmarketvalueofthecompany'sshares(andsopresumablythetotalworthofthecompany) justbeforetherightsissueis£600,000.

Therightsissueconsistsof20,000sharesandraisesextraresourcesof£84,000(20,000x£4.20). Sotheworthofthecompanybecomes£684,000andthenumberofissuedsharesrisesto120,000. Thetheoreticalmarketpriceofthecompany'ssharesjustaftertherightsissueistherefore£684,000/120,000=£5.70pershare.

EXAMPLE7

Acompany'sprofitaftertaxfortheyearto31March2020was£351,000.Thecomparativefigurefor theyearto31March2019was£288,000.

Thecompany'sissuedsharecapitalat1April2018consistedof100,000ordinaryshares.Noshare swereissuedduringtheyearto31March2019buta1for2rightsissuewasmadeon1October2019 at60ppershareandthiswasfullysubscribed.Themarketvalueofthecompany'ssharesjustbefor etherightsissuewas£1.20pershare.

CalculatebasicEPSfortheyearto31March2020andtherestatedcomparativefigurefortheyearto 31March2019.

Solution

Thissolutionfollowsthe3-stepapproachsuggestedaboveinrelationtorightsissues.

Step1.Thetotalmarketvalueofthecompany'ssharesjustbeforetherightsissue(andsopresuma blythecompany'sworth)was£120,000.Therightsissueconsistedof50,000sharesandraised£3 0,000(50,000x60p).Thereforethenumberofissuedsharesroseto150,000andthecompany'swo rthincreasedto£150,000.Sothetheoreticalmarketpriceofthecompany'ssharesjustaftertherig htsissuewas£1pershare.

Step2.Iftherehadbeenabonusissueinsteadofarightsissue,thecompany'sworthwouldhavere mainedat£120,000.Ifthemarketpricepersharehadfallento£1asaresultofthishypotheticalbon usissue,thecompany'sissuedsharecapitalafterthebonusissuewouldhaveconsistedof120,00 0shares(since120,000x£1=£120,000).Sothesizeofbonusissuethatwouldhavecausedafallin marketpriceto£1pershareisanissueof20,000shares(a1for5bonusissue).

Alternatively,thebonuselementis100,000×((£1.20/£1.00)−1)=20,000shares.

Step3.Therightsissuecannowbedividedintoabonusissueof20,000sharesandanissueofshare satfullmarketpriceoftheremaining30,000shares.

Thevalidityofthisseparationcanbedemonstratedbyobservingthatifabonusissueof20,000sh areshadoccurredandthishadreducedmarketpriceto£1pershare,thenanissueof30,000shares atfullmarketpricewouldhaveraised£30,000.Thisisindeedtheamountofmoneythattherightsis suehasraised(50,000sharesat60p).

CalculationofbasicEPS

ThecalculationofbasicEPSisnowstraightforward.Asusual,thebonuselementoftherightsissue (20,000shares)istreatedasifithadoccurredatthebeginningoftheperiod,givingatotaln umberofordinarysharesoutstandingfortheyearto31March2019of120,000shares.Theweighte daveragenumberofordinarysharesoutstandingfortheyearto31March2020is120,000+(30,000 x6/12)=135,000shares.Therefore:

$$\text{RestatedbasicEPSfortheyearto31March2019is}\ \frac{\pounds 288,000}{120,000} = \pounds 2.40\text{pershare.}$$

$$\text{BasicEPSfortheyearto31March2020is}\ \frac{\pounds 351,000}{135,000} = \pounds 2.60\text{pershare.}$$

CalculationofDilutedEPS

ThecalculationofbasicEPStakesintoaccountonlythoseordinaryshareswhichare alreadyoutstanding.However,acompanymayhaveissuedfinancialinstrumentswhich give the holder the right to acquire ordinary shares at some time in the future. When these "potentialordinaryshares"areeventuallyissued,thecompany'searningswillbespread over a greater number of shares than before and so EPS will usually be reduced. The most common examples of potential ordinary shares are:

(a) liabilitiesthatareconvertibleintoordinaryshares(e.g.convertibleloanstock)
(b) optionstopurchaseordinaryshares.

Toensurethatexistingshareholdersaremadeawareoftheextenttowhichearningsper sharewouldbereduced(or"diluted")ifpotentialordinaryshareswereissued,companies arerequiredbyIAS33tocalculateafigurefor"dilutedEPS"aswellasforbasicEPS.

Diluted EPS is defined as the earnings per share figure which would arise if all "dilutive potentialordinaryshares"wereissued.Potentialordinarysharesareregardedasdilutiveif the effect of their issue would be to *decrease*EPS. If the issue of potential ordinary shares would *increase*EPS (see below), the shares are then said to be "antidilutive". Antidilutive potentialordinarysharesareignoredwhencalculatingdilutedEPS.

Acompanywhichreportsaprofitorlossondiscontinuedoperationsmustcalculate dilutedEPSbasedonthewholeofthecompany'sprofitandanotherdilutedEPSfigure basedontheprofitfromcontinuingoperations.Comparativesmustbegivenforthe previousaccountingperiod.ThecalculationofdilutedEPSgenerallyrequiresthe followingadjustmentstothefigureswhichwereusedwhencalculatingbasicEPS:

(a) **Earnings**. The company's earnings must be adjusted for the after-tax effect of anychange in income or expenses that would result from the issue of dilutive potential ordinaryshares.Forinstance,earningswouldbeincreasedbytheamountofextra after-taxprofitthatwouldariseastheresultofnolongerpayingintereston convertible loan stock.

(b) **Weightedaveragenumberofshares**.Theweightedaveragenumberofordinary sharesmustbeincreasedtoreflectthemaximumnumberofadditionalordinary sharesthatwouldbecomeoutstandingifalldilutivepotentialordinaryshareswere issued (assuming the most advantageous conversion rate from the point of view of the holder of the potential ordinary shares). These shares are treated as if issued at the beginning of the accounting period or (if later) on the date of issue of the financial instrument concerned.

Potential ordinary shares are antidilutive if the effect of issuing those shares would be to increaseearningsbyproportionatelymorethantheincreaseinthenumberofshares.

EXAMPLE8

Acompanyhasanissuedsharecapitalconsistingof8millionordinaryshares.Thecompany'safter-taxprofitfortheyearto30September2020is£2million.

In2017,thecompanyissued£10millionof8%convertibleloanstock.Thisstockisconvertibleintoordinarysharesduringyear2023attherateofoneordinaryshareper£5ofloanstock.Ataxrateof19%maybeassumed.

(a) Calculatethecompany'sbasicEPSfortheyearto30September2020.

(b) Determinewhetherthepotentialordinarysharesderivedfromtheloanstockaredilutiveorantidilutiveandcalculatethecompany'sdilutedEPSfortheyear.

(c) Explainhowthesituationwoulddifferiftheloanstockattractedinterestat5%ratherthan8%.

Solution

(a) BasicEPSis£2milliondividedby8millionshares,giving25ppershare.

(b) Ifalloftheloanstockwereconvertedintoshares,thecompanywouldsaveinterestof £800,000perannum.Profitbeforetaxwouldriseby£800,000,givinganincreaseinafter-taxprofitsof£648,000(£800,000less19%tax).

Therewouldbe2millionextraordinaryshares,soEPSfortheyearto30September2020would dbe26.48p(£2,648,000dividedby10millionshares).Thisexceedsthecompany'sbasicEPSsotheeffectofconversionwouldbetoincreaseEPS,nottoreduceit.Thereforethepotentialordinarysharesareantidilutiveandcanbeignored.DilutedEPSisthesameasbasicEPS.

(c) Iftheloanstockattractedinterestatonly5%,theincreaseinafter-taxprofitsonconversionwouldbe£405,000(£500,000less19%).EPSfortheyearwouldbecome24.05p(£2,405,000dividedby10millionshares).ThisislessthanbasicEPSandsothepotentialordinarysharesaredilutive.DilutedEPSis24.05ppershare.

Options

Asharеoptiongenerallygivestheholderofthatoptiontherighttoacquiresharesatless thanfullmarketprice.Whensuchanoptionisexercised,theresultingincreaseinthe number of shares outstanding will have a dilutive effect on EPS but this effect will bemitigatedbecauseoftheextraresourcesthatwillenterthecompanywhentheoption-holderpaysfortheshares.WhencalculatingdilutedEPS,shareoptionsaredealtwithin the following way:

(a) Thetotalamountofmoneythatwillbepayablebytheoption-holderwhentheoption is exercised is divided by the average market price per share during the currentaccountingperiod,sogivingthenumberofsharesthatcouldbeacquiredforthat amount of money at full market price.

(b) Baseduponthiscalculation,thepotentialshareissueisnowsplitintoapotential issue of shares at full market price and a potential issue of free shares ("shares for no consideration").

(c) Shares issuedat full price are not dilutive, sothe weightedaverage number of shares usedinthedilutedEPScalculationisadjustedtoreflectonlythepotentialissueof shares for no consideration.

Themethodisillustratedintheexamplegivenbelow.

EXAMPLE9

Acompany'sissuedsharecapitalconsistsof5millionordinaryshares.Thecompany'safter-taxprofitfortheyearto31December2019is£2.6million.Shareoptionsexistwhich,whenexercised,wouldresultintheissueofafurther400,000ordinarysharesatapriceof £1pershare.Theaveragemarketpriceperordinaryshareduring2019was£5.Comput

ebasicanddilutedEPSfortheyearto31December2019.

Solution

BasicEPSis52ppershare(£2.6milliondividedby5millionshares).

Whentheoptionsareexercised,afurther400,000shareswillbeissuedforatotalconsiderationof£400,000.Ataveragemarketprice,thenumberofshareswhichcouldbeobtainedforthisconsideration is80,000(£400,000dividedby£5)sothepotentialissueof400,000sharesissplitintoapotential issueof80,000sharesatfullmarketpriceandapotentialissueof320,000sharesfornoconsideration.

Thepotential80,000sharesarenotdilutiveandcanbeignored.ThereforetheweightedaveragenumberofsharesusedinthecalculationofdilutedEPSis5.32million(5millionsharescurrentlyoutstandingplusapotential320,000furthershares).

DilutedEPSis48.9ppershare(£2.6milliondividedby5.32millionshares).

Presentationanddisclosurerequirements

ThemainpresentationanddisclosurerequirementsofIAS33areasfollows:

Presentation

(a) Basic and diluted EPS (both for the profit or loss attributable to ordinary shareholdersand for the profit or loss from continuing operations attributable to ordinary share- holders) must be presented "*inthestatementofcomprehensiveincome*". It is not permissibletopresentthesefiguresinthenotesinstead.

(b) An entity which presents a separate statement of profit or loss (see Chapter 3) should presentitsbasicanddilutedEPSfiguresinthatseparatestatement.

(c) If a company's financial statements report a discontinued operation, basic EPS anddiluted EPS figures must be presented for that operation, either in the statement of comprehensive income or in the notes.

(d) EPSfiguresmustbepresentedeveniftheyarenegative(i.e.alosspershare).

Disclosure

(a) The company must disclose the earnings figures used in the EPS calculations and reconcile these figures to the profit or loss for the period as shown in the statement of comprehensive income.

(b) The company must disclose the weighted average number of shares used in thecalculation of basic EPS and in the calculation of diluted EPS. These figures must be reconciled to each other.

(c) Financialinstrumentswhichcouldpotentiallydiluteearningspershareinthefuture, but which have not been included in the calculation of diluted EPS (because they are currently antidilutive) must also be disclosed.

Summary

- EPSiswidelyusedasameansofassessingacompany'sfinancialperformanceandas a basis for performance comparisons. Therefore it is important that EPS should be calculated on a consistent basis.
- IAS33laysdownasetofrulesforthecalculationandpresentationofEPSfigures. Thisstandardappliestocompanieswhoseordinarysharesarepubliclytraded.
- Basic EPS for an accounting period is calculated by dividing the profit attributable to ordinaryshareholdersforthatperiodbytheweightedaveragenumberofordinary shares outstanding during the period.
- Bonusissuesmadeduringanaccountingperiodaretreatedasifmadeatthe beginning of the previous period.
- Rights issues are separated into a bonus element and an issue of shares at full market price.Eachcomponentoftherightsissueisthentreatedaccordingly.
- Diluted EPS for an accounting period is the EPS which would arise if all dilutivepotential ordinary shares were issued. The calculation of diluted EPS requires that adjustmentsaremadetothefiguresforearningsandnumberofsharesoutstanding which were used when computing basic EPS.
- BasicEPSanddilutedEPSmustbepresentedinthestatementofcomprehensive income.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

23.1 A company's issued share capital is £2 million, comprising four million ordinary shares of 25p each and one million 8% preference shares of £1. An extract from the company's statement of comprehensive income for the year to 31 March 2020 is as follows:

	£000
Profitbeforetax	485
Taxation	95
Profitaftertax	390

Preferencedividendsof£80,000werepaidduringtheyear.

Required:

(a) CalculatebasicEPSfortheyear.

(b) RecalculatebasicEPSfortheyearontheassumptionthatthecompany'sprofit after tax includes profit of £50,000 from a discontinued operation.

23.2 The profit after tax of B plc for the year to 30 June 2020 is £217,500. The comparative figure for the year to 30 June 2019 was £188,000.

On 1 July 2018, the company's issued share capital consisted of 100,000 ordinary shares of £1each. On1December 2019, afurther 15,000ordinaryshareswereissuedat full market price.

Required:

(a) CalculatebasicEPSfortheyearto30June2019.

(b) CalculatebasicEPSfortheyearto30June2020.

23.3 Cplchasthefollowingafter-taxprofitsforitstwomostrecentaccountingperiods:

	£000
yearto31October2018	330
yearto31October2019	341

On 1 November 2017, the company's issued share capital consisted of 500,000 ordinary shares. On 1 August 2019, the company made a 1 for 10 bonus issue.

Required:

(a) CalculatebasicEPSfortheyearto31October2019.

(b) Calculate restatedbasic EPS for the year to 31 October 2018 and explain why this restatement is necessary.

23.4 TheprofitsaftertaxofDplcareasfollows:

	£
yearto30September2018	50,000
yearto30September2019	52,800

On1October2017,thecompany'sissuedsharecapitalconsistedof150,000ordinary shares. On 1 July 2019, the company made a 1 for 5 rights issue at 50p per share. This issuewasfullysubscribed.Themarketvalueofthecompany'ssharesjustbeforethe rights issue was 80p per share.

Required:

(a) CalculatebasicEPSfortheyearto30September2019.

(b) Calculaterestatedbasic EPSfortheyearto30September2018.

23.5 Eplchasanissuedsharecapitalconsistingof800,000ordinaryshares.Thereareno preference shares. Some years ago, the company issued £1 million of 10% convertible loan stock, convertible in 2024 at the rate of two ordinary shares for every £10 of loan stock. The company's profit after tax for the year to 31 March 2020 is £640,000.

Required:

(a) CalculatebasicEPSfortheyearto31March2020.

(b) Calculate diluted EPS for the year to 31 March 2020, assuming that the company pays tax at 19%.

(c) Rework both of the above calculations, now assuming that the loan stock was not issued "some years ago" but was in fact issued on 1 October 2019.

***23.6** TheprofitsattributabletotheordinaryshareholdersofFplcareasfollows:

	£000
yearto31December2018	1,800
yearto31December2019	2,475

For many years, the company's issued share capital has consisted of 9 million ordinary shares. However, on 1 April 2019, the company made a 1 for 4 rights issue at 50p per share.Thisissuewasfullysubscribed.Themarketvalueofthecompany'ssharesjust before the rights issue was £1 per share.

Required:

(a) CalculatebasicEPSfortheyearto31December2019.

(b) Calculaterestatedbasic EPSfortheyearto31December2018.

*23.7On 1 January 2018, G plc issued £2 million of 7% convertible loan stock. The holders of thisstockmaychoosetoconvertthestocktoordinary shareson 1 January 2022,2023or
2024.Thenumberofordinarysharesintowhichthestockwillbeconvertedisasfollows:

Dateofconversion	*Numberofsharesissued*
1January2022	400sharesper£1,000ofstock
1January2023	420sharesper£1,000ofstock
1January2024	440sharesper£1,000ofstock

The company's profit after tax for the year to 30 September 2019 was £2.2 million. The comparative figure for the year to 30 September 2018 was £2.4 million. The company pays tax at 19%.

On1October2017,thecompany'sissuedsharecapitalconsistedof1.5million12% preference shares of £1 each and 5 million ordinary shares of 20p each. On 1 April 2019 the company issued a further 500,000 ordinary shares at full market price.

The preference dividend was paid in full in both the year to 30 September 2018 and the year to 30 September 2019.

Required:

(a) CalculatebasicEPSanddilutedEPSfortheyearto30September2018.

(b) CalculatebasicEPSanddilutedEPSfortheyearto30September2019.

Chapter24

Segmentalanalysis

Introduction

Manyentities(especiallylargecompanies)engageinawiderangeofbusinessactivities and operate in a number of economic environments. Each business activity or economic environment may be subject to differing rates of profitability, differing opportunities for growth, differing future prospects and differing risks, but this is not apparent from the aggregated information given in the main financial statements. Accordingly, international
standardIFRS8*OperatingSegments*requiresanentitywhichfallswithinitsscopeto disclose information that will enable the users of the financial statements to "*evaluatethenatureandfinancialeffectsofthebusinessactivitiesinwhichitengagesandthe economicenvironmentsinwhichitoperates*".

Thepurposeofthischapteristoexplaintherequirementsof IFRS8,whichwasissuedby the IASB in 2006 as part of its convergence project with the US Financial Accounting Standards Board. The requirements of this standard apply only to entities whose shares or securities are publicly traded.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explaintheterm"operatingsegment"asdefinedinIFRS8
- explaintheterm"reportablesegment"asspecifiedinIFRS8
- identifyanentity'sreportablesegments
- statethedisclosuresrequiredbyIFRS8foreachreportablesegment
- explainthereconciliationsrequiredbyIFRS8
- listtheentity-widedisclosuresrequiredbyIFRS8
- prepareanentity'ssegmentreport.

Operatingsegments

IFRS8adoptsa"managementapproach"tosegmentreportinganddefinesthesegmentsof anentityinawaywhichisconsistentwiththeentity'sowninternalmanagementstructure. AnoperatingsegmentisdefinedbyIFRS8as"*acomponentofanentity:*

(a) thatengagesinbusinessactivitiesfromwhichitmayearnrevenuesandincurexpenses(i ncludingrevenuesandexpensesrelatingtotransactionswithothercomponentsofthes ameentity),

(b) whoseoperatingresultsareregularlyreviewedbytheentity'schiefoperatingdecisionm akertomakedecisionsaboutresourcestobeallocatedtothesegmentandassessitsper formance,and

(c) forwhichdiscretefinancialinformationisavailable."

The standard points out that not every component of an entity is necessarily an operating segmentorevenpartofanoperatingsegment.Forexample,acorporateheadquartersmay notearnrevenueandthereforewouldnotbeanoperatingsegment.

Theterm"chiefoperatingdecisionmaker"identifiesafunctionratherthanamanager withaspecifictitle.Inmanycasesthisfunctionwillbeperformedbythechiefexecutive or chief operating officer but the function might be performed by a group of executivedirectorsorothermanagers.Ingeneral,eachoperatingsegmentwillbemanagedb ya segmentmanagerwhoreportstothechiefoperatingdecisionmaker.

Reportablesegments

IFRS8 requires an entity to provide separate information about each of its "reportable segments".Thisinformationisdisclosedinthenotes tothefinancialstatements.The followingrulesareusedtoidentifyanentity'sreportablesegments:

(a) Two or more operating segments may be combined into one operating segment if the segmentshavesimilareconomiccharacteristicsandaresimilarineachofthe following respects:

- thenatureoftheproductsandservicesinvolved
- thenatureoftheproductionprocesses
- thetypeorclassofcustomerfortheproductsandservices
- thedistributionmethodsused
- thenatureoftheapplicableregulatoryenvironment(ifany).

(b) Areportablesegmentisasingleorcombinedoperatingsegmentwhichmeets*any*of the following "quantitative thresholds":

(i) its reported total revenue from sales to external customers and sales to other operatingsegmentsisatleast10%ofthetotalrevenue(externalandinternal)of all operating segments, or

(ii) its reported profit or loss is at least 10% of the combined profit of all operating segmentsthatreportedaprofitorthecombinedlossofalloperatingsegments that reported a loss, whichever is the greater, or

(iii) itsassetsareatleast10%ofthetotalassetsofalloperatingsegments.

(c) Anoperatingsegmentthatdoesnotmeetanyofthe10%thresholdsmaynonetheless be treated as a reportable segment if management believes that information about the segmentwouldbeusefultotheusersofthefinancialstatements.Alternatively:

(i) such a segment may be combined into a reportable segment with one or moresimilaroperatingsegmentsthatalsofailtomeetanyofthe10%thresholds,or

(ii) itmaybeincludedinan"allothersegments"categoryinthesegmentreport.

(d) If the total external revenue attributable to reportable segments is less than 75% of the entity's total external revenue, additional operating segments must be identified as reportable(eventhoughtheyarebeneaththe10%thresholds)untilatleast75%of total external revenue is included in reportable segments.

EXAMPLE1

Alistedcompanyhasidentifiedsevenoperatingsegments(labelledAtoG).Thefollowinginformation isavailableinrelationtoeachsegment'srevenue,profitorlossandassetsfortheyearto31December2019:

	External revenue	*Salestoother segments*	*Profitor (loss)*	*Assets*
	£000	£000	£000	£000
SegmentA	3,040	2,440	720	3,170
SegmentB	1,460	0	(160)	1,590
SegmentC	1,580	60	(60)	1,480
SegmentD	1,720	0	120	2,150
SegmentE	760	520	150	1,620
SegmentF	2,360	1,740	560	3,780
SegmentG	1,520	0	(50)	1,460
	12,440	4,760	1,280	15,250

Identifythecompany'sreportablesegmentsforthisaccountingperiod.

Solution

(a) Thecompany'stotalrevenue(externalandinternal)is£17.2m(£12.44m+£4.76m).Soasegmentmusthaverevenueofatleast£1,720,000tosatisfythefirst10%test.

(b) Thecombinedprofitsofprofitablesegmentsare£1.55mandcombinedlossesofloss-makingsegmentsare£0.27m.Thelargeroftheseis£1.55m.Soasegmentmusthaveaprofitorlossofatleast£155,000tosatisfythesecond10%test.

(c) Totalassetsare£15.25m.Soasegmentmusthaveassetsofatleast£1,525,000tosatisfythethird10%test.

(d) Theresultsofthethree10%testsforeachoperatingsegmentareasfollows:

	Totalrevenueat least£1.72m	*Profitorlossat least£0.155m*	*Assetsat least£1.525m*	*Reportable segment*
SegmentA	Y	Y	Y	Y
SegmentB	N	Y	Y	Y
SegmentC	N	N	N	N
SegmentD	Y	N	Y	Y
SegmentE	N	N	Y	Y
SegmentF	Y	Y	Y	Y
SegmentG	N	N	N	N

SegmentsCandGfailallthreeofthe10%tests,sothesewillnotbereportableaslongastheremainingsegmentssatisfythe75%test.

(e) 75%ofthecompany'stotalexternalrevenueis£9.33m(75%×£12.44m).Thetotalexternalrevenueofreportablesegments A,B,D,EandFis£9.34m,sothe75%testissatisfied.

DisclosuresrequiredbyIFRS8

IFRS8requiresthatentitiesshoulddisclosefourmainclassesofinformationforeach accounting period. These are as follows:

(a) generalinformation
(b) informationabouteachreportablesegment
(c) certainreconciliations
(d) entity-wideinformation.

Eachoftheseclassesisexplainedbelow.

Generalinformation

Anentityshoulddisclosethefactorsusedtoidentifyitsreportablesegmentsandthetypes ofproductsorservicesfromwhicheachreportablesegmentearnsitsrevenues.

The way in which the entity is organised internally should be made clear (e.g. by product group or geographical area). The entity should also disclose whether or not any operating segmentshavebeencombinedforsegmentreportingpurposesandthejudgementsthat havebeenmadewhendecidingwhethertocombineoperatingsegments.

Informationaboutreportablesegments

Anentityshoulddisclosetheprofitorlossofeachreportablesegment.Totalassetsand total liabilities for each reportable segment should also be disclosed if these amounts are regularly provided to the chief operating decision maker.

In addition, certain items should be disclosed for each reportable segment if these are includedinthesegmentprofitorlossfiguresorareotherwiseregularlyprovidedtothe chief operating decision maker. These items include:

(a) segmentexternalrevenueandinternalrevenue

(b) segmentinterestexpenseandinterestrevenue

(c) segmentdepreciationandamortisation

(d) segmentincometaxexpense(orincome)

(e) segmentnon-cashitemsotherthandepreciationandamortisation(ifmaterial)

Theentityshoulddiscloseadditionstonon-currentassetsforeachreportablesegmentif thisinformationisregularlyprovidedtothechiefoperatingdecisionmaker.

Theamountsofalltheitemslistedaboveshouldbetheamountswhicharereportedto thechiefoperatingdecisionmaker,regardlessofwhethertheseamountsaremeasuredfor thatpurposeinthesamewayastheyaremeasuredinthefinancialstatements.

An entity should explain the way in which segment profit or loss, segment assets andsegment liabilities have been measured for segment reporting purposes. The explanationshould disclose the basis of accounting for inter-segment transactions and any differences between the measurement bases used for segment reporting purposes and the measurement bases used in the financial statements.

Note also that entities are encouraged (but are not required) by IAS7 *StatementofCashFlows*todisclosecashflowinformationforeachreportablesegment,sho wingtheamount of segment cash flows arising from operating activities, investing activities and financing activities (see Chapter 16).

Reconciliations

The entity must provide certain reconciliations between the information disclosed forreportable segments and the information given in the financial statements. The required reconciliations are as follows:

(a) totalrevenueofreportablesegmentstotheentity'srevenue

(b) totalprofitorlossofreportablesegmentstotheentity'sprofitorloss

(c) totalassetsofreportablesegments(ifdisclosed)totheentity'sassets

(d) totalliabilitiesofreportablesegments(ifdisclosed)totheentity'sliabilities.

For every other material item in the segment report, a reconciliation should be provided betweenthetotalamountofthatitemforreportablesegmentsandthecorresponding amount for the entity.

Entity-wideinformation

Therearethreetypesof"entity-wide"disclosuresrequiredbyIFRS8.Theseare:

(a) **Productsandservices**.Theentityshouldreportitsrevenuefromexternalcustomers foreachproductandservice(oreachgroupofrelatedproductsandservices)unless thisinformationisunavailableorwouldcosttoomuchtoderive.Theamountsof revenuethat arereportedshouldbebasedontheinformationwhichis usedtoproduce the entity's financial statements.

(b) **Geographicalareas**. The entity should report the following geographical information unlessthisinformationisunavailableorwouldcosttoomuchtoderive:

  (i) revenuesfromexternalcustomersattributedto:
    – theentity'shomecountry
    – allforeigncountries(intotal)

  (ii) non-currentassetslocatedin:
    – theentity'shomecountry
    – allforeigncountries(intotal)

  Theamountsreportedshouldbebasedontheinformationwhichisusedtoproduce the entity's financial statements. Amounts for an individual foreign country should be disclosed separately if material.

(c) **Majorcustomers**. The entity should provide information about the extent to which it reliesuponitsmajorcustomers.Inparticular,ifanysinglecustomeraccountsforat least 10% of the entity's external revenues, then:

  (i) thatfactshouldbedisclosed

  (ii) thetotalamountofrevenuefromeachsuchcustomershouldbedisclosed,along withtheidentityofthesegment(s)inwhichthisrevenueisreported.

  However,theentityisnotrequiredtodisclosetheidentityofmajorcustomers.

EXAMPLE2

TheimplementationguidancewhichaccompaniesIFRS8providesseveralillustrationsoftheway inwhichanentitymightdisclosesegmentinformation.Thetablesshownbelowarebaseduponso meoftheseillustrations:

(a) Table1givesinformationaboutreportablesegments.
(b) Table2reconcilessegmentrevenuestotheentity'stotalrevenue.
(c) Table3providescertaingeographicalinformation.

Table1:Informationaboutreportablesegments

	SegA £m	*SegB* £m	*SegC* £m	*Allother* £m	*Total* £m
Revenuefromexternal customers	800	950	1,700	100	3,550
Inter-segmentrevenue	–	300	150	–	450
Interestrevenue	125	100	250	–	475
Interestexpense	95	70	110	–	275
Depreciationandamortisation	30	5	260	–	295
Segmentprofit	27	90	280	10	407
Segmentassets	700	300	6,900	200	8,100
Non-currentassetadditions	100	50	140	–	290
Segmentliabilities	405	180	3,800	–	4,385

Table2:Revenuereconciliation

	£m
Totalrevenueforreportablesegments	3,900
Otherrevenue	100
Eliminationofinter-segmentrevenue	(450)
Entity'srevenue	3,550

Table3:Geographicalinformation

	Revenue £m	*Non-currentassets* £m
UnitedStates	1,900	1,100
Canada	420	–
China	340	650
Japan	290	350
Othercountries	600	300
Total	3,550	2,400

Summary

- IFRS8 requires entities whose shares are publicly traded to disclose certain segment information.Thisinformationshouldrelatetotheentity'soperatingsegments.
- An operating segment is a revenue-earning component of an entity whose operating results are regularly reviewed by the entity's chief operating decision maker and forwhich discrete financial information is available.
- In general, an operating segment is reportable if it meets at least one out of three 10% thresholds relating to the segment's revenue, profit or loss and assets. But reportable segmentsmustaccountforatleast75%oftheentity'stotalexternalrevenue.
- The main disclosures required by IFRS8 for each reportable segment usually include profit or loss, total assets and liabilities, external revenue, internal revenue, interest revenueandexpense,depreciation,incometaxexpense,significantnon-cashitems and additions to non-current assets.
- IFRS8 requires a number of reconciliations between the information disclosed for reportablesegmentsandtheinformationgiveninthefinancialstatements.
- IFRS8 also requires a number of entity-wide disclosures. The entity must disclose the amountofrevenueearnedfromeachofitsproducts/services,ageographicalanalysis of revenues and non-current assets and information about the extent to which it relies upon major customers.

Exercises

Asetofmultiplechoicequestionsforthischapterisavailableontheaccompanyingwebsite.

24.1 (a) Explainwhytheusersoffinancialstatementsmayfindasegmentreportuseful.
(b) Identify the entities which lie within the scope of IFRS8 *OperatingSegments*and which must therefore prepare a segment report.

24.2 (a) Explaintheterm"operatingsegment"asusedinIFRS8.
(b) List the main tests which determine whether or not a particular operating segmentis reportable.

24.3 IFRS8 requires disclosure of four main classes of information. Identify these classes and list the main disclosures required for each class.

24.4 McTavich plc has four operating segments. The following information relates to the year ending 31 March 2020:

	External Revenue	*Profit/(loss)*	*Assets*
	£000	£000	£000
SegmentP	27,300	2,450	14,540
SegmentQ	36,100	3,150	16,490
SegmentR	6,200	(230)	3,170
SegmentS	7,800	(550)	3,800

Inadditiontotheexternalrevenueshownabove,SegmentPearnedrevenueof£4.6m from sales to other operating segments. Identify the company's reportable segments for the year to 31 March 2020 in accordance with the requirements of IFRS8.

24.5 Overtan plc has four operating segments. The following figures relate to the year to 30 April 2020. Similar information is provided to the chief operating decision maker on a monthly basis.

	Segment A	*SegmentB*	*SegmentC*	*SegmentD*
	£m	£m	£m	£m
Externalsales	652	764	389	1,220
Salestoothersegments	127	234	87	333
Interestincome	17	12	-	56
Segmentrevenue	796	1,010	476	1,609
Costofsales	267	350	124	632
Distributioncosts	98	129	67	196
Administrativeexpenses	120	171	130	179
Interestexpense	34	51	20	87
Depreciation	101	132	65	253
Othernon-cashexpenses	17	12	7	29
Segmentexpenses	637	845	413	1,376
Segmentprofit	159	165	63	233
Segmentassets	530	653	310	982
Segmentliabilities	245	276	119	398
Segmentcapitalexpenditure	99	68	-	122

Generaladministrativeexpensesfortheyear(notallocatedbetweensegments)were £120m.The company's tax expense forthe yearwas £95m.Unallocated assets and liabilities were £457m and £658m respectively.

Insofarasthisinformationpermits,preparetheinformationaboutreportablesegments
andthereconciliationswhichshouldappearinthecompany'ssegmentreportfortheyear to 30 April 2020, in accordance with the requirements of IFRS8.

***24.6** Floothairplcisalargeinternationalairlinecompanywiththreeoperatingsegments:

- Internationalairlinebusiness
- Domesticairlinebusiness
- Non-airlinebusiness.

Thecompanyreportssegmentinformationfortheyearto31May2020inaccordancewith IFRS8 *OperatingSegments*. The following information is available for the year:

	£m
Totalrevenue:	
Internationalairlinebusiness	8,207
Domesticairlinebusiness	402
Non-airlinebusiness	267
Unallocatedincome	22
Profit/(loss)beforetaxandfinancecosts:	
Internationalairlinebusiness	803
Domesticairlinebusiness	(30)
Non-airlinebusiness	16
Profitonsaleofassets:	
Non-airlinebusiness	32
Unallocated	4
Netfinancecosts	149
Incometaxexpense	130
Assets:	
Internationalairlinebusiness	12,050
Domesticairlinebusiness	240
Non-airlinebusiness	140
Liabilities:	
Internationalairlinebusiness	4,566
Domesticairlinebusiness	84
Non-airlinebusiness	350
Unallocated	5,420
Totalrevenueincludesthefollowinginter-segmentsales:	
Internationalairlinebusiness	103
Domesticairlinebusiness	14
Non-airlinebusiness	7

Required:

(a) Prepare,insofarastheaboveinformationpermits,asegmentreportforFloothairplc for the year to 31 May 2020. Assume that the company decides to treat all three segments as reportable segments.

(b) Use the segment report to identify three significant aspects of the performance of Floothair plc which would not otherwise be evident. *(CIPFA)*

Part5

SMALLANDMEDIUM-SIZEDENTITIES

Chapter25

TheIFRSforSMEsStandard

Introduction

The text of the full international standards, together with their accompanying guidance and *BasesforConclusions*,occupiesover4,500pagesoffineprint.Anentitywhichcomplies withthesestandardsmustprepareandpresentanintricatesetoffinancialstatementsand must make very extensive disclosures. It is apparent, therefore, that the full standards are intended for use mainly by large sophisticated entities with complex finances. It is also apparent that the full standards are generally unsuitable for use by smaller entities with relatively simple financial affairs. In consequence, the main users of the full international standards are large public companies whose shares and securities are traded on stockexchanges throughout the world.

The IASB accepts that the full international standards are not well suited to small and medium-sizedentities(SMEs)andestimatesthatover95%ofallcompaniesworldwide fallintothiscategory.Therefore,inanattempttomeetthefinancialreportingneedsof these entities, the IASB has issued the *IFRSforSMEs*Standard. This standard is only 400 pages long (including accompanying documentation) and is tailored for use by small and medium-sizedentities.The"SMEsstandard"coversallaspectsofaccountingforsuch entities and is self-contained (i.e. it is not linked to the full international standards). The recognition and measurement rules are simpler than those in the full standards and topicswhich are not relevant to SMEs are omitted. Furthermore, entities which comply with the SMEsstandardarerequiredtomakefarfewerdisclosuresthanthosewhicharerequired by the full international standards.

The purpose of this chapter is to explain the principal features of the SMEs standard and highlight the main distinctions between this standard and the full standards. More detailed informationisavailableatwebsitewww.ifrs.org/issued-standards/ifrs-for-smes.

OrganisationoftheIFRSforSMEsStandard

TheSMEsstandardisorganisedbytopicandconsistsof35numberedsections.Afulllist of these sections can be found in the contents pages at the front of this book. The require-ments of each section are briefly described below.

Notethattherearethreetopicswhicharedealtwithinthefullstandardsbutnotinthe SMEsstandard.Theseareearningspershare(IAS33),interimfinancialreporting(IAS34) andsegmentreporting(IFRS8).Noneofthesetopicsisthoughttoberelevantto SMEs.

Objectives

Bytheendofthischapter,thereadershouldbeableto:

- explainthepurposeofthe*IFRSforSMEs*Standard(the"SMEsstandard")
- definetheterm"smallandmedium-sizedentities"
- explaintheconceptsandprincipleswhichunderlietheSMEsstandard
- identify the financial statements which must be presented by an entity whichcomplies with the SMEs standard
- explain the structure and required content of each component of a set of financialstatementsdrawnupinaccordancewiththeSMEsstandard
- outline the requirements of the SMEs standard in relation to each of the topicsaddressed by this standard
- briefly summarise the main distinctions between the SMEs standard and the fullinternational standards.

Section1

Smallandmedium-sizedentities

The *IFRSforSMEs*Standard is intended for use only by small and medium-sized entities. These are defined as "*entitiesthat:*

(a) donothavepublicaccountability,and

(b) publishgeneralpurposefinancialstatementsforexternalusers". External users arestated to include owners who are not involved in managing the business, existing and potentialcreditorsandcreditratingagencies.Financialstatementsproducedsolelyfor the benefit of owner-managers and the tax authorities are not normally treated as general purpose financial statements.

An entity has public accountability if its shares or securities are publicly traded. Financial institutionssuchasbanks,creditunionsandinsurancecompaniesarealsoregardedas having public accountability.

TheSMEsstandardmaybeadoptedbyanycountry(whetherornotthat countryhas adopted the full international standards) and each country which adopts the SMEs standardmaydetermineforitselfwhichtypesofentityshouldusethatstandard.However,th e above definition makes it clear that publicly accountable entities should not use the SMEs standard and that the standard is not intended for use by very small owner-managedbusinesses. It would seem that the main intended users are unlisted companies which areownedbytheirshareholdersbutmanagedbytheirdirectors.

At the time of writing, the IASB asserts that over 80 countries have already adopted the SMEsstandardandthatseveralothercountriesareconsideringitsadoption.

Section2

Conceptsandpervasiveprinciples

This section of the *IFRSforSMEs*Standard serves a similar purpose to the *ConceptualFramework*†andsetsouttheprinciples which underliethefinancialstatements ofsmall andmedium-sizedentities.Themainmattersdealtwithinthissectionareasfollows:

(a) **Objectiveoffinancialstatements**.TheobjectiveofaSME'sfinancialstatementsis to"*provideinformationaboutthefinancialposition,performanceandcashflowsofthee ntitythatisusefulforeconomicdecision-makingbyabroadrangeofusers...*". The financial statements also show the results of the stewardship of management and provideameans of holdingmanagement accountable.

(b) **Qualitativecharacteristics**.Thequalitativecharacteristicsoffinancialinformation are *understandability*, *relevance*, *reliability*and *comparability*. Information cannot be relevant unless it is material and is presented to users in sufficient time for it to affecttheir economic decisions. Information cannot be reliable unless it provides a faithful representation and is free from material error and bias. Reliability is enhanced if the substance of transactions is reported (not just their legal form) and if the information provided is complete and prepared with the exercise of prudence. Comparability is achievedbyusingconsistentaccountingpoliciesandbydisclosingthosepolicies.

(c) **Definitions**. The SMEs standard gives similar definitions of *asset*, *liability*, *equity*,*income*and*expenses*tothosegiveninthe*ConceptualFramework*(seeChapter2) .

(d) **Recognition**.Anitemisrecognisedinthefinancialstatementsonlyifitisprobable thatanyfutureeconomicbenefitsassociatedwiththeitemwillflowtoorfromthe entityandiftheitem'scostorvaluecanbemeasuredreliably.

(e) **Measurement**. The only measurement bases specified in the SMEs standard arehistorical cost and fair value. Fair value is defined as "*theamountforwhichanassetcouldbeexchanged,oraliabilitysettled,betweenknowle dgeable,willingpartiesinanarm'slengthtransaction*".
At initial recognition, assets and liabilities are measured at historical cost unless the SMEsstandardrequirestheuseofadifferentbasis.Subsequentmeasurementof varioustypesofassetandliabilityisdealtwithinlatersectionsofthestandard.

(f) **Accrualbasis**. Thefinancial statements of SMEs (other thanthestatement of cash flows)shouldbepreparedusingtheaccrualbasisofaccounting.

(g) **Totalcomprehensiveincomeandprofitorloss**. Total comprehensive income isdefinedas"*thearithmeticaldifferencebetweenincomeandexpenses*".Profitorloss isdefinedas"*thearithmeticaldifferencebetweenincomeandexpensesotherthanthos eitems...thatthisStandardclassifiesasitemsofothercomprehensiveincome*".

(h) **Offsetting**.Ingeneral,assets/liabilitiesandincome/expensesshouldnotbeoffset.

† *TheSMEsStandardhasnotyetbeenamendedinlinewiththe2018ConceptualFramework.*

Section3

Financialstatementpresentation

Sections 3-6 of the *IFRSforSMEs*Standard serve a similar function to IAS1 in the full standards.Section3specifiesthegeneralfeaturesoffinancialstatementsandthendefines acompletesetoffinancialstatements.Asummaryofthissectionisasfollows:

(a) **Fairpresentation**. Financial statements should "*presentfairlythefinancialposition,financialperformanceandcashflows*"oftheentity. Itispresumedthatapplicationof theSMEsstandardwillusuallyachievetherequiredfairpresentation.

(b) **Compliance**.AnentitywhichcomplieswiththeSMEsstandardmuststatethatfact inthenotestothefinancialstatements.Itispermissibletodepartfromarequirement of the standard only in the very rare circumstances where compliance with that requirementwouldconflictwiththeobjectiveoffinancialstatements.

(c) **Goingconcern**. Financial statements should be prepared on the going concern basis unless there is good reason to believe that the entity intends to cease operations.
Anentitywhichisnotagoingconcernshoulddisclosethatfact(withreasons)andstate thebasisonwhichthefinancialstatementshavebeenprepared.

(d) **Frequencyofreportingandcomparativeinformation**. Financial statements should usuallybepresentedat least annuallyandshouldprovidecomparativeinformationfor thepreviousperiod.Ingeneral,thewayinwhichitemsarepresentedandclassifiedin thefinancialstatementsshouldbeconsistentbetweenaccountingperiods.

(e) **Materiality/aggregation**. Each material class of similar items should be presented separately in the financial statements.

(f) **Completesetoffinancialstatements**.Acompletesetoffinancialstatementsfora small or medium-sized entity normally comprises:
- astatementoffinancialpositionatthereportingdate
- a single statement of comprehensive income for the reporting period or a separate incomestatementandaseparatestatementofcomprehensiveincome
- astatementofchangesinequity
- astatementofcashflows
- asetofnotes.

However,anentitywithno"othercomprehensiveincome"(OCI)maydispensewith thestatementofcomprehensiveincomeandpresentonlyanincomestatement.Since the SMEs standard requires only very few items to be classified as OCI, this option is likely to be widely used. It is also permissible in certain circumstances to merge the statement of comprehensive income and the statement of changes in equity into a combined"statementofincomeandretainedearnings"(seeSection6).
Thefinancial statementsshouldbeclearlyidentifiedwithsuitableheadings. Other titlesmaybeusedforthefinancialstatementsaslongasthesearenotmisleading.

Section4

Statementoffinancialposition

Section4ofthe*IFRSforSMEs*Standardsetsouttheinformationwhichistobepresented inastatementoffinancialposition.Theminimumlistofrequiredlineitemsisbasically thesameastheequivalentlistgiveninIAS1(seeChapter3)exceptthat:

(a) "Investmentsinassociates"and"investmentsinjointlycontrolledentities"areshown as two separate items on the list in the SMEs standard, whereas the list in IAS1 has a combineditemfor"investmentsaccountedforbytheequitymethod".

(b) ThelistintheSMEsstandardomitsassetsandliabilitiesclassifiedas"heldforsale" (see Section 17).

Asinthefullstandards,SMEsshouldpresentadditionallineitems,headingsandsubtotals ifthesearerelevanttoanunderstandingoftheentity'sfinancialposition.

Section 4 also sets out further information which should be disclosed in the statement of financial position or in the notes. This information consists mostly of sub-classifications oflineitemspresentedinthestatementoffinancialposition(e.g.analysesofproperty,plant and equipment, inventories, trade receivables and trade payables). Disclosures required in relationtotheentity'ssharecapitalandreservesarealmostidenticaltothoseinIAS1.

Section 4 reproduces the definitions of current/non-current assets and liabilities that are providedinIAS1butallowsSMEstoignorethisclassificationandtopresentallassets and liabilities in order of approximate liquidity (ascending or descending) if this provides information which is reliable and more relevant.

Section5

Statementofcomprehensiveincomeandincomestatement

Section 5 of the *IFRSforSMEs*Standard repeats that small and medium-sized entities may presenteitherasinglestatementofcomprehensiveincomeoraseparateincomestatement andseparatestatementofcomprehensiveincome.Thissectionalsosetsouttheinfor-mationthatshouldbepresentedinthesefinancialstatements.Theminimumlistof required items is much the same as in IAS1 (see Chapter 3) and segregates the results of discontinuedoperations.Additionallineitems,headingsandsubtotalsshouldbepresented iftheseassistusersinunderstandingtheentity'sfinancialperformance.Furthermore:

(a) Itemsofincomeorexpensemustnotbedescribedas"extraordinary"inthestatement ofcomprehensiveincome,theincomestatement(ifpresented)orthenotes.

(b) TheSMEsstandardrequiresthatentitiesshouldpresentananalysisofexpensesbased oneitherthenatureoftheexpensesortheirfunctionwithintheentity.Ananalysis basedonfunctionmustdiscloseafigureforcostofsales.

Section6

StatementofchangesinequityandStatementof incomeandretainedearnings

Section 6 of the *IFRSforSMEs*Standard requires that SMEs should present either a state-ment of changes in equity or (if certain conditions are satisfied) a statement of income and retainedearnings.Asinthefullstandards,astatementofchangesinequityshowshow eachcomponentofequityhaschangedduringthereportingperiod.

A statement of changes in equity is notrequired if the only changes in equity during the periodarisefromprofitorloss,paymentofdividends,changesinaccountingpolicyand the correction of prior period errors. In these circumstances, the entity may present a"statementofincomeandretainedearnings"insteadofastatementofcomprehensive income and a statement of changes in equity. This statement shows all of the information normallyshowninthestatementofcomprehensiveincome,togetherwithareconciliation ofretainedearningsatthebeginningandendoftheperiod.

Section7

Statementofcashflows

Section7ofthe*IFRSforSMEs*StandardistheequivalentofIAS7inthefullstandards. Therearenosignificantdifferencesbetweentherequirementsof Section7andthoseof IAS7, except that some detailed requirements in IAS7 relating to entities with subsidiaries, associatesorjointventuresareomittedfromSection7oftheSMEsstandard.

Allsmallandmedium-sizedentitiesmustpresentastatementofcashflowsinwhich cash inflows and outflows are classified by operating activities, investing activities and financing activities. Cash flows from operating activities may be presented using either the direct methodor theindirect method(seeChapter 16).

Section8

Notestothefinancialstatements

Thenotestothefinancialstatementsshouldpresent:

(a) astatementthatthefinancialstatementscomplywiththeSMEsstandard
(b) asummaryofsignificantaccountingpolicies(seeSection10)
(c) supportinginformationforitemspresentedinthefinancialstatements
(d) anyotherdisclosuresrelevanttoanunderstandingofthefinancialstatements.

Informationshouldalsobeprovidedrelatingtojudgementsmadebymanagementwhich havehadasignificanteffectonthefiguresshowninthefinancialstatements.Keysources of estimation uncertainty should be disclosed.

Section9

Consolidatedandseparatefinancialstatements

SMEs that are parent companies are generally required to present consolidated financial statementsinthesamewayaslargercompanies.Butasmallormedium-sizedparent company is exempted from this requirement if:

(a) thecompanyisitselfasubsidiary,and

(b) it has a parent which produces consolidated general purpose financial statements that complywiththefullinternationalstandardsortheSMEsstandard.

A subsidiary is defined as "*anentitythatiscontrolledbytheparent*". Control is defined as"*thepowertogovernthefinancialandoperatingpoliciesofanentitysoastoobtainbenefitsfromitsactivities*".Controloveranentityisusuallydeemedtoexistwhenthe parentowns,directlyorindirectly,morethan50%ofthevotingpowerofthatentity.

The consolidation procedures and disclosures required by the SMEs standard are broadly similar to those set out in IFRS10 (see Chapters 18 and 19). However, non-controllinginterests must be measured at the appropriate proportion of the subsidiary's identifiable net assets.Theoptionofmeasuringnon-controllinginterestsatfairvalueisnotavailable.

Section10

Accountingpolicies,estimatesanderrors

This section of the *IFRSforSMEs*Standard is equivalent to IAS8 in the full standards. Accounting policies are defined in the same way as in IAS8 (see Chapter 4). Entities are required to select their accounting policies as follows:

(a) IftheSMEsstandardspecificallyaddressesthetransactionoritemconcerned,then the entity must apply the rules set out in that standard.

(b) Otherwise,managementshoulduseitsjudgementindevisinganaccountingpolicy thatresultsinrelevant,reliableinformation,takingintoaccountanyrequirementsof the SMEs standard in relation to similar issues, the concepts and principles set out in Section2ofthatstandardand(possibly)therequirementsofthefullstandards.

Accountingpoliciesshouldbeappliedconsistentlyandshouldbechangedonlyifrequired by an amendment to the SMEs standard or if the change would result in reliable and more relevant information. If an accounting policy is changed because of an amendment to theSMEs standard, the change should be accounted for in accordance with the transitional provisionsspecifiedinthatamendment.Otherwise,achangeinaccountingpolicyshould be accounted for retrospectively (see Chapter 4).

Correctionofmaterialpriorperioderrorsshouldalsobeaccountedforretrospectively, butachangeinanaccountingestimateshouldbeaccountedforprospectively.

Sections11and12

Financialinstruments

Sections 11 and 12 of the *IFRSforSMEs*Standard deal with financial instruments. Entitiesmayapplythesetwosectionsinfullormayinsteadapplytherecognitionandmeasure- mentrequirementsofIAS39†andthedisclosurerequirementsofSections11and12.

Section 11 is concerned with basic financial instruments and covers most of the financial assets and liabilities that might arise in the case of SMEs, including trade receivables and payables, loans and investments. Most of these items are measured initially at transactionprice,butfinancialassetsandliabilitiesthatariseinconnectionwithafinancingar range- ment(e.g.loansandlong- termreceivables)aremeasuredatpresentvalue.Subsequently:

(a) Debts that areclassifiedas current assets or liabilities shouldnormallybemeasuredat the undiscounted amount expected to be received or paid.

(b) Mostotherdebtsshouldbemeasuredatamortisedcost(seeChapter11).

(c) Investmentsinsharesshouldbemeasuredatfairvalueifthiscanbedetermined(e.g. ifthesharesarepubliclytraded)oratcostlessimpairmentotherwise.

Section 12 of the SMEs standard deals with more complex financial instruments such as hedginginstrumentsandisbeyondthescopeofthisbook.

† *IAS39hasbeenreplacedbyIFRS9inthefullinternationalstandards(seeChapter11)andisnolon gerdealtwithinthisbook.Thereaderwhorequiresinformationregarding IAS39isreferredtoprev iouseditionsofthisbookortotheIASBwebsite.*

Section13

Inventories

Section13ofthe*IFRSforSMEs*StandardcorrespondstoIAS2inthefullstandards.There arenosignificantdifferencesbetweenthissectionandIAS2(seeChapter10).

Sections14and15

Investmentsinassociatesandjointventures

The definition of an associate given in the *IFRSforSMEs*Standard is very similar to the equivalent definition in IAS28 (see Chapter 20). However, whereas IAS28 requires that investments in associates should normally be measured by the equity method, the SMEs standardoffersachoiceofthreemeasurementmodels.Thesamemodelshouldbeusedfor allinvestmentsinassociates.Ingeneralterms,themodelsareasfollows:

(a) **Costmodel**. The investment is measured at cost less impairment losses. Dividends received are recognised as income. An investment in an associate for which there is a publishedpricequotationismeasuredusingthefairvaluemodel(seebelow).

(b) **Equitymethod**.Thisistheequitymethodasspecifiedin IAS28(seeChapter20).

(c) **Fairvaluemodel**. The investment is measured initially at cost. Subsequently, the investment is measured at fair value. Changes in fair value are recognised in the calculationofprofitorloss.Aninvestmentinanassociateforwhichitis impracticabletomeasurefairvaluereliablyshouldbemeasuredusingthecostmodel.

AjointventureisdefinedbytheSMEsstandardas"*acontractualarrangementwherebytwoor morepartiesundertakeaneconomicactivitythatissubjecttojointcontrol*". This is similartothedefinitionofa"jointarrangement"inIFRS11(seeChapter20).

Whereas IFRS11 distinguishes between only two types of joint arrangement, the SMEs standard distinguishes between jointly controlled operations, jointly controlled assets and jointlycontrolledentities.Jointlycontrolledoperationsorassetsexistiftheparties concerned use their own assets (or jointly controlled assets) in the arrangement and do not establishaseparateentityforthispurpose.Inthiscase,therequiredaccountingtreatment isbroadlythesameasfor"jointoperations"inIFRS11(seeChapter20).

Aninterestinajointlycontrolledentity(a"jointventure"inIFRS11)maybeaccounted for by using any of the three models listed above in relation to associates, though the same modelshouldbeusedforallinterestsinjointlycontrolledentities.

Section16

Investmentproperty

Section 16 of the *IFRSforSMEs*Standard corresponds to IAS40 in the full standards. TheonlysignificantdifferencebetweenthissectionandIAS40(seeChapter5)isconcerned withsubsequentmeasurement.WhereasIAS40offersachoicebetweenthefairvalue model and the cost model, the SMEs standard requires that investment property should normally be measured at fair value. However, if the fair value of an investment propertycannotbemeasuredreliably(withoutundueeffort)thenthecostmodelmaybeused.

Section17

Property,plantandequipment

Thissectionofthe*IFRSforSMEs*StandardisequivalenttoIAS16inthefullstandards (seeChapter5).Theonlysignificantdeparturesfromthefullstandardsareasfollows:

(a) Thereisnoneedtoreviewtheresidualvalueandusefullifeofanassetunlessthere are indications that these have changed. Nor is it necessary to review the depreciation methodappliedtoanassetunlesstherearеindicationsofachangeinusagepattern.

(b) There is no equivalent of IFRS5 (see Chapter 8) with regard to the treatment of assetsheld for sale. Instead, the fact that an item is held for sale is treated as an

indicator of possibleimpairmentandtriggersanimpairmentreview.

Section18

Intangibleassetsotherthangoodwill

Section 18 of the *IFRSforSMEs*Standard is equivalent to IAS38 in the full standards. An intangible asset is defined as in IAS38 but the section states that intangible assets may be recognisedonlyif"*theassetdoesnotresultfromexpenditureincurredinternally*".Thisis a departure from IAS38, which requires capitalisation of development expenditure in some cases(seeChapter6).Afurtherdepartureisthat,afterinitialrecognition,intangiblesmust bemeasuredusingthecostmodel.Therevaluationmodelisnotavailable.

For the purposes of the SMEs standard, all intangible assets are deemed to have a finiteusefullife.Ifthiscannotbeestablishedreliably,itmustbeestimated.Butthisestimate cannot exceed ten years. There is no requirement to review residual values, useful lives or amortisationmethodsunlesstherareindicationsthatthesemayneedtobechanged.

Section19

Businesscombinationsandgoodwill

Section 19 of the *IFRSforSMEs*Standard is equivalent to IFRS3 in the full standards. TheonlysignificantdifferencebetweenthissectionandIFRS3isconcernedwiththesub-sequent measurement of goodwill. Whereas IFRS3 requires that goodwill should not be amortised,theSMEsstandardstatesthatgoodwillacquiredinabusinesscombination should be measured subsequently "*atcostlessaccumulatedamortisationandaccumulatedimpairmentlosses*". If the useful life of goodwill cannot be established reliably, it must be estimated. But this estimate cannot exceed ten years.

Section20

Leases

Section 20 of the *IFRSforSMEs*Standard is based upon IAS17† in the full standards (now replaced by IFRS16) and there are no significant differences between this section and the requirementsofIAS17.Bothlesseesandlessorsmustclassifyleasesaseitherfinance leasesoroperatingleases(seeChapter9)andaccountforthemaccordingly.

† *IAS17isnolongerdealtwithinthisbook.Thereaderwhorequiresinformationregarding IAS17isreferredtopreviouseditionsofthisbookortotheIASBwebsite.*

Section21

Provisionsandcontingencies

Section21ofthe*IFRSforSMEs*StandardistheequivalentofIAS37inthefullstandards. Therearenosignificantdifferencesbetween Section21andIAS37(seeChapter12).

Section22

Liabilitiesandequity

Section 22 of the *IFRSforSMEs*Standard establishes principles for the classification of financialinstrumentsaseitherliabilitiesorequity.ThistopiciscoveredbyIAS32inthe full standards (see Chapter 11). In general, a financial instrument should be classified as a liability(regardlessofitslegalform)iftheentitycouldberequiredtomakeapaymentto the holder of that instrument. Examples given in Section 22 include redeemable preference sharesandshareswhichentitletheholdertoamandatorydividend.

ThissectionoftheSMEsstandardalsodealswithaccountingfortransactionssuchas shareissuesandthesaleofoptions.Thesetopicsarenotaddressedinthefullstandards.

Section23

Revenue

Thissectionofthe*IFRSforSMEs*Standarddealswiththemeasurementandrecognition ofrevenue,includingrevenuefromconstructioncontracts.Therequirementsarebased uponthosethatexistedinthefullstandardspriortotheissueofIFRS15(i.e.standards IAS18†and IAS11†). The main points are as follows:

(a) Revenueismeasuredatthefairvalueoftheconsiderationreceivableandexcludes salestaxesandotheramountscollectedonbehalfofthirdparties.

(b) Iftheinflowofcashisdeferred,thefairvalueoftheconsiderationisdeterminedby discounting future receipts to their present value.

(c) Revenuefromthesaleofgoodsisrecognisedwhen:
- therisksandrewardsofownershiphavebeentransferredtothebuyer
- theentitynolongerhascontroloverthegoods
- theamountofrevenuecanbemeasuredreliably
- itisprobablethateconomicbenefitswillflowtotheentity
- anycostsassociatedwiththetransactioncanbemeasuredreliably.

(d) Revenue from the rendering of services is recognised by reference to the stage of completionofthetransactionattheendofthereportingperiod.

(e) Whentheoutcomeofaconstructioncontractcanbeestimatedreliably,contract revenueandcontractcostsarerecognisedbyreferencetothestageofcompletionof the contract activity at the end of the reporting period.

(f) Interest receivable is recognised using the effective interest method (see Chapter 11). Royalties are recognised on the accruals basis and dividends are recognised when theright to receive payment is established.

† *IAS18andIAS11arenolongerdealtwithinthisbook.Thereaderwhostillrequiresinformationreg ardingthesestandardsisreferredtopreviouseditionsofthisbookortotheIASBwebsite.*

Sections24and25

GovernmentgrantsandBorrowingcosts

Section24ofthe*IFRSforSMEs*Standarddefinesgovernmentgrantsinthesamewayas they are defined in IAS20 (see Chapter 5) but then establishes a much simpler accounting treatmentforthesegrants.Therequirementsofthissectionareasfollows:

(a) Agrantthatdoesnotimposespecificfutureperformanceconditionsontheentityis recognisedasrevenueassoonasthegrantproceedsbecomereceivable.
(b) Agrantthatimposesspecificfutureperformanceconditionsisrecognisedasrevenue when these performance conditions are met.
(c) Ifagrantisreceivedbeforerevenuecanberecognised,itistreatedasaliability.
(d) Governmentgrantsaremeasuredatthefairvalueoftheamountorassetreceivable.

Section 25 of the SMEs standard requires that all borrowing costs should be treated as an expenseintheperiodinwhichtheyareincurred.IncontrasttoIAS23(seeChapter5) therearenocircumstancesinwhichborrowingcostsmaybecapitalised.

Section26

Share-basedpayment

Section 26 of the *IFRSforSMEs*Standard deals with share-based payments and is the equivalentofIFRS2inthefullstandards.Atanintroductorylevel(seeChapter14)there arenosignificantdifferencesbetweenthissectionandIFRS2.

Section27

Impairmentofassets

Section27ofthe*IFRSforSMEs*Standarddealswiththeimpairmentofinventoriesand otherassets.Inallcases,animpairmentlossoccursifthecarryingamountofanasset exceeds its recoverable amount. For inventories, recoverable amount is defined as "*sellingpricelesscoststocompleteandsell*". Inventories should be written down to this amount if impairment has occurred. The impairment rules relating to assets other than inventories are verysimilartotheircounterpartsinIAS36(seeChapter7).However:

(a) The SMEs standard does not require goodwill to be tested for impairment every year. Goodwillistestedonlyiftherareindicationsofimpairment.
(b) Since all intangible assets are deemed to have finite useful lives (see Section 18) thereare no rules relating to intangibles with indefinite lives.

Impairment losses are recognised as an expense unless the asset concerned is carried at a revaluedamount,inwhichcasethelossistreatedasarevaluationdecrease.

Section28

Employeebenefits

Section 28 of the *IFRSforSMEs*Standard corresponds to IAS19 in the full standards. This sectionclassifiesemployeebenefitsinthesamewayasinIAS19(seeChapter14)and makes very similar accounting requirements. However:

(a) Whereas IAS19 requires actuarial gains and losses arising in connection with defined benefitpensionplanstoberecognisedinothercomprehensiveincome,entitiesusing theSMEsstandardmaychoosetorecognisesuchgainsandlosseseitherinprofitor loss or in other comprehensive income.

(b) Terminationbenefitsshouldberecognisedwhentheentityisdemonstrably committedtoterminatingtheemploymentofanemployeebeforethenormalretire-mentdateortoprovidingsuchbenefitssoastoencouragevoluntaryredundancy.

Section29

Incometax

This section of the *IFRSforSMEs*Standard deals with accounting for income taxes. The required accounting treatment of both current tax and deferred tax is broadly similar to the treatmentrequiredbyIAS12inthefullstandards(seeChapter15).

Sections30and31

ForeigncurrencytranslationandHyperinflation

Section 30 of the *IFRSforSMEs*Standard prescribes the accounting treatment of foreign currency transactions and sets out procedures for translating financial statements into a presentationcurrencyandfortranslatingthefinancialstatementsofaforeignoperation. ThissectionisequivalenttoIAS21inthefullstandardsandcontainssimilarrules.

Section 31 requires small and medium-sized entities whose functional currency is the currency of a hyperinflationary economy to prepare financial statements that have been adjustedfortheeffectsofinflation.Theadjustmentprocessinvolvesrestatingallamounts inthefinancialstatements"*intermsofthemeasuringunitcurrentattheendofthereportingpe riod*"andissimilartotheprocessrequiredbyIAS29inthefullstandards.

Section32

Eventsaftertheendofthereportingperiod

Section32ofthe*IFRSforSMEs*StandardistheequivalentofIAS10inthefullstandards.

TherearenosignificantdifferencesbetweenSection32andIAS10(seeChapter12).

Section33

Relatedpartydisclosures

Section33oftheIFRSforSMEsStandarddefinestheterm"relatedparty"inthesameway as that term is defined in IAS24 (see Chapter 21).

ThedisclosuresrequiredbythissectionoftheSMEsstandardarealsoverysimilarto those required by IAS24. However, key management personnel compensation may bedisclosedintotal,ratherthanbeinganalysedintocategories.

Section34

Specialisedactivities

This section of the *IFRSforSMEs*Standard is concerned with entities that are involved in agriculture,extractiveactivitiesandserviceconcessions.Allofthesearoutsidethescope ofthisbookandthereforetherequirementsofthissectionarenotconsideredhere.

Section35

TransitiontotheIFRSforSMEsStandard

Section35appliestofirst-timeadoptersoftheIFRSforSMEsStandard,regardlessof whetherthepreviouslyadoptedaccountingframeworkwasthefullinternationalstandards oranothersetofgenerallyacceptedaccountingprinciples(GAAP).

First-timeadoptersarerequiredtofollowasimilarproceduretotheonesetoutinIFRS1 for first-time adopters of full international standards (see Chapter 1). This involves restate- mentofpriorperiodfiguressoastomaintaincomparabilitywiththecurrentperiod.

Summary

- The *IFRSforSMEs*Standard is a single, self-contained international standard which covers all aspects of accounting for small and medium-sized entities. The standard is organisedbytopicandconsistsof35numberedsections.
- A small or medium-sized entity is an entity which does not have public accountabilityandwhichpublishesgeneralpurposefinancialstatementsforexternalu sers.
- TheSMEsstandardsetsoutthebasicprincipleswhichunderliethefinancialstate- mentsofsmallandmedium-sizedentitiesandexplainswhatismeantbyacomplete setoffinancialstatementsforasmallormedium-sizedentity.
- ThestandardalsoprovidesdetailedguidanceonthewayinwhichSMEsshould account for awidevarietyof transactions andother items.

Part6

ANSWERS

Answerstoexercises

Chapter1

1.1

Theterm"regulatoryframework"referstothecollectionofrulesandregulationswhichgovern financialreporting.Theregulatoryframeworkappliesmainlytocompaniesandconsistsof legislation,accounting standardsand stock exchange regulations.Thisframework isneeded so asto ensurethatshareholdersandotherstakeholdersreceivefinancialstatementswhichfaithfully represent the financial performance and financial position of the business concerned.

1.2

The structure and functions of these bodies are explained in detail in Chapter 1. A brief summary is as follows:

(a) The IFRS Foundation consists of twenty-two trustees drawn from a diversity of geographical and professional backgrounds. They are responsible for appointing the members of the IASB and its associated bodies and for establishing and maintaining the necessary funding for their work. The Trustees also review the strategy and effectiveness of the IASB.

(b) TheIASBconsistsoffourteenmemberschosenfortheirprofessionalcompetenceandtheir relevant experience. The job of the IASB is to develop and improve the IFRS Standards and the IAS Standards.

(c) TheIFRSAdvisoryCouncilcomprisesthirtyormoremembersdrawnfromdiverseback-grounds.ThemainfunctionoftheAdvisoryCouncilistoofferadvicetotheIASBwithregard to its agenda and priorities.

(d) TheIFRSInterpretationsCommittee(whichhasfourteenvotingmembersandanon-voting Chair)interpretstheapplicationofinternationalstandardsandprovidestimelyguidanceon financial reporting matters which are not specifically addressed by standards.

1.3

Theterm"generallyacceptedaccountingpractice"(GAAP)referstotheaccountingregulations whichapplyinacertainjurisdiction,togetherwithanyaccountingprinciplesorconventionsthatar enormallyfollowedinthatjurisdiction.Accountingrulesandpracticescurrentlyvarybetween countriesandsothereisno"globalGAAP"atpresent.However,theInternationalAccounting StandardsBoard(IASB)isdevelopingandpromotingasetofinternationalstandardswhichithope s will attain global acceptance and form the basis for a global GAAP. Some of the main causes of differences in accounting practice from one country to another are as follows:

(a) Thelegalsystemsofsomecountriessetoutdetailedaccountingrules;othercountrieshave legal systems which provide only a broad framework of accounting principles.

(b) Insomecountries,businessentitiesarelargelyfinancedbyshareholders;inothercountries, banks and other lenders are the main providers of business finance. The quantity and types of accounting information that these two groups need from financial reports may differ and this has an effect on the accounting systems of the countries concerned.

(c) In some countries, accounting rules are dictated by the needs of the tax system, since the way in which profits are computed for financial reporting purposes is the same as the way in which they are computed for tax purposes. This is not the case in other countries (e.g. the UK).

(d) Some of the more developed countries have had the opportunity and the resources to developa strong accounting profession and a body of accounting theory, both of which have had an impact on accounting practice. This is not true of less developed countries.

(e) Insomecountries,businesseshavesuddenlycollapsedonlyashorttimeafterpublishing apparently healthy financial reports. This has led to attempts to tighten up accounting rules in these countries, generally by the strengthening of accounting standards.

1.4

An IFRS Standard or IAS Standard consists of a set of numbered paragraphs and is broken downinto sections. These sections usually comprise some or all of the following:

- anintroduction
- objectivesandscope
- definitions
- thebodyofthestandard
- effectivedate
- applicationguidanceorimplementationguidance
- illustrativeexamples
- basisforconclusions.

1.5

Themainpurposeofaccountingstandardsistoreduceoreliminatevariationsinaccountingpracticeandsointroduceadegreeofuniformityintofinancialreporting. Theadvantagesofsuch standardisation include faithful representation and comparability.

Oneperceiveddisadvantageofaccountingstandardsmightbealackofflexibilityandtheworrythat a single accounting treatment might not be appropriate in all cases. The IASB overcomes this disadvantage by allowing entities to override a standard in the extremely rare event that compliance with that standard would prevent faithful representation.

1.6

The first IFRS reporting period is the year to 30 June 2020. The date of transition to international standards is 1 July 2017 since this is the beginning of the earliest period reported in the first IFRS financial statements. The company must:

(i) prepareanopeningIFRSstatementoffinancialpositionasat1July2017(or30June2017)

(ii) useidenticalaccountingpoliciesintheopeningIFRSstatementoffinancialpositionandinthe financial statements for the year to 30 June 2020 and in the comparative figures provided forthe two previousyears;these accounting policiesmustcomply with

internationalstandards in force for periods ending on 30 June 2020

(iii) provide a reconciliation of equity as reported under previous GAAP with equity recalculated under international standards, for 30 June 2017 and 30 June 2019

(iv) provideareconciliationoftotalcomprehensiveincomeasreportedunderpreviousGAAPwithtotalcomprehensiveincomeasitwouldhavebeenreportedunderinternationalstandards, for the year to 30 June 2019.

1.7

(a) ThemainobjectivesoftheIASBare:

(i) todevelopasinglesetofhighqualityglobalaccountingstandards

(ii) topromotetheuseandrigorousapplicationofthosestandards

(iii) tobringabouttheconvergenceofnationalaccountingstandardsandtheinternational standards.

The IFRS Advisory Council provides a forum for participation in the standard-setting process by interested organisations and individuals. The Council advises the IASB on its agenda and priorities and also passes on Council members' views with regard to standard-setting projects.

The IFRS Interpretations Committee interprets the application of international standards and provides advice on matters not specifically addressed in the standards.

(b) The term "GAAP" refers to the complete set of accounting regulations from all sources (e.g. legislation,standardsandstockexchangeregulations)whichapplyinagivenjurisdiction, togetherwithanygeneralaccountingprinciples,conceptsorconventionswhichareusually applied in that jurisdiction.

Chapter2

2.1

A conceptual framework for financial reporting is a coherent set of fundamental principles which underpinfinancialaccountingandprovideasoundtheoreticalbasisforthedevelopmentof accounting standards. The main purposes of the IASB *ConceptualFramework*are:

(a) toassisttheIASBinthedevelopmentofinternationalstandardsbasedonconsistentconcepts

(b) to assist the preparers of financial reports to develop consistent accounting policies if there is no international standard that applies to a particular transaction or event, or if an international standard permits a choice of accounting policy

(c) toassistallinterestedpartiestounderstandtheinternationalstandardsandinterpretthem.

The *ConceptualFramework*is not an international standard and does not override the standards. If there is a conflict between the *ConceptualFramework*and an international standard, the standard prevails.Butthe*ConceptualFramework*providesthefoundationforprinciples-basedstandards which improve the quality of financial information, providing the information needed to assess the stewardship of management and to help investors identify opportunities and risks.

2.2

(a) The *ConceptualFramework*states that the objective of general purpose financial reporting is

"*toprovidefinancialinformationaboutthereportingentitythatisusefultoexistingandpotentialinvestors,lendersandothercreditorsinmakingdecisionsaboutprovidingresourcestotheentity*".

(b) Mainclassesofinformationthatshouldbepresentedingeneralpurposefinancialreportsare:

(i) informationabouttheentity's*financialposition*ofthereportingentity(i.e.informationabouttheentity's economic resources and claims against those resources)

(ii) informationaboutchangesinfinancialpositioncausedbytheentity's*financialperformance*during the reporting period (e.g. the making of a profit)

(iii) informationabouttheentity's*cashflows*duringthereportingperiod

(iv) informationaboutchangesinfinancialpositionnotcausedbytheentity'sfinancial performance (e.g. changes caused by share issues and the payment of dividends).

(c) Theprimaryusersofgeneralpurposefinancialreportsareexistingandpotentialinvestors, lendersandothercreditors.Otherpartieswhomayfindgeneralpurposefinancialreportsusefulincludeemployees,customers,governments(andtheiragencies)andthepublic.See Chapter2foranexplanationofwhyeachusergroupmaybeinterestedintheinformation provided in general purpose financial reports.

2.3

Anassetis"*apresenteconomicresourcecontrolledbytheentityasaresultofpastevents*".An economic resource is "*arightthathasthepotentialtoproduceeconomicbenefits*".

A liability is "*apresentobligationoftheentitytotransferaneconomicresourceasaresultofpastevents*".

Equityis"*theresidualinterestintheassetsoftheentityafterdeductingallitsliabilities*".

Incomeis "*increasesinassets,ordecreasesinliabilities,thatresultinincreasesinequity,otherthanthoserelatingtocontributionsfromholdersofequityclaims*".

Expensesare"*decreasesinassets,orincreasesinliabilities,thatresultindecreasesinequity,otherthanthoserelatingtodistributionstoholdersofequityclaims*".

An asset or liability should be recognised in the financial statements only if the recognition of that asset or liability (and any resulting income, expenses or changes in equity) would provide users of the financial statements with useful information. The information provided must be relevant to user needsandmustofferafaithfulrepresentation.Whetherrecognisinganassetorliabilityprovides useful information (at a cost that does not outweigh benefits) is a matter of judgement.

(a) A trade receivable meets the definition of an asset because it comprises a right to receive cash and isevidenced by a legally binding contractofsale (i.e.the entity hascontrol).Furthermore, the receivable arises from a past event (the sale of goods or services).

(b) Atradepayablemeetsthedefinitionofaliabilitybecauseitcomprisesapresentobligation (which the entity cannot practically avoid) to transfer cash to a creditor and arises as a resultof a past event (the purchase of goods or services).

(c) Inventory meets the definition of an asset because it comprises a right to use or sell physical objects and so generate economic benefits. The inventory is controlled by the entity through legal ownership and arises as a result of a past event (purchase from a supplier).

2.4

The*ConceptualFramework*identifiesthetwofundamentalqualitativecharacteristicsofuseful

financialinformationasrelevanceandfaithfulrepresentation.Theenhancingcharacteristicsare comparability,verifiability,timelinessandunderstandability.SeeChapter2foranexplanationof each characteristic and the factors which contribute to its achievement.

2.5

(a) Measurementbasesarehistoricalcostandcurrentvalue(fairvalue,valueinuse,currentcost).

(b) The capital maintenance concepts are financial capital maintenance (either in nominal units or in units of purchasing power) and physical capital maintenance.

SeeChapter2foranexplanationofeachofthese.

2.6

Relevance

Tobeuseful,financialinformationmustberelevanttotheneedsofuserswhentheyaremaking economic decisions. Information is relevant if it helps users to predict future events or to confirm(or refute) previous predictions. The relevance of information is affected by its level of materiality. Information is material if omitting, mis-stating or obscuring it could influence user decisions.

Faithfulrepresentation

Tobeuseful,financialinformationmustfaithfullyrepresenttransactionsandotherevents.The informationmustbecomplete,freeofbiasandfreefrommaterialerror.Financialinformation should also represent the substance of transactions and events rather than their legal form.

Comparability

Users should be able to compare financial information for a period with information about the same entityforotherperiodsandwithinformationaboutotherentitiesforthesameperiod.Comparabilit y is improved if consistent accounting treatments are adopted between periods and entities.

Chapter3

3.1

(a) Financial statements must present fairly the financial position, financial performance and cash flowsoftheentityconcerned. Thisrequiresthattheeffectsoftransactionsandotherevents should be faithfully represented in accordance with the definitions and recognition criteria for assets,liabilities,incomeandexpensessetoutinthe*ConceptualFramework*.Itisusually assumed that the application of international standards will achieve a fair presentation.

A fair presentation also requires entities to select and apply appropriate accounting policies, to provide information that is relevant, reliable, comparable and understandable and to provide further information if compliance with international standards is insufficient to enable users to understand the financial statements.

(b) Financialstatementsshouldbepreparedonthegoingconcernbasisunlesstheentityintend sto cease trading or has no realistic alternative but to do so. Financial statements apart from the statement of cash flows should be prepared on the accrual basis.

(c) Anitemismaterialifitssizeoritsnatureissuchthatitcouldinfluenceusers'economic decisions.Financialstatementsarepreparedbyanalysingtransactionsandothereventsint o classes and then aggregating each class to produce line items.IAS1 requires thateach material

classofsimilaritemsshouldnormallybepresentedseparatelyinthefinancialstatements. However, a line item which is not material may be aggregated with other line items.

(d) Assetsandliabilitiesshouldnormallybereportedseparatelyinthestatementoffinancial position and not offset against one another. Similarly, income and expenses should normallybe reported separately in the statement of comprehensive income.

(e) Financialstatementsshouldnormallybepresentedatleastannually.

(f) Comparative information should be disclosed in respect of the previous period for all amounts reportedinthefinancialstatements.Inordertomaintaincomparability,thewayinwhichitem sarepresentedandclassifiedinthefinancialstatementsshouldbeconsistentfromone accounting period to the next. The need for consistency is overridden only if it is apparent that a change in presentation or classification would be appropriate, or if such a change is required by an international standard.

3.2

(a) A*currentasset*isonewhichsatisfiesanyofthefollowingcriteria:

(i) itisexpectedtoberealised,soldorconsumedwithintheentity'snormaloperatingcycle

(ii) itisheldprimarilyforthepurposeofbeingtraded

(iii) itisexpectedtoberealisedwithintwelvemonthsafterthereportingperiod

(iv) itiscashoracashequivalent.

Anassetwhichsatisfiesnoneofthesecriteriaisanon-currentasset.

(b) A*currentliability*isonewhichsatisfiesanyofthefollowingcriteria:

(i) itisexpectedtobesettledwithintheentity'snormaloperatingcycle

(ii) itisheldprimarilyforthepurposeofbeingtraded

(iii) itisduetobesettledwithintwelvemonthsafterthereportingperiod

(iv) the entity does not have the right to defer settlement until at least twelve months after the reporting period.

Aliabilitywhichsatisfiesnoneofthesecriteriaisanon-currentliability.

(c) Thecurrent/non-currentseparationdistinguishesbetweennetassetsthatarecirculatingas workingcapitalandthosethatareusedinthelong-term.Thisseparationalsoidentifiesthe assets that are expected to be realised within the current operating cycle and the liabilities that are due for settlement within the same period.

3.3

The*draftstatementofcomprehensiveincome*fortheyearto31March2020isasfollows:

	£000	£000
Salesrevenue(50,332–3,147)		47,185
Costofsales(7,865+29,778–8,107)		29,536
Grossprofit		17,649
Distributioncosts(8,985+157)	9,142	
Administrativeexpenses	7,039	16,181
Profitfromoperations		1,468
Financecosts(200+200)		400
Profitbeforetax		1,068
Taxation		235
Profitfortheyear		833

The*draftstatementoffinancialposition*asat31March2020isasfollows:

	£000	£000
Assets		
Non-currentassets		
Property, plant and equipment (59,088 – 25,486)		
33,602 Current assets		
Inventories(8,407–300)	8,107	
Tradereceivables(9,045–3,147)	5,898	
Cashatbank	182	14,187
		47,789
Equity		
Ordinarysharecapital		10,000
Sharepremiumaccount		5,000
Retainedearnings(23,457+833)		24,290
		39,290
Liabilities		
Non-currentliabilities		
Bankloans		5,000
Currentliabilities		
Tradepayables(2,481+157+426+200)	3,264	
Taxation	235	3,499
		47,789

Notes:

(a) Inventoriesarevaluedatthelowerofcostandnetrealisablevalue(seeChapter10).

(b) Total comprehensive income for the year is equal to the profit for the year, since the company has no "other comprehensive income".

3.4

Thepurposeofastatementofchangesinequityistoshowhoweachcomponentofequityhas changed during an accounting period. In the case of a company, these components are share capital and each of the company's reserves. The main items that should be shown in a statement of changes in equity are as follows:

(a) totalcomprehensiveincomefortheperiod

(b) theeffectsofanyretrospectiveapplicationofaccountingpoliciesorrestatementofitems

(c) foreachcomponentofequity,areconciliationoftheopeningandclosingbalanceforthat component, separately disclosing changes arising from:

  (i) profitorloss

  (ii) othercomprehensiveincome

  (iii) transactions with the owners of the entity, separately showing distributions to owners and contributions by owners.

3.5

Thenotesshouldcontain:

(i) information about the measurement bases used in preparing the financial statements and other relevant accounting policies

(ii) informationasrequiredbyinternationalstandards,totheextentthatthisisnotpresented elsewhere in the financial statements

(iii) anyadditionalinformationwhichisrelevanttoanunderstandingofanyofthefinancial statements.

3.6

(a)

WalruspIc
StatementofcomprehensiveincomefortheyearTo31March2020

	£000	£000
Salesrevenue		1,432
Costofsales(107+488–119)		476
Grossprofit		956
Otherincome		30
		986
Distributioncosts(seeworkings)	229	
Administrativeexpenses(seeworkings)	601	830
		156
Financecosts		9
Profitbeforetaxation		147
Taxation(30–6)		24
Profitfortheyear		123
Othercomprehensiveincomefortheyear:		
ItemsthatwillnotbereclassifiedtoprofitorIoss:		
Gainonpropertyrevaluation		180
TotalcomprehensiveincomefortheyeaI		303

Note:
Thetreatmentoftaxationinfinancialstatementsisdealtwithin Chapter 15.

(b)

Walrusplc
Statementoffinancialpositionasat31March2020

	£000	£000
Assets		
Non-currentassets		
Property,plantandequipment(seeworkings)		603
Goodwill		300
		903
Currentassets		
Inventory	119	
Tradereceivables(183–8–7)	168	287
		1,190
Equity		
Sharecapital		200
Revaluationreserve		180
Retainedearnings		606
		986
Liabilities		
Currentliabilities		
Tradeandotherpayables	117	
Bankbalance	57	
Currenttaxpayable	30	204
		1,190

(c)

Walrusplc
Statementofchangesinequityfortheyearto31March2020

	Share capital	*Revaluation reserve*	*Retained earnings*	*Total equity*
	£000	£000	£000	£000
Balanceat1April2019	200	-	503	703
Totalcomprehensiveincome		180	123	303
Dividendpaid			(20)	(20)
Balanceat31March2020	200	180	606	986

Workings

Distributioncosts	£000
Pertrialbalance	101
Wagesandsalaries(25%)	69
Buildingsdepreciation	5
Equipmentdepreciation	12
Vehiclesdepreciation	42
	229

Administrativeexpenses	£000
Pertrialbalance	186
Bankoverdraftinterest	(9)
Directors'fees	150
Wagesandsalaries(75%)	207
Buildingsdepreciation	5
Equipmentdepreciation	36
Vehiclesdepreciation	18
Lossondisposal(44–33–10)	1
Baddebt	8
Reductioninallowanceforreceivables	(1)
	601

Property,plantandequipment	£000	£000	
£000 Landatvaluation			
300			
Buildingsatcost		250	
Depreciationto31/3/2019	90		
Depreciationforyear(4%×250)	10	100	150
Equipmentatcost		196	
Depreciationto31/3/2019	76		
Depreciationforyear(40%×120)	48	124	72
Motorvehiclesatcost(284–44)		240	
Depreciationto31/3/2019(132–33)	99		
Depreciationforyear(25%×240)	60	159	81
			603

Chapter4

4.1

(a) Accountingpoliciesare"*thespecificprinciples,bases,conventions,rulesandpracticesappliedbyanentityinpreparingandpresentingfinancialstatements*". For example, an entity can choose between the cost model and the revaluation model for measuring property, plant and equipment. The entity's choice is one of its accounting policies.

Accounting estimates are judgements applied when measuring items that cannot be measured with precision (e.g. the estimated useful life of a non-current asset).

(b) A change in accounting policy should be accounted for retrospectively. Comparative figures for the previous period(s) must be adjusted and presented as if the new accounting policy had always been applied. This approach maintains comparability between accounting periods.

(c) A change in an accounting estimate should be accounted for prospectively. The effect of the change should be dealt with in the financial statements for the period of the change and future periods, but comparative figures for prior periods are not restated.

4.2

(a) IfthereisnoapplicableinternationalstandardorIFRICInterpretation,managementshoulduseitsjudgementinselectinganaccountingpolicythatresultsininformationwhichisrelevantandreliable.Referenceshouldbemadetoanystandardswhichdealwithsimilar issues and to the IASB *ConceptualFramework*.

(b) An accounting policy may be changed if this is required by an international standard or by an IFRICInterpretationorifthechangeimprovesthereliabilityandrelevanceofthefinancial statements.

4.3

If a change in accounting policy is caused by the initial application of an international standard or IFRICInterpretation,theentityshoulddisclosethetitleofthatstandardorinterpretation.Ifachangeinaccountingpolicyisvoluntary,theentityshoulddiscloseitsreasonsformakingthe change.Inallcases,theentityshoulddisclosethenatureofthechangeandtheamountofthe adjustment made to each affected item in the financial statements.

4.4

(a) A material prior period error is a material omission or mis-statement occurring in an entity's financialstatementsforapriorperiod.Materialpriorperioderrorsshouldbecorrected retrospectively. This generally involves restating the comparative figures for the prior periodin which the error occurred.

(b) The entity should disclose the nature of the prior period error. For each prior period presented, the entity should disclose the amount of the correction to each affected line itemin the financial statements. The amount of the correction at the beginning of the earliest prior period presented should also be disclosed.

4.5

(a)

	2019	(restated) 2018
	£000	£000
Profitbeforeoperatingexpenses	1,510	1,450
Operatingexpenses	190	230
Profitbeforetaxation	1,320	1,220
Taxation	264	244
Profitaftertaxation	1,056	976

(b)

	Retainedearnings
	£000
Balanceb/faspreviouslyreported	2,371
Changeinaccountingpolicy	(112)
Restatedbalance	2,259
Profitfortheyearto31December2019	1,056
Balancec/f	3,315

Note:
Thechangeinaccountingpolicyresultsinadditionaloperatingexpensesof£140,000for2016, 2017 and 2018 combined. Tax saved at 20% is £28,000. Therefore retained earnings at 31 December 2018 fall by £112,000.

4.6

(a)

	2020	(restated) 2019
	£000	£000
Sales	1,660	1,840
Costofgoodssold	670	730
Grossprofit	990	1,110
Expenses	590	560
Profitbeforetaxation	400	550
Taxation	80	110
Profitaftertaxation	320	440

(b)

	Retainedearnings
	£000
Balance b/f as previously reported	1,220
Correctionofpriorperioderror(440–360)	80
Restatedbalance	1,300
Profitfortheyearto30June2020	320
Balancec/f	1,620

Chapter5

5.1

(a) Property,plantandequipmentconsistsoftangibleitemswhichareheldforuseinthe production or supply of goods or services, for rental to others, or for administrative purposes and which are expected to be used during more than one period.

(b) An item of property, plant and equipment should be recognised as an asset when its cost canbe measured reliably and it is probable that future economic benefits associated with the item will flow to the entity. The item should be derecognised when it is disposed of or no future economic benefits are expected from either its use or its disposal.

(c) Thepurchaseprice,plusimportduties,deliverychargesandnon-refundablepurchasetaxes should be included in the asset's cost. The small spares should be treated as inventory and the cost of maintenance should be treated as an expense of the period covered by the contract.

5.2

(a) Underthecostmodel,itemsofproperty,plantandequipmentarecarriedatcostlessany accumulated depreciation and less any accumulated impairment losses. Under the revaluation model, an item of property, plant and equipment is carried at a revalued amount, consisting of the item's fair value at the date of revaluation, less any subsequent accumulated depreciation and less any subsequent accumulated impairment losses.

(b) A revaluation increase is generally creditedto a revaluation reserve and accounted for as other comprehensive income. But a revaluation increase is recognised as income when calculatingan entity's profit or loss to the extent that it reverses any revaluation decrease in respect of the same item that was previously recognised as an expense.

Arevaluationdecreaseisgenerallyrecognisedasanexpensewhencalculatingtheentity's profit or loss. But a revaluation decrease is debited to the revaluation reserve and accountedfor (as a negative figure) in other comprehensive income to the extent of any credit balance previously existing in the revaluation reserve in respect of that same item.

(c) On 31 December 2019, a revaluation increase of £0.2m is credited to revaluation reserve and accounted for as other comprehensive income. On 31 December 2020, £0.2m is debited to the revaluation reserve and accounted for as (negative) other comprehensive income. An expense of £0.3m is recognised when calculating the company's profit or loss for the year.

If the valuations on 31 December 2019 and 2020 are reversed, then an expense of £0.3mis recognised when calculating profit or loss for the year to 31 December 2019. In the financial statementsfortheyearto 31 December2020,incomeof£0.3m isrecognised when calculating thecompany'sprofitand£0.2miscreditedtotherevaluationreserve(andaccountedforas other comprehensive income).

5.3

(a) Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. Depreciable amount is the cost of the asset (or other amount substituted for cost) less its residual value. Useful life is generally the period over

which the asset is expected to be usedby the entity. Residual value is the estimated disposal value of the asset, after deducting the estimated costs of disposal.

(b) Depreciable amount is £49,500 and useful life is 5 years. Therefore straight-line depreciationis £9,900 per annum. Diminishing balance depreciation is calculated as follows:

Year	*Carryingamount b/f*	*Depreciation at30%*	*Carryingamount c/f*
	£	£	£
2020	59,500	17,850	41,650
2021	41,650	12,495	29,155
2022	29,155	8,746	20,409
2023	20,409	6,123	14,286
2024	14,286	4,286	10,000
		49,500	

The company should choose the method which most closely matches the usage pattern of the asset concerned.

5.4

(a) Borrowingcostsconsistofinterestandothercostsincurredbyanentityinconnectionwiththe borrowingoffunds.IAS23requiresthatborrowingcoststhataredirectlyattributabletothe acquisition,constructionorproductionofaqualifyingassetshouldbecapitalisedaspartoft he cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

(b) Loans A, B and C total £23m and interest for the year totals £2.3m so the capitalisation ratefor the year is 10%. Capitalised borrowing costs are £227,500, as follows:

	£
£1,500,000×10%×9/12	112,500
£2,400,000×10%×5/12	100,000
£1,800,000×10%×1/12	15,000
	227,500

5.5

(a) An investment property is land or a building or a part of a building held to earn rentals or for capital appreciation or both, rather than for use. Investment property may be measured using eitherthefairvaluemodelorthecostmodel.Underthefairvaluemodel,thepropertyis measuredatitsfairvalueandanygainorlossarisingfrom achangeinfairvalueisrecognised as income or as an expense when calculating the entity's profit or loss. The cost model is the same as for property, plant and equipment.

(b) As stated above, gains arising in connection with investment property measured at fair value are recognised as income when calculating the entity's profit or loss. Revaluation gains arising in connection with property, plant and equipment measured under the revaluation model are generally excluded from profit or loss and are recognised as other comprehensive income.

5.6

This ship is a complex asset and should be treated as three separate assets. The carrying amount of these assets at 30 September 2019 (eight years after purchase) is as follows:

	£m
Ship'sfabric(£300m×17/25)	204
Cabinsetc.(£150m×4/12)	50
Propulsionsystem(£100m×10,000/40,000)	25
	279

Ship'sfabric

Depreciationof£12m(£300m×1/25)shouldbechargedintheyearto30September2020.The repainting costs do not meet the recognition criteria for an asset and should be treated as repairs and maintenance.

Cabinsandentertainmentareafittings

Theupgrade(at acost of£60m) hasextendedtheremaininguseful lifeofthecabinsetc. byoneyearandsothecostsoftheupgrademeettherecognitioncriteriaforanasset.Thecostof£60 m should be added to the cost of the fittings. Any of the old fittings which have been replaced should bederecognised.Assumingthatnoneoftheoldfittingsarederecognised,therevisedcarrying amountis£110m andthisshouldbedepreciatedovertheremainingusefullifeoffiveyears. Therefore depreciation of £22m is charged in the year to 30 September 2020.

Propulsionsystem

The carrying amount of the old system (£25m) should be written off. This assumes that the system hasascrapvalueofzero.Depreciationofthenewsystemfortheyearto30September2020is £14m(£140m×5,000/50,000).

Entriesinfinancialstatements

Expensesfortheyearto30September2020willincludethefollowing:

	£m
Depreciationofship'sfabric	12
Depreciationofcabinsetc.	22
Depreciationofpropulsionsystem	14
Lossondisposalofpropulsionsystem	25
Repairsandmaintenance	20

Thestatementoffinancialpositionasat30September2020willshowthecruiseshipasanon- current asset at a carrying amount of £406m. This is calculated as follows:

	£m
Ship'sfabric(£204m–£12m)	192
Cabinsetc.(£110m–£22m)	88
Propulsionsystem(£140m–£14m)	126
	406

Chapter6

6.1

(a) Anintangibleassetisanidentifiable,non-monetaryassetwithoutphysicalsubstance.

Anassetisidentifiablewhenitarisesfromcontractualorotherlegalrightsorwhenitis "separable". An asset is separable if it can be separated from the entity and sold, transferred, licensed, rented or exchanged. Goodwill is not separable and is therefore excluded fromthe IAS38 definition of intangible assets.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.Intangibleassetsarenon-monetaryandthereforeitemssuchascash,bankdepositsand trade receivables are excluded from the definition.

Intangibleassetsaredistinguishedfrom property,plantandequipmentbythefactthattheyare without physical substance.

(b) Anintangibleassetacquiredinaseparatetransactionshouldbemeasuredinitiallyatitscost.

(c) An intangible asset acquired in a business combination should be measured initially at its fair value on the date of the acquisition.

6.2

(a) Researchexpenditureisexpenditureon originalandplannedinvestigationundertakenwiththe prospect of gaining new scientific or technical knowledge and understanding.

Development expenditure is expenditure on the application of research to a plan or design for theproductionofneworsubstantiallyimprovedmaterials,devices,products,processes, systems or services.

(b) All research expenditure must be written off as an expense when it is incurred. Development expenditure must be recognised as an intangible asset if certain conditions are satisfied. If any oftheseconditionsarenotsatisfied,thedevelopmentexpendituremustbewrittenoffasan expense (see Chapter 6 for more details).

(c) The £370,000 is research expenditure and must be written off as an expense. The £460,000 is development expenditure and must be capitalised as an intangible asset if all of the conditions listed in IAS38 are satisfied (see Chapter 6). Otherwise, this amount must also be written offas an expense.

6.3

(a) Usefullifeissixyears.Theassetshouldberecognisedinitiallyatcostandthenamortisedover these six years. The asset's depreciable amount is its cost less its residual value.

(b) Usefullife is30 years.The assetshould be recognised initially atcostand then amortised over these 30 years. The asset's depreciable amount is equal to its cost.

(c) Useful life is three years. The asset should be recognised initially at cost and then amortised over these three years. The residual value of the asset will depend upon whether the company intends to sellthe trademark atthe end of its usefullife and whetherornota customeris likely to be found.

Ineachcase,thechosenamortisationmethodshouldmatchtheusagepatternoftheasset.

6.4

Underthecostmodel,intangibleassetsarecarriedatcostlessanyaccumulatedamortisationand accumulated impairment losses. Under the revaluation model, intangible assets are carried at their fair value at the date of revaluation, less any subsequent accumulated amortisation and accumulated impairment losses. If the revaluation model is applied to an intangible asset, then it must be applied to the entire class of assets to which the asset belongs. But the revaluation model cannot be applied to an intangible asset for which there is no active market.

6.5

(a) IFRS3 defines goodwill as "*anassetrepresentingthefutureeconomicbenefitsarisingfrom...assetsacquiredinabusinesscombinationthatarenotindividuallyidentifiedandseparatelyrecognised*".Abusinesscombinationoccurswhenoneentityacquiresanother.Goodwillwhich has been developed by an entity rather than purchased from another entity is known as internally generated goodwill and is excluded from the IFRS3 definition.

(b) Goodwillisnotseparableoridentifiable.Internallygeneratedgoodwillhasnoreliablecost figure.Ingeneralterms,goodwillissubjecttounpredictablefluctuationsinvalueandmay easily be damaged or destroyed.

(c) Goodwillhasanunpredictableusefullifeanddoesnotamortiseatasteadyrate.Itismore logical to conduct regular impairment reviews than to amortise purchased goodwill.

6.6

(a) ThefairvalueoftheassetslessliabilitiesofBLtdis£450,000.ThepricepaidbyALtdis £500,000.Sotheamountpaidforgoodwillis£50,000.

(b) ThestatementoffinancialpositionofALtdjustafterthepurchaseisasfollows:

	£000	£000
Assets		
Non-currentassets		
Goodwill		50
Property,plantandequipment(4,320+390)		4,710
		4,760
Currentassets		
Inventories(1,210+160)	1,370	
Tradereceivables(940+80)	1,020	
Cashatbank(1,650–500)	1,150	3,540
		8,300
Equity		
Ordinarysharecapital		1,000
Retainedearnings		3,650
		4,650
Liabilities		
Non-currentliabilities		2,500
Currentliabilities(970+180)		1,150

6.7

(a) *Research*isoriginalandplannedinvestigationundertakenwiththeprospectofgainingnew scientificortechnicalknowledgeandunderstanding.*Development*istheapplicationof researchtoaplanordesignfortheproductionofneworsubstantiallyimprovedmaterials, devices, products, processes, systems or services.

(b) (i)This is research work, since it is undertaken with the prospect of gaining new technical knowledge. The expenditure should be written off as an expense.

(ii)This type of expenditure might normally qualify as development expenditure. However,it seems that the project is not technically feasible at present. Therefore the expenditure should be written off as an expense.

Chapter7

7.1

(a) IAS36 defines an impairment loss as "*theamountbywhichthecarryingamountofanassetoracash-generatingunitexceedsitsrecoverableamount*".

(b) IAS36 lists a number of possible indications of impairment. Some of these are derived from external sources of information and some from internal sources. See Chapter 7 for details.

(c) Thetwotypesofassetwhichmustalwaysbetestedforimpairmentareintangibleassetswhi chhaveanindefiniteusefullife(orwhicharenotyetavailableforuse)andgoodwill acquired in a business combination.

(d) Recoverableamountisthehigheroffairvaluelesscostsofdisposalandvalueinuse.

Fair value less costs of disposal is defined as the price that would be received to sell the asset inanorderlytransactionbetweenmarketparticipantsatthemeasurementdate,lessthe estimated costs of disposal.

Valueinuseisthepresentvalueofthefuturecashflowsexpectedfromtheasset.

7.2

	Carrying amount	*Recoverable amount*	*Impairment loss*
	£	£	£
Asset1	25,000	27,500	
Asset2	6,500	4,800	1,700
Asset3	18,250	17,500	750
Asset4	11,400	13,400	

7.3

(a)

	Cash inflows	*Discount factor*	*Present value*
	£		£
Year1	20,000	1/1.1=0.909	18,180
Year2	20,000	$1/(1.1)^2$=0.826	16,520

Year3	30,000	$1/(1.1)^3=0.751$	22,530
Valueinuse			57,230

(b) Theasset'srecoverableamountisthehigherof£48,000(£50,000–£2,000)and£57,230whi ch is £57,230. Therefore the impairment loss is £42,770 (£100,000 – £57,230). The asset's carrying amount should be reduced to £57,230 and an impairment loss of £42,770 should be recognised as an expense.

(c) Assuming that residual value remains at £10,000, the asset's depreciable amount is £47,230. Annual depreciation is approximately £15,743 (£47,230 ÷ 3).

7.4

(a) IAS36definesacash-generatingunitas"*thesmallestidentifiablegroupofassetsthatgeneratescashinflowsthat arelargelyindependentofthecashinflowsfromotherassetsorgroupsofassets*".

(b) A CGU should be tested for impairment is there are indications that an asset which belongs to the CGU is impaired or that the CGU as a whole is impaired. A CGU to which goodwill has been allocated should be tested for impairment every year, regardless of whether or not there are any indications of impairment.

7.5

Theimpairmentlossis£80m(£275m–£195m).Goodwillisreducedfrom£25mtozero,leaving £55m of the loss remaining. This is initially allocated in the ratio 50:200 between the patents andthe property, plant and equipment (PPE), so that patents are reduced by £11m to £39m and PPE is reduced by £44m to £156m. However, £156m is £4m less than the fair value less costs of disposalofthePPE. ThereforePPEisset to£160mandanextra£4missubtractedfromthepatents. The assets are now patents £35m and PPE £160m, giving a total of £195m.

7.6

(a) An impairment loss occurs when the carrying amount of an asset is higher than its recoverable amount. The recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use.

Fairvaluelesscostsofdisposal

The fair value of an asset for this purpose is the price that would be received to sell the assetin an orderly transaction between market participants at the measurement date. If the asset isof a type that is traded in an active market involving identical assets, then the quoted price in that market will be used. Otherwise, the fair value of the asset will have to be determined by using one of the other valuation techniques listed in IFRS13. Estimated costs of disposal are deducted when calculating an asset's fair value less costs of disposal.

Valueinuse

The value in use of an asset is the present value of the future net cash flows expected to be derived from use of the asset. Many assets do not produce independent cash flows, so it maybe necessary to consider the value in use (and the fair value less costs of disposal) of the cash generating unit (CGU) to which the asset belongs.

Frequencyoftestingforimpairment

Goodwillandanyintangibleassetthathasanindefiniteusefullifemustbetestedfor impairmenteveryyear.Thisisalsothecaseforanyintangibleassetthathasnotyetbeen broughtintouse.Otherassetsaretestedforimpairmentonlyifthereisanindicationthat impairment may have occurred. IAS36 provides a list of such indications.

(b) Animpairmentlossissubtractedfromthecarryingamountoftheassetconcerned.Future depreciation charges will be based upon the reduced carrying amount. An impairment loss is usually accounted for as an expense. But if the asset has previously been revalued upwards,the loss should first be deducted from the revaluation surplus.

An impairment loss relating to a CGUis used to eliminate any goodwill in the CGUand isthen allocated to the other assets in proportion to their carrying amounts. However, an asset other than goodwill should not be reduced to less than the higher of its fair value less costs of disposal and its value in use.

(c) The plant's carrying amount was £240,000 on 1 October 2019. Depreciation from 1 October 2019to1April2020is£40,000(£640,000×12.5%×6/12)givingacarryingamountof £200,000atthedateofimpairment.

Recoverableamountisthehigheroftheplant'svalueinuse(£150,000)andfairvalueless costs of disposal. If Wilderness trades in the plant it will receive £180,000 but Wilderness is reluctant to do this. A better estimate of fair value less costs of disposal is £20,000. Therefore recoverable amount is £150,000 and the impairment loss is £50,000.

Sincetheremaining usefullife ofthe plantisonly twoyears(from the date ofimpairment)the depreciationchargeforthelastsixmonthsoftheyearis£37,500(£150,000/2×6/12).The financial statements for the year to 30 September 2020 will show:

Statementoffinancialposition

Plant(£150,000–£37,500)=£112,500

Statementofcomprehensiveincome

Plantdepreciation(£40,000+£37,500)=£77,500

Plant impairment loss £50,000

Chapter8

8.1

(a) Anon-currentassetisclassifiedasheldforsaleifitscarryingamountwillberecovered principallythroughasaletransactionratherthanthroughcontinuinguse.Forthistobethe case, the asset must be available for immediate sale in its present condition (subject only to termsthatareusualandcustomaryforsalesofsuchassets)andthesalemustbehighly probable. International standard IFRS5 lists the conditions under which a sale is regarded as highly probable (see Chapter 8).

(b) If a non-current asset is held for sale rather than use, the notion of "useful life" is inapplicable and therefore it is no longer appropriate to make depreciation charges or to carry the asset atits cost (or revalued amount) less depreciation to date.

(c) IFRS5 requires that a non-current asset which is held for sale should be measured at the lower of its carrying amount when it was initially classified as held for sale and its fair value less coststosell.Fairvalueisthepricethatwouldbereceivedtosellthe assetinanorderly transactionbetweenmarketparticipantsatthemeasurementdate.Coststosellarecosts directly attributable to the disposal of the asset, excluding finance costs and tax.

8.2

(a) There is an impairment loss of £600 on 1 March 2019 and a further impairment loss of £200on 30 June 2019. There is a loss on disposal of £60 in the year to 30 June 2020.

(b) Thereisnoimpairmentlossoneither1March2019or30June2019.Thereisagainon disposal of £630 in the year to 30 June 2020.

(c) Thereisanimpairmentlossof£100on1March2019andagainof£50on30June2019. There is a loss on disposal of £30 in the year to 30 June 2020.

(d) There is an impairment loss of £100 on 1 March 2019 and a gain of £100 (not £150) on 30 June 2019.This gain is capped at£100 to ensure thatthe assetis notmeasured atmore than its carrying amount when it was originally classified as held for sale. There is a gain on disposal of £80 in the year to 30 June 2020.

8.3

(a) Adiscontinuedoperationisacomponentofanentitythateitherhasbeendisposedoforis classified as held for sale. For this purpose, a component comprises operations and cash flows that can be clearly distinguished from the rest of the entity.

(b) IFRS5 requires that entities should present and disclose information that enables users of the financial statements to evaluate the effects of discontinued operations. This information will helpuserstomakemoreaccurateassessmentsofanentity'slikelyfinancialperformancein future years.

8.4

On 31 December 2019, the assets of the operation cannot be classified as held for sale since theyarenotavailableforimmediatesale.Theseassetsshouldbepresentedandmeasuredinthes ame way as in previous years. However, the decision to close down the operation might suggest that the assetsareimpairedandsoanimpairmentreviewshouldbecarriedout.Theoperationdoesnotcou ntasadiscontinuedoperationat31December2019,soitsresultsshouldbeincludedin continuing operations in the financial statements.

Assuming that the operation is closed down and theassets sold by 31 December 2020, the results of theoperationshouldbeshownunderdiscontinuedoperationsinthestatementofcomprehensive incomefor2020.Thereshouldbeasinglefigurecomprisingtheafter-taxprofitorlossofthe operation and the gain or loss on disposal of its assets. This figure will then be analysed, either inthe statement of comprehensive income or in the notes.

8.5

(a) The total carrying amount of the disposal group at 25 January 2020 is £3.06m, so there is an impairment loss of £60,000. This is deducted from goodwill, leaving £140,000.

The measurement requirements of IFRS5excludetheinvestment properties, inventories and liabilities.Soon31May2020,thecarryingamountoftheseitemsmustberemeasuredin accordance with the applicable standards. The carrying amount of the disposal group becomes

£3.02m (£140,000 + £2,100,000 + £760,000 + £380,000 – £360,000) and the remeasurement gainis£20,000.Thereisafurtherimpairmentlossof£170,000(£3.02m –£2.85m)on31May 2020.Goodwillisreducedtozeroand£30,000isdeductedfromtheproperty,plantand equipment, leaving this at £2,070,000.

(b) Whenthedisposalgroupissoldfor£2.8m,thereisalossondisposalof£50,000.

8.6

Therevisedextractfromthestatementofcomprehensiveincomeisasfollows:

	£000	£000
Continuingoperations		
Salesrevenue(558–103)		455
Costofsales(184–38)		146
Grossprofit		309
Otherincome		12
		321
Distributioncosts(59–2)	57	
Administrativeexpenses(148–20–17)	111	168
Profitbeforetax		153
Taxation(35–9+3)		29
Profitfortheyearfromcontinuingoperations		124
Discontinuedoperations		
Profitfortheyearfromdiscontinuedoperations		20
Profitfortheyear		144

Therewouldbeanoteshowingthattheprofitfromdiscontinuedoperationsisasfollows:

	£000	£000
Salesrevenue		103
Costofsales		38
Grossprofit		65
Distributioncosts	2	
Administrativeexpenses	20	22
Profitbeforetax		43
Taxation		9
Profitaftertax		34
Lossondisposalofassets	(17)	
Taxrelief	3	(14)
Profitfromdiscontinuedoperations		20

(Thisnotecouldbelessdetailedifsomeofthefiguresconcernedarethoughtnottobematerial).

Chapter9

9.1

(a) IFRS16 defines a lease as "*acontract,orpartofacontract,thatconveystherighttouseanasset(theunderlyingasset)foraperiodoftimeinexchangeforconsideration*". The inception date of a lease is the earlier of the date of the lease agreement and the date that the parties to the lease become committed to its principal terms and conditions. The commencement date of

a lease is the date on which the underlying asset is made available for use by the lessee.

(b) A lessor is an entity which supplies an underlying asset for use by another entity and receives lease payments in return. A lessee is an entity which acquires the right to use an underlying asset (supplied by a lessor) in exchange for making lease payments.

(c) IFRS16definesaright-of-useassetas"*anassetthatrepresentsalessee'srighttouseanunderlyingassetfortheleaseterm*". At the commencement of a lease, a right-of-use asset is initially measured as the sum of:

- theinitialamountoftheleaseliability
- anyleasepaymentsmadeonorbeforethecommencementdate
- anyinitialdirectcostsincurredbythelessee
- estimateddismantling,removingorrestorationcoststobeincurredattheendofthelease.

A lease liability is initially measured as the present value of the lease payments which falldue after the commencement date.

(d) Alesseeisnotrequiredtorecognisearight-of-useassetandaleaseliabilityforshort-term leases (12 months or less in duration) or for leases of low-value assets.

9.2

(a) The initial lease liability is £45,303 ×(1/1.14 + 1/1.14^2+ 1/1.14^3+ 1/1.14^4) = £132,000. The finance charge for each year and the liability at the end of the year are calculated as follows:

Yearto 30June	*Liability b/f*	*Finance charge14%*	*Lease paymen t*	*Liability c/f*
	£	£	£	£
2020	132,000	18,480	45,303	105,177
2021	105,177	14,725	45,303	74,599
2022	74,599	10,444	45,303	39,740
2023	39,740	5,563	45,303	0

Thetotalliabilityat30June2020is£105,177.Ofthis,£30,578(£45,303–£14,725)isa current liability and the remaining £74,599 is a non-current liability.

(b)The right-of-use asset is measured at £132,000 on 1 July 2019. This asset is then depreciated over the next four years (or over a shorter period if the useful life of the right-of-use asset is less than four years).

9.3

The company should recognise a lease liability equal to the present value of the three payments that fall due after the commencement date. With a discountrate of 9%, discount factors for one, two and threeyearsare0.917(1/1.09),0.842(1/1.09^2)and0.772(1/1.09^3).Thesumofthesefactorsis2.531, giving an initial lease liability of (£30,000 ×2.531) = £75,930. The interest expense for each year and the outstanding liability at the end of each year are calculated as follows:

Year	*Liability b/f*	*Lease paymen t*	*Balance*	*Interest expense9 %*	*Liability c/f*	*Current*	*Non-current*
	£	£	£	£	£	£	£
2019	75,930	0	75,930	6,834	82,764	30,000	52,764

2020	82,764	30,000	52,764	4,749	57,513	30,000	27,513
2021	57,513	30,000	27,513	2,487	30,000	30,000	0
2022	30,000	30,000	0	0	0	0	0

(Interestexpensefor2021hasbeenroundeduptoensurethattheleaseliabilityreducestozero).

On1January2019,thecompanyshouldalsorecognisearight-of-useassetof£105,930.Thisis equal to the initial lease liability of £75,930 plus the £30,000 paid on commencement. If the lease transfers ownership of the office machinery to Crimmock Ltd at the end of the lease term, the right- of-use assetshould be depreciated over the usefullife of this machinery.Otherwise,the right-of-use asset should be depreciated over the lease term (or over the useful life of the right-of-use asset ifthis is shorter than the lease term).

9.4

Theinitial lease liability is £7,674 ×(1/1.06 + 1/1.06^2+ 1/1.06^3+ 1/1.06^4+ 1/1.06^5) = £32,326. The finance charge for each year and the liability at the end of the year are calculated as follows:

6months to	*Liability b/f*	*Lease payment*	*Balance*	*Finance charge6%*	*Liability c/f*
	£	£	£	£	£
30/9/2020	32,326	0	32,326	1,940	34,266
31/3/2021	34,266	7,674	26,592	1,595	28,187
30/9/2021	28,187	7,674	20,513	1,231	21,744
31/3/2022	21,744	7,674	14,070	844	14,914
30/9/2022	14,914	7,674	7,240	434	7,674
31/3/2023	7,674	7,674	0	0	0

Thefinancechargefortheyearto31March2021is£3,535(£1,940+£1,595).Similarly,the finance charges for the years to 31 March 2022 and 2023 are £2,075 and £434 respectively.

Theright-of-useassetisinitiallymeasuredat£32,326+£7,674=£40,000.

9.5

Theinitial lease liability is £6,595 ×(1/1.1 + 1/1.1^2+ 1/1.1^3+ 1/1.1^4) = £20,905. The finance charge for each year and the liability at the end of the year are calculated as follows:

Year	*Liability b/f*	*Lease payment*	*Balance*	*Finance charge10%*	*Liability c/f*	*Current*	*Non-current*
	£	£	£	£	£	£	£
2019	20,905	0	20,905	2,091	22,996	6,595	16,401
2020	22,996	6,595	16,401	1,640	18,041	6,595	11,446
2021	18,041	6,595	11,446	1,145	12,591	6,595	5,996
2022	12,591	6,595	5,996	599	6,595	6,595	0
2023	6,595	6,595	0	0	0	0	0

Note that the current liability element of the liability at the end of each year is equal to the amountofthepaymentmadeatthestartofthefollowingyear(sincethispaymentismadebeforeth e following year's finance charge starts to accrue).

The right-of-use asset is initially measured at £20,905 + £6,595 + £500 = £28,000. The depreciable amount is £25,000, so the depreciation charge is approximately £3,571 per annum over the useful life of seven years.

9.6

(a) The present value of the lease payments amounts to substantially less than the fair value of the underlying asset. The lease term is not for the major part if the asset's useful life. Legal title appears not to be transferred. Therefore this is an operating

lease.

(b) The machine will continue to be shown as an asset in Lessor's statement of financial position and should be depreciated as usual. Lease payments of £6,000, £12,000, £12,000 and £6,000 should be shown respectively as income in Lessor's statements of comprehensive income for the years to 30 June 2020, 2021, 2022 and 2023. Any accruals or prepayments will be shownin the statements of financial position in the usual way.

Chapter10

10.1

See Chapter 10 for the IAS2 definition of inventories, detailed information on costs which shouldbe included when measuring the cost of inventories and the IAS2 definition of net realisable value.

10.2

(a) A cost formula may be used for interchangeable items that cannot be distinguished from one another.

(b) **FIFO**

	Noofkg				*Cost(£)*
IssuedJune2019	25,000	25,000	@£7.50		187,500
IssuedSept.2019	12,000	7,000	@£7.50	52,500	
		5,000	@£8.75	43,750	96,250
IssuedOct.2019	5,000	5,000	@£8.75		43,750
IssuedFeb.2020	4,000	4,000	@£8.75		35,000
InventoryApril2020	11,000	1,000	@£8.75	8,750	
		10,000	@£9.50	95,000	**103,750**

AVCO

	Noofkg		*Totalcost (£)*	*Weighted average*	*Cost(£)*
Openinginventory	32,000	@£7.50	240,000	£7.50	
IssuedJune2019	25,000	@£7.50	~~187,500~~		187,500
	– 7,000		52,500		
BoughtAug.2019	15,000	@£8.75	131,250		
	– 22,000		~~183,750~~	£8.35	
IssuedSept.2019	12,000	@£8.35	100,200		100,200
	– 10,000		83,550		
IssuedOct.2019	5,000	@£8.35	~~41,750~~		41,750
	– 5,000		41,800		
BoughtJan.2020	10,000	@£9.50	95,000		

10.3

(a) The cost and NRV of inventories should (if possible) be compared item by item. Therefore itis not permissible to measure inventories at the lower of total cost and total NRV.

(b)

	Cost	*NRV*	*Lowerofcostand NRV*
	£	£	£
MachineW	10,950	(12,500×96%)−0=12,000	10,950
MachineX	16,600	(17,500×96%)−400=16,400	16,400
MachineY	18,950	(23,000×96%)−2,100=19,980	18,950
MachineZ	8,300	(9,500×96%)−900=8,220	8,220
			54,520

10.4

(a) £240,000dividedby80,000=£3perunit.

(b) £240,000dividedby100,000=£2.40perunit.

(c) Theallocationshouldbe£3perunit(basedonnormalproductioncapacity).Thisabsorbs £150,000 of the fixed production overheads. The remaining £90,000 should be written off as an expense in the year to 31 March 2020.

Chapter11

11.1

(a) (i) A financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

(ii) A financial asset is an asset which is either cash, an equity instrument of another entityor a contractual right to receive cash (or another financial asset) from another entity.

(iii) A financial liability is a contractual obligation to deliver cash or another financial assetto another entity.

(iv) An equity instrument is a contract that evidences a residual interest in the assets of anentity after deducting all of its liabilities.

(b) IAS32 takes a substance over form approach to the classification of financial instruments. An instrument is classified as an equity instrument only if it includes no contractual obligation to deliver cash or another financial asset to another entity.

(c) Redeemable preference shares are classified as liabilities and dividends relating to such shares are treated as an expense.

11.2

(a)A compound financial instrument is one that contains both a liability component and an equity component(e.g.convertibleloanstock).Acompoundinstrumentisseparatedintoitstwo components by first evaluating the liability component and then subtracting this from the fair value of the whole instrument to give the equity component.

(b)

	Payment due £	*Discount factor*	*Present value* £
31/3/2019	20,000	1/1.065	18,779
31/3/2020	20,000	$1/(1.065)^2$	17,633
31/3/2021	20,000	$1/(1.065)^3$	16,557
31/3/2022	20,000	$1/(1.065)^4$	15,546
31/3/2023	520,000	$1/(1.065)^5$	379,538
Liabilitycomponent			448,053

Theequitycomponentis£51,947(£500,000–£448,053).

11.3

(a)The three categories of financial assets which are identified by IFRS9 are "financial assets at amortised cost","financialassetsatfairvalue through othercomprehensive income"and "financial assets at fair value through profit or loss".

Subsequenttoinitialrecognition,"financialassetsatamortisedcost"aremeasuredattheir amortisedcostusingtheeffectiveinterestmethod."Financialassetsatfairvaluethrough comprehensiveincome"aremeasuredatfairvalueandchangesinfairvalueareregenerally recognisedinothercomprehensiveincome."Financialassetsatfairvaluethroughprofitor loss"aremeasuredatfairvalueandchangesinfairvalueareta kenintoaccountwhen calculating the entity's profit or loss.

SeeChapter11foramoredetaileddescriptionofeachtypeoffinancialasset.

(b)

Date	*b/f* £	*Interest at3.5%* £	*Received* £	*c/f* £
30/6/2019	411,225	14,393	10,000	415,618
31/12/2019	415,618	14,547	10,000	420,165
30/6/2020	420,165	14,706	10,000	424,871
31/12/2020	424,871	14,870	10,000	429,741
30/6/2021	429,741	15,041	10,000	434,782
31/12/2021	434,782	15,218	450,000	0

Theamountreceivedon31December2021consistsofinterestof£10,000,repaymentofthe £400,000andapremiumof£40,000.

Interest income for the year to 30 June 2019 is £14,393. Income for the year to 30 June 2020is£29,253(£14,547+£14,706).Similarly,incomefortheyearsto30June2021and202 2is

£29,911and£15,218respectively.

Thestatementsoffinancialpositionat30June2019,2020,2021and2022shouldshowanas set of £415,618, £424,871, £434,782 and zero respectively.

11.4

(a) (i) Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation (e.g. a bad debt).

(ii) Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities.

(iii) Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Such changes may occur because of changesinexchangerates("currencyrisk"),changesinmarketinterestrates("interest rate risk") or for other reasons ("other price risk").

(b) SeeChapter11foranoutlineofdisclosuresrequiredinrelationtothesethreetypesofrisk.

11.5

(a) Theamountreceivedis£712,500(95%of£750,000).Issuecostsof£13,175reducethisto £699,325.Thisistheamountatwhichtheloanstockshouldbemeasuredon1May2019.

(b)

Yearto 30April	*b/f*	*Interest at7.25%*	*Paid*	*c/f*
	£	£	£	£
2020	699,325	50,701	22,500	727,526
2021	727,526	52,746	22,500	757,772
2022	757,772	54,938	22,500	790,210
2023	790,210	~~57,290~~	847,500	0
		~~215,675~~		

The figures that will appear in the statement of financial position are shown in the rightmost columnofthistable.Theamountpaidon30April2023consistsofinterestof£22,500, repayment of the original £750,000 and a premium of £75,000.

Thetotalcostoftheloanis£215,675.Thisconsistsofinterestof£90,000,thediscounton issue of £37,500, the premium on repayment of £75,000 and the issue costs of £13,175. The effective interest method spreads all these costs fairly over the duration of the loan.

Chapter12

12.1

(a) There is a constructive obligation at the end of the reporting period. A provision of £375,000 should be made.

(b) There is no obligation (legal or constructive) at the end of the reporting period. The decision could be reversed. No provision should be made.

(c) A provision equal to the present value of £5m is required in relation to the rectification costsin the first country (for which there is a legal obligation). Although there is no legal obligation inrelationtotheothercountry,aprovisionequaltothepresentvalueof£10mshouldbe

recognised if the company's behaviour has created a constructive obligation.

(d) Thereisnopresentobligationandthereforenoprovisionshouldbemade.Provisionsforfuture operating costs are not allowed by IAS37.

12.2

(a) The amount of a provision should be the best estimate of the expenditure required to settle the obligation concerned. If the effect of the time value of money is material, the amount of the provision should be the present value of the expenditure required to settle the obligation.

(b) Themostlikelyoutcomeisthattherepairwillcost£100,000.However,bothoftheother possibleoutcomesinvolvehigherexpenditureandsoahigherprovisionisrequired.IAS37 does not explain how this higher amount should be calculated but one possibility might be to calculate the expected value of the obligation. This is 60% of £100,000 plus 30% of £150,000 plus10%of£200,000,i.e.£125,000.However,thisisnotdefiniteandmanagementshould exercise its judgement in estimating the amount of the provision.

12.3

(a) Recogniseaprovision.

(b) Discloseacontingentliability unlessthepossibility ofan outflow ofeconomicbenefitsisonly remote (in which case do nothing).

(c) Discloseacontingentliability unlessthepossibility ofan outflow ofeconomicbenefitsisonly remote (in which case do nothing).

(d) Recogniseaprovision.

12.4

Thepasteventisthesaleofgoodstothecustomer.Butdidthisgiverisetoapresentobligation?

(a) Thereisprobablyanobligationandaprovisionshouldbemade,assumingthatareliable estimate can be made of the amount of the obligation.

(b) There is probably no obligation and so there is no provision. A contingent liability should be disclosed unless the customer has only a remote chance of winning the case.

12.5

(a) Acontingentassetshouldbedisclosed.

(b) Aprovisionisrequiredequaltothepresentvalueof£3m.

12.6

(a) Thisisanadjustingeventwhichhelpsthecompanytoassessthenetrealisablevalueofits inventories.Thismayaffectthevalueatwhichinventoriesareshowninthestatementof financial position at 31 December 2019.

(b) Thisisanon-adjustingevent.Discloseinthenotestothefinancialstatements.

(c) Thisisanon-adjustingevent.Discloseinthenotestothefinancialstatements.

(d) This is probably an adjusting event. The customer was probably already in financial trouble at 31 December 2019. The company should either write off a bad debt or make an allowance fora doubtful debt, depending upon the likelihood of receiving any part of the amount owed.

(e) Thisisanon-adjustingevent.Discloseinthenotestothefinancialstatements.

(f) Thisisanadjustingevent.Thecashfigureinthestatementoffinancialpositionasat31 December 2019 should be reduced. If the theft is not covered by insurance, an

expense should be recognised in the statement of comprehensive income for the year to 31 December 2019.

(g) Thisisanon-adjustingevent.Discloseinthenotestothefinancialstatements.

(h) IAS10 states that this is a non-adjusting event. It should therefore be disclosed in the notes to the financial statements (see Chapter 15).

12.7

(i) IAS37*Provisions,ContingentLiabilitiesandContingentAssets*requiresthatthecostsof decontamination should be provided for in full, since the contamination has already occurred. It is correct to discount the amount of the provision to its present value. Therefore the amount of the provision should be £5m, not £500,000.

IAS16 *Property,PlantandEquipment*states that the initial cost of an item of property, plant andequipmentincludesanyestimatedcostsofdismantlingandrestoration,aslongasthe obligationtomeetthosecostsisincurredwhentheitemisacquired(asinthiscase).Sothe £5mdecontaminationcostsshouldbeaddedtothecostoftheplant,bringingthisto£20m.

The statement of comprehensive income for the year to 31 March 2020 will be charged with depreciationof£2m(£20m/10years).Furthermore,thedateonwhichthedecontamination costs are payable is now a year closer than it was when the provision was raised, so its present value increases by 8% and there will be a finance charge of £400,000 (8% of £5m) to reflect one year's "unwinding" of the discount.

The statement of financial position at 31 March 2020 will show a non-current asset of £18m and a non-current liability of £5.4m.

(ii) IAS10 *EventsaftertheReportingPeriod*requires that the fraud of £210,000 should be treated asanadjustingeventandthatthefinancialstatementsfortheyearto31March2020shouldbe adjustedaccordingly.£210,000shouldbedeductedfromcostofsalesandshownasanexpe nseinthestatementofcomprehensiveincome.Thismayrequireseparatedisclosureifthe amount is considered to be material.

The remaining £30,000 of the fraud should be treated as a non-adjusting event and should be disclosed in the notes (if material).

(iii) The possible insurance claim is a contingent asset. Since it is only possible (not probable) that the claim will be successful, it should be ignored when preparing the financial statements for the year to 31 March 2020.

Chapter13

13.1

Revenue is defined by international standard IFRS15 as "*incomearisinginthecourseofanentity'sordinaryactivities*". Revenue excludes borrowings, amounts contributed by shareholders and gains. Revenue also excludes rental income, interest and dividends. The five-step model set out in IFRS15 for the recognition and measurement of revenue is as follows:

Step1:Identifyacontractwithacustomer

Step2:Identifytheperformanceobligationsinthecontract

Step3:Determinethetransactionprice

Step4:Allocatethetransactionpricetotheperformanceobligationsinthecontra

ct

Step5:Recogniserevenuewhenorastheentitysatisfiesaperformanceobligatio
n. Detailed information relating to each of these steps in given in Chapter
13.

13.2

Assumingthattheexpectedvaluemethodprovidesthebestpredictionoftheamountofthe consideration to which the company will be entitled, the transaction price is £5.2m ((25% ×£6m) + (70% ×£5m) + (5% ×£4m)).

13.3

Revenuerecognisedonthedateofdeliveryis£2,500+£7,938(£10,000×1/(1.08)^3)=£10,438.The remaining £2,062 is treated as a finance charge. Assuming for the sake of simplicity that the sale occurs at the start of an accounting year, interest income is £635 in the first year, £686 in the second year and £741 in the third year. The calculations are as follows:

	Receivable b/f	*Interest at 8%*	*Received*	*Receivable c/f*
	£	£	£	£
Year 1	7,938	635	-	8,573
Year 2	8,573	686	-	9,259
Year 3	9,259	741	10,000	0

13.4

The total of the stand-alone selling prices is £40, so the customer is receiving a discount of £10 for purchasing all three DVDs as a bundle. The amount of the transaction price allocated to each DVD is £8.25 (£11 ×(£30 ÷ £40)), £10.50 (£14 ×(£30 ÷ £40)) and £11.25 (£15 ×(£30 ÷ £40)).

13.5

(a) Estimated total contract costs are £500,000 (£190,000 + £30,000 + £280,000). Costs incurred for the work performed to date (£190,000) are 38% of this total, so the company measures its progress on the contract to be 38%. The statement of comprehensive income for the year to 31 May 2020 should include revenue of £228,000 (38% of £600,000) in relation to the contract andexpenses(costofsales)of£190,000.Thismeansthatcontractprofitrecognisedintheyear is £38,000.

The statement of financial position at 31 May 2020 should show inventory of £30,000 and a contract asset of£53,000(£228,000–£175,000) for theamount not yet invoicedtothe customer for the work done to date. The £45,000 which has been invoiced to the customer but has not yet been received (£175,000 – £130,000) should be shown as a trade receivable.

(b) Ifthecontractpriceis£480,000,thestatementofcomprehensiveincomefortheyearwill include contract revenue of £182,400 (38% of £480,000). As well as recognising expenses of £190,000inrelationtothecontract,thecompanymustalsorecogniseanimpairmentlossof £12,400 (see below). So the total expense shown in cost of sales is £202,400. In effect, a net expenseof£20,000(£182,400–£202,400)ischargedtothestatementofcomprehensive income for the year. This recognises the fact that an overall loss of £20,000 is expected on the contract (£480,000 – £500,000).

As regards the impairment loss, the contract costs that are recognised as an asset at the end of

theyearare£30,000.However,theremainingconsiderationwhichthecompanyexpectsto receive is only £297,600 (£480,000 – £182,400) and the remaining costs which are expectedto be incurred are £280,000. The remaining consideration less remaining costs is only £17,600 so there is an impairment loss of £12,400 (£30,000 – £17,600).

The statement of financial position at 31 May 2020 should show inventory of £30,000 and a contract liabilityof £5,000. This comprises the revenue recognised to date (£182,400) less the amount invoiced to the customer (£175,000) and the impairment loss (£12,400).

As before, the £45,000 (£175,000 – £130,000) which has been invoiced to the customer buthas not yet been received is shown as a trade receivable.

13.6

The customer does not receive or consume benefits whilst the building work is proceeding and does notcontrolthepartly-completedproperty.Althoughtheentitymayretainthedepositifthecustomerdefaultsonthecontract,itdoesnothaveanenforceablerighttopaymentforthework completedtodate.Itappearsthatnoneoftherequiredcriteriaaremetforthisperformance obligation to be satisfied over time. Therefore the obligation is satisfied at a point in time.

Chapter14

14.1

Thefourcategoriesofemployeebenefitsare:

(i) short-termemployeebenefits(e.g.wagesandsalaries)

(ii) post-employmentbenefits(e.g.pensions)

(iii) otherlong-termemployeebenefits(e.g.long-serviceleave)

(iv) terminationbenefits(e.g.redundancypay).

14.2

Theliabilityis£261,000(870×2×£150).

14.3

(a) Defined contribution pension plans are those where an employer pays fixed contributions into the pension fund each year and is not obliged to make any further contributions, even if the fund's assets are insufficient to pay adequate benefits to employees. The risk that benefits will be less than expected falls upon the employees, not the employer.

Defined benefit plans are those where the employer is obliged to provide an agreed level of pensions to employees. The employer's contributions are not limited to any fixed amount and these contributions may need to be increased if the pension fund has insufficient assets to pay the agreed level of pensions. The risk of having to make further contributions is borne by the employer, not the employee.

(b) The statement of comprehensive income should show an expense of £350,000. The statement offinancialposition should show an accrued expenseof£30,000.Theemployerhasno further liability since this is a defined contribution scheme.

(c) Accountingfordefinedbenefitplansisdifficultbecausetheexpenserecognisedineach accounting period should be the cost to the employer of the pensions that will eventually be paid to employees as a result of the services that they have provided during that period. The cost of these pensions is difficult to determine in advance because of the unpredictability of factors such as employee mortality rates and future

returns on investments.

14.4

(a) (i) The defined benefit obligation is the amount of the accumulated benefits which past and present employees have earned in return for their services to date and which will be payable to them in the future.

(ii) The current service cost is the extra amount of benefits that employees have earned in return for their services during the current period.

(iii) The interest cost for a period is equal to the increase during that period of the present value of the defined benefit obligation which was calculated at the end of the previous period.

(iv) Actuarial gains and losses include adjustments arising from differences between previous actuarial assumptions and actual events. Actuarial gains and losses also include the effects of changes in actuarial assumptions.

(b) The main components of the *defined benefit expense* for an accounting period are:

(i) the present value of the current service cost for the period, plus interest cost, less interest income and less any employee contributions

(ii) the aggregate of actuarial gains or losses and the return on plan assets (excluding interest income).

Item (i) is taken into account when calculating the profit or loss for the period. Item (ii) is shown in other comprehensive income.

(c) The *defined benefit liability* is equal to the present value of the defined benefit obligation at the end of the period, less the fair value of the plan assets at that date.

14.5

In summary, the defined benefit obligation and plan assets are as follows:

	£
m Present value of DB obligation at 31 December 2018	22.5
Interest cost	1.8
Present value of current service cost for the year	3.7
Benefits paid during the year	(1.9)
	26.1
Actuarial loss (balancing figure)	1.3
Present value of DB obligation at 31 December 2019	27.4

	£m
Fair value of plan assets at 31 December 2018	21.9
Interest income	2.1
Return on plan assets (after deducting interest income)	0.8
Employer contributions	3.8
Employee contributions	1.5
Benefits paid during the year	(1.9)
Fair value of plan assets at 31 December 2019	28.2

Thedefinedbenefitexpenseis£2.4m,calculatedasfollows:

	£m
Presentvalueofcurrentservicecostfortheyear	3.7
Less:employeecontributions	(1.5)
	2.2
Interestcost	1.8
Interestincome	(2.1)
Expenserecognisedinprofitorloss	1.9
Actuariallosses	1.3
Returnonplanassets	(0.8)
Expenserecognisedinothercomprehensiveincome	0.5
Totaldefinedbenefitexpense	2.4

Thedefinedbenefitassetis£0.8m,calculatedasfollows:

	£m
Fairvalueofplanassetsat31December2019	28.2
PresentvalueofDBobligationat31December2019	27.4
	0.8

There was an opening defined benefit liability of £0.6m (£22.5m – £21.9m). This has now become anassetof£0.8m,animprovementof£1.4m.Thisarisesbecausetheemployerhascontributed £3.8mduringtheyear,whichis£1.4mgreaterthantheexpensefortheyearof£2.4m.

Chapter15

15.1

CurrentTax

		£000			£000
1May2019	Bank	127	1Aug2018	Balanceb/	120
			31Jul2019	d SoCI	7
		127			127
31Jul2019	Balancec/d	140	31Jul2019	SoCI	140
		140			140
			1Aug2019	Balanceb/d	140

Notes:

(i) Thecurrenttaxexpensefortheyearcomprises£140,000plusthe£7,000underestimatefort he previousyear.Thetotalof£147.000isthetaxexpensewhichisshowninthestatementof comprehensive income (SoCI).

(ii) Thecurrenttaxliabilityattheendoftheyearis£140,000.

15.2

(a) Current tax is the amount of tax payable (or recoverable) in respect of the taxable profit (or loss)foranaccountingperiod.Deferredtaxisthetaxpayable(orrecoverable)infutureperiod s in respect of taxable (or deductible) temporary differences.

(b) Permanent differences arise because some of the income shown in financial statements may notbechargeabletotaxandsomeoftheexpensesshownmaynotbedeductiblefortax purposes. Permanent differences cause no accounting problems and can be ignored.

Temporarydifferencesarisewhensomeoftheincomeorexpensesshowninthefinancial statements in one accounting period are dealt with for tax purposes in a different period. Such differences are accounted for by making transfers to or from a deferred tax account.

(c) Unlessdeferredtaxistakenintoaccount,temporarydifferencescanleadtoasignificant distortion of reported figures for profit after tax. This could give a misleading impression ofan entity's financial performance. This point is illustrated in Examples 2 and 3 in Chapter 15.

15.3

(a)	2018	2019	2020
	£	£	£
Taxableprofit	75,000	140,000	175,000
Profitbeforetax	125,000	130,000	135,000
Tax@19%ontaxableprofit	14,250	26,600	33,250
Profitaftertax	110,750	103,400	101,750

Theimpressiongivenbythesefiguresisthatthecompany'sprofitaftertaxisonadownwardtrend.

(b)	2018		2019		2020	
	£		£		£	
Profitbeforetax		125,000		130,000		135,000
Currenttax	14,250		26,600		33,250	
Deferredtax	9,500	23,750	(1,900)	24,700	(7,600)	25,650
Profitaftertax		101,250		105,300		109,350

Thetransfertothedeferredtaxaccountin2018is£9,500(19%of£50,000).Ofthis,£1,900is transferred back in 2019 and the remaining £7,600 is transferred back in 2020. The result is that the total tax expense is a level 19% of accounting profit and profit after tax is seen to be rising.

15.4

The tax base of an asset or liability is the amount which is attributed to that asset or liability for tax purposes. The IAS12 definitions of the tax base of an asset and the tax

base of a liability are givenin Chapter 15.

If the tax base of an asset or liability differs from its carrying amount, this is an indication that a temporary difference exists. Therefore, determining the tax base of each asset and liability helps to identify the situations in which deferred tax adjustments are required.

15.5

(a) Thetaxbaseofthelorryis£30,000.Thereisadeductibletemporarydifferenceof£10,000 which gives rise to a deferred tax asset.

(b) The tax base of the loan is £60,000 (£60,000 – £nil). This is the same as its carrying amountso there is no temporary difference and there are no deferred tax implications.

(c) The amount receivable of £45,000 can be considered as two separate receivables, of £25,000 and £20,000 respectively. When the £25,000 is received it will not be taxable, so its tax baseis also £25,000 and there is no temporary difference. When the £20,000 is received it will be taxableandnothingwillbedeductiblefromthisamountfortaxpurposes.Soitstaxbaseis £nilandthereisataxabledifferenceof£20,000whichgivesrisetoadeferredtaxliability.

(d) The tax base of the amount payable is £nil (£3,000 – £3,000). There is a deductible temporary difference of £3,000 and this gives rise to a deferred tax asset.

15.6

Thereis a taxable temporary difference of £1.4m between the carrying amount and the tax base of thecompany's assets. This gives rise to a deferred tax liability of £1.4m ×25% = £350,000. So the deferred tax figure shown in non-current liabilities should be £350,000. The statement of financial position should also show a current liability of £260,000 in relation to current tax.

The deferred tax liability has risen by £70,000. Therefore the tax expense shown in the statement of comprehensive income should be £385,000 (£55,000 + £260,000 + £70,000).

Chapter16

16.1

(a) Cash comprises cash on hand and demand deposits. Bank overdrafts are also included. This means that the total cash figure could be negative.

(b) Cashequivalentsareshort-term,highlyliquidinvestmentsthatarereadilyconvertibleto known amounts of cash and which are subject to insignificant risk of changes in value. Cash equivalents are regarded by IAS7 as being virtually indistinguishable from cash itself and are treated as cash rather than as investments.

(c) Operating activities are the principal revenue-producing activities of the entity (e.g. the sale of goods and services).

(d) Investing activities comprise the acquisition and disposal of long-term assets and other invest- ments. The acquisition and disposal of property, plant and equipment are included under this heading.

(e) Financingactivitiesareactivitiesthatresultinchangesinthesizeandcompositionofthe contributedequityandborrowingsoftheentity.Thisheadingincludesshareissues,share redemption, borrowings and repayments of borrowings.

16.2

(a) Ifthedirectmethodisused,majorclassesofreceiptsandpaymentsarisingfromoperating activities are disclosed individually and are then aggregated to give the total amount of cash generated from operations.

Theindirectmethodtakestheprofitorlossfortheperiod(beforetax)asitsstartingpointand then makes a number of adjustments to this profit or loss so as to calculate the total amount of cash generated from operations.

(b) Iftheindirectmethodisused,profitbeforetaxisadjustedasfollows:

(i) Non-cashexpenses(e.g.depreciation)areaddedback.

(ii) Interestpayableisaddedback.

(iii) Non-cashincome(e.g.adecreaseinallowancefordoubtfulreceivables)issubtracted.

(iv) Losses on the disposal of non-current assets are added back. Profits on the disposal ofnon-current assets are subtracted.

(v) Items of income or expense which are included in the profit calculation but are derived from investing or financing activities are subtracted (income) or added (expenses).

(vi) Increases in inventories, trade receivables and prepayments are subtracted. Decreases in these items are added.

(vii) Increasesin trade payablesand accrued expensesare added.Decreasesin theseitemsare subtracted.

Interest paid and taxes paid are then deducted to give the final figure for the entity's net cash flow from operating activities.

16.3

(a) The purchase of the equipment has no effect on profit or loss but gives rise to a cash outflow when payment is made. The depreciation charges reduce profits (or increase losses) but have no cash flow implications.

(b) Thepaymentofasupplier'sinvoicehasnoeffectonprofitorlossbutgivesrisetoacash outflow in the accounting period in which the payment is made.

(c) Accounting for an accrued expense reduces profit (or increases a loss) but has no cash flow effect.

(d) Thepaymentofadividendhasnoeffectonprofitorlossbutcausesanoutflowofcash.

(e) The purchase of inventory for cash causes an outflow of cash but has no immediate impact on profit or loss. The impact on profit or loss is delayed until the inventory is used or sold.

(f) This is a transfer from cash to a cash equivalent and is not a cash flow. Nor is there any effect on profit or loss.

16.4

(a)

Statementofcashflowsfortheyearto30June2020

	£	£
Cashflowsfromoperatingactivities		
Profitbeforetaxation	171,180	
Depreciation(£151,650–£107,340)	44,310	
Interestpayable	6,120	
Investmentincome	(7,100)	
Decreaseininventories(£86,220–£97,430)	11,210	
Increaseintradereceivables(£82,610–£58,100)	(24,510)	
Increaseinprepaidexpenses(£7,200–£7,000)	(200)	
Decreaseintradepayables(£40,920–£44,310)	(3,390)	
Increaseinaccruedexpenses(£9,130–£8,250)	880	
Cashgeneratedfromoperations		198,500
Interestpaid	(6,120)	
Taxationpaid	(32,300)	(38,420)
Netcashinflowfromoperatingactivities		160,080
Cashflowsfrominvestingactivities		
Acquisitionofproperty,plantandequipment (£369,300–£210,000)	(159,300)	
Investmentincome	~~7,100~~	
Netcashoutflowfrominvestingactivities		(152,200)
Cashflowsfromfinancingactivities		
Proceedsfromissueofsharecapital	20,000	
Proceedsfromlong-termborrowings	25,000	
Dividendspaid	~~(85,000)~~	
Netcashoutflowfromfinancingactivities		(40,000)
Netdecreaseincashandcashequivalents		(32,120)
Cashandcashequivalentsat1July2019		(2,790)

(b) The direct method could not be used because only an extract from the company's statement of comprehensive income is provided. In particular, the sales revenue figure is not available and this makes it impossible to calculate the cash received from customers.

(c) The statement of cash flows explains why the company's bank overdraft increased by £32,120 intheyear.Themainproblemisthatnearlyallofthecashgeneratedbythecompany's operatingactivities,afterthepaymentoftax,wasneededtofundthelargeinvestmentin property, plant and equipment. This problem was compounded by a material increase in trade receivablesbutwaspartlyalleviatedbyareductionininventories.Paymentofan£85,000 dividend absorbed all of the £45,000 raised in extra financing. As a result, the

company's cash position at the end of June 2020 is worse than a year previously.

16.5

Statementofcashflowsfortheyearto31October2019

	£000	£000
Cashflowsfromoperatingactivities		
Profitbeforetaxation	3,269	
Depreciation	3,545	
Profitondisposalofproperty,plantandequipment	(224)	
Interestpayable	91	
Increaseininventories(3,696–2,464)	(1,232)	
Increaseintradereceivables(3,360–2,464)	(896)	
Decreaseintradepayables(1,232–1,848)	(616)	
Cashgeneratedfromoperations		3,937
Interestpaid	(91)	
Taxationpaid	(944)	(1,035)
Netcashinflowfromoperatingactivities		2,902
Cashflowsfrominvestingactivities		
Acquisitionofproperty,plantandequipment(W1)	(5,237)	
Disposalofproperty,plantandequipment(W2)	845	
Netcashoutflowfrominvestingactivities		(4,392)
Cashflowsfromfinancingactivities		
Bankloansraised	500	
Proceedsofshareissue	500	
Netcashinflowfromfinancingactivities		1,000
Netdecreaseincashandcashequivalents		(490)
Cashandcashequivalentsatbeginningofyear		129
Cashandcashequivalentsatendofyear		(361)

Workings:

W1. Openingbalanceofpropertyplantandequipment	24,100	
Disposal(976–355)	(621)	
Depreciationchargefortheyear	(3,545)	
	19,934	
Acquisitions(balancingfigure)	5,237	
Closingbalanceofproperty,plantandequipment	25,171	

W2. Thecarryingamountofthesoldpropertyplantandequipmentwas£621,000(W1)andthe profit on sale was £224,000, so the sale proceeds must have been £845,000.

16.6

(a) *Indirectmethod*:

	£000	£000
Cashflowsfromoperatingactivities		
Profitbeforetaxation	6,136	
Depreciation	750	
Deficitonsaleofnon-currentassets	72	
Interestexpense	380	
Decreaseininventories(620–790)	170	
Decreaseintradereceivables(3,290–4,700)	1,410	
Decreaseintradepayables(1,040–1,099)	(59)	
Cashgeneratedfromoperations		8,859
Interestpaid	(380)	
Taxationpaid(1,140–420)	(720)	(1,100)
Netcashinflowfromoperatingactivities		7,759

(b) *Directmethod*:

	£000	£000
Cashflowsfromoperatingactivities		
Cashreceiptsfromcustomers(W1)		34,163
Cashpaidtosuppliersandemployees(W2)		(25,304)
Cashgeneratedfromoperations		8,859
Interestpaid	(380)	
Taxationpaid(1,140–420)	(720)	(1,100)
Netcashinflowfromoperatingactivities		7,759

Workings:

W1.Tradereceivablesb/f	4,700
Sales	32,900
Discountsallowed	(147)
Cashreceiptsfromcustomers(balancingfigure)	(34,163)
Tradereceivablesc/f	3,290

W2.Tradepayablesb/f	1,099
Purchases	14,290
Discountsreceived	(55)
Cashpaidtosuppliers(balancingfigure)	(14,294)

Thetotalamountpaidtosuppliersandemployeesis(14,294+4,490+6,520)=25,304.

16.7

(a)

Retained earnings have decreased by £55,000 but a dividend of £100,000 has been paid, so profit after tax must have been £45,000. The tax charge for the year is £9,000, so profit before tax must have been £54,000.

(b)

Thecost ofPPEhasincreasedby£40,000, but PPEwithacost of£30,000hasbeendisposedof during the year. Therefore PPE must have been acquired at a cost of £70,000. Of this, £20,000 isstill owing at the end of the year, so only £50,000 has been spent during the year.

Accumulateddepreciationhasincreasedby£40,000,butaccumulateddepreciationonequipme nt soldduringtheyearwas£18,000(60%of£30,000)sothedepreciationchargefortheyearmust have been £58,000. The loss on disposal of equipment was £2,000 (£30,000 – £18,000 – £10,000).

Thestatementofcashflowscannowbeprepared.

Statementofcashflowsfortheyearto31July2020

	£000	£000
Cashflowsfromoperatingactivities		
Profitbeforetaxation	54	
Depreciation	58	
Lossondisposalofequipment	2	
Lossondisposalofinvestments	4	
Increaseinallowancefordoubtfuldebts	22	
Interestpayable	8	
Dividendsreceived	(5)	
Increaseininventories(£289,000–£176,000)	(113)	
Increaseintradereceivables(£231,000–£106,000)	(125)	
Increaseinprepayments(£13,000–£12,000)	(1)	
Increaseintradepayables(£60,000–£55,000)	5	
Increaseinaccruals(£9,000–£8,000)	1	
Cashgeneratedfromoperations		(90)
Interestpaid	(8)	
Taxationpaid	(47)	(55)
Netcashoutflowfromoperatingactivities		(145)
Cashflowsfrominvestingactivities		
Acquisitionofproperty,plantandequipment	(50)	
Disposalofproperty,plantandequipment	10	
Disposaloflong-terminvestments	21	
Dividendsreceived	5	
Netcashoutflowfrominvestingactivities		(14)
		c/f(159)

	b/f	(159)
Cashflowsfromfinancingactivities		
Proceedsofshareissue	80	
Proceedsofdebentureissue	30	
Dividendspaid	(100)	
Netcashinflowfromfinancingactivities		10
Netdecreaseincashandcashequivalents		(149)
Cashandcashequivalentsat1August2019		109
Cashandcashequivalentsat31July2020		(40)

(c)

	1August 2019	*Change inyear*	*31July 2020*
	£000	£000	£000
Cashatbankandinhand	59	(59)	-
Cashequivalents	50	(50)	-
Bankoverdraft	-	(40)	(40)

(d)

The company's cash position has deteriorated during the year, despite selling investments and rais- ing £110,000 of new finance. The main problem seems to be that operating activities generated a cash outflow rather than a cash inflow, and this made it difficult for the company to find the cash required to pay dividends and to replace non-current assets.

The cash outflow from operating activities was caused principally by large increases in inventories and trade receivables. It may be that the company has been trying to make itself more attractive to customersbyholdinggreaterinventoriesandofferinglongercredit,butthispolicyhashadthe inevitable effect on the company's cash position. The large proportionate increase in the allowance for doubtful debts suggests that less rigorous credit control might not be entirely advisable.

Withoutaccesstorecentfinancialstatements,itisdifficulttobesurewhetherthecompanyhas becomemoreorlessprofitablein theyearto 31 July2020,butthemassivereduction in thetaxation liability may indicate that profits have fallen.

Insummary,thecompanyseemstohavehadabadyear, frombothcashandprofitspointof view. However, further information would be required before a full analysis of the situation couldbe carried out.

Chapter17

17.1

(a)Nominalfinancialcapitalmaintenancemeasurescapitalinmoneytermswithnoregardto changes in the purchasing power of money. Profit is defined as the amount by which nominal financial capital has increased during the period.

Generalpurchasingpowermaintenancemeasurescapitalintermsofgeneralpurchasingpower(withreferencetoageneralpricesindex)anddefinesprofitastheamountbywhich general purchasing power has increased during the period.

Physical capital maintenance measures capital in terms of purchasing power with regard to the specificitemswhichtheentityneedstobuy.Profitisdefinedastheincreaseinspecific purchasing power during the period.

(b)

	Nominal financialcapitalmaintenance	*General purchasingpowermaintenance*	*Physical capitalmaintenance*
	£000	£000	£000
Assetsattheendofthemonth:			
Cash	475	475	475
Inventory	100	105	107
	575	580	582
Assetsrequiredtobeaswelloff asatthebeginningofthemonth:			
(i)nominalmonetaryunits	400		
(ii)generalpurchasingpower (£400,000×105/100)		420	
(iii)physicaloperatingcapability (£400,000×107/100)			428
Netprofitforthemonth	175	160	154

Notes:

In order to maintain its operating capability, the company needs to be able to replace the inventory which was sold during the month. This inventory cost £300,000 originally but its replacement costis now £321,000 (£300,000 ×107/100).

(i) Innominalmonetaryterms,thecompanyhasmadeaprofitof£175,000.However, ifallofthisprofitispaidoutasadividend,theremainingcashof£300,000willbeinsufficientto replenish the company's inventory. In effect, part of the dividend will be paid out of capital.

(ii) In terms of general purchasing power, the company has made a profit of £160,000. If all ofthisprofitispaidoutasadividend,theremainingcashof£315,000willhavethesamegeneralpurchasingpoweras£300,000atthestartofthemonth.However,thiswillstillbe insufficient to replenish the company's inventory.

(iii) In terms of physical capital maintenance, the company has made a profit of £154,000. If all of this is paid out as a dividend, the remaining cash of £321,000 will be sufficient

to replace the company's inventory and so maintain its operating capability.

17.2

On 31 December 2019, C Ltd needs £224,000 (£200,000 ×112/100) to maintain the same general purchasingpowerasithadon1January2018.Theamountreceivedon31December2019is £232,000, so the overall gain is £8,000. This comprises interest of £32,000, less a loss of £24,000on the capital amount of the loan (a monetary item).

17.3

(a) Inventories held by an entity during a period of inflation will increase in monetary value. This is known as a holding gain.

(b) Innominalfinancialterms,salesare£55,000andcostofsalesis£40,000,givingagrossprofit of£15,000.Theholding gain on thegoodswhich havebeen sold is£3,200 (8% of£40,000)so it could be argued that the true gross profit is only £11,800.

There is also a holding gain of £1,600 in relation to the goods which are still held. This willnot be recognised until those goods are sold.

17.4

(a) Historicalcostaccounting(HCA)isanaccountingmethodwherebyeachtransactionis recorded atitsmonetary amountatthe time ofthe transaction and no attemptismade to adjust recorded amounts to take account of inflation.

(b) Strengths of HCA include simplicity and objectivity. Perceived weaknesses of HCA in a time ofinflationincludeoverstatedprofits,inadequatedepreciationcharges,failuretodisclosegains and losses on monetary items, failure to identify holding gains, unrealistic non-current asset values etc. (See Chapter 17 for more details).

(c) ThetwomainalternativestoHCA arecurrentpurchasingpower(CPP)accountingandcurrent cost accounting (CCA). These accounting methods adopt the concepts of general purchasing powermaintenanceandphysicalcapitalmaintenancerespectively.Neitherhasgainedwide acceptance, but IAS29 uses a CPP approach when dealing with financial reporting in a hyper- inflationary economy. (See Chapter 17 for more details).

Chapter18

18.1

(a) Theconsolidatedstatementoffinancialpositionisasfollows:

	£000
Assets	
Non-currentassets(510+150)	660
Goodwill(W1)	40
Currentassets(325–225+75)	175
	875
Equity	
Ordinarysharecapital	500
Retainedearnings	185
	685
Liabilities	
Currentliabilities(150+40)	190
	875

Workings:

W1.Goodwill

	£000	£000
Pricepaidbyparent		225
Subsidiary'ssharecapitalat1January2020	100	
Subsidiary'sretainedearningsat1January2020	60	
Fairvalueadjustment(150–125)	25	185
Goodwillat1January2020		40

(b) The only difference between this situation and the previous one is that A1 Ltd has increasedits issued share capital by £150,000 and established a £75,000 share premium account, rather than spending cash of £225,000. The consolidated statement of financial position is:

	£000
Assets	
Non-currentassets(510+150)	660
Goodwill(W1)	40
Currentassets(325+75)	400
	1,100
Equity	
Ordinarysharecapital	650
Sharepremiumaccount	75
Retainedearnings	185
	910
Liabilities	
Currentliabilities(150+40)	190
	1,100

18.2

Theconsolidatedstatementoffinancialpositionisasfollows:

	£000
Assets	
Non-currentassets	
Property,plantandequipment(3,700+440)	4,140
Goodwill(W1)	150
	4,290
Currentassets(2,750+250)	3,000
	7,290
Equity	
Ordinarysharecapital	2,000
Retainedearnings	3,550
	5,550
Non-controllinginterest(W2)	100
	5,650
Liabilities	
Currentliabilities(1,450+190)	1,640
	7,290

Workings:

W1.Goodwill

	£000	£000
Pricepaidbyparent		550
Subsidiary'ssharecapitalat31December2019	100	
Subsidiary'sretainedearningsat31December2019	280	
Fairvalueadjustment(440–320)	120	
	80%×500	400
Goodwillat31December2019		150

W2.Non-controllinginterest

	£000	£000
Subsidiary'ssharecapitalat31December2019	100	
Subsidiary'sretainedearningsat31December2019	280	
Fairvalueadjustment(440–320)	120	
	20%×500	100
Non-controllinginterestat31December2019		100

18.3

(a) Theconsolidatedstatementoffinancialpositionisasfollows:

	£000
Assets	
Non-currentassets	
Property,plantandequipment(2,265+345+180)	2,790
Currentassets(2,124+466)	2,590
	5,380
Equity	
Ordinarysharecapital	3,000
Retainedearnings(W2)	982
	3,982
Liabilities	
Currentliabilities(1,160+238)	1,398
	5,380

Workings:

W1.Goodwill

	£000	£000
Pricepaidbyparent		800
Subsidiary'ssharecapitalat30April2016	350	
Subsidiary'sretainedearningsat30April2016	195	
Fairvalueadjustment(500–320)	180	725
Goodwillat30April2016		75
Less:Impairment(100%)		75
Goodwillat30April2020		0

W2.Groupretainedearnings

	£000	£000
Parent'sretainedearningsat30April2020		1,029
Subsidiary'sretainedearningsat30April2020	223	
Subsidiary'sretainedearningsat30April2016	195	28
		1,057
Less:Goodwillimpairment		75

(b)The additional depreciation of £40,000 reduces the carrying amount of group property, plant andequipmentto£2,750,000andreducesgroupretainedearningsto£942,000.Apartfrom making the necessary changes to totals and sub-totals, these are the only changes required.

18.4

(a) Theconsolidatedstatementoffinancialpositionisasfollows:

	£000
Assets	
Non-currentassets	
Property,plantandequipment(6,910+1,640+150)	8,700
Goodwill(W1)	350
	9,050
Currentassets(3,110+1,120)	4,230
	13,280
Equity	
Ordinarysharecapital	4,000
Retainedearnings(W2)	5,870
	9,870
Non-controllinginterest(W3)	660
	10,530
Liabilities	
Currentliabilities(2,040+710)	2,750
	13,280

Workings:

W1.Goodwill

	£000	£000
Pricepaidbyparent		1,400
Subsidiary'ssharecapitalat31May2012	500	
Subsidiary'sretainedearningsat31May2012	850	
Fairvalueadjustment	150	
	70%×1,500	1,050
Goodwillat31May2012(and31May2020)		350

W2.Groupretainedearnings

	£000	£000
Parent'sretainedearningsat31May2020		5,380
Subsidiary'sretainedearningsat31May2020	1,550	
Subsidiary'sretainedearningsat31May2012	850	
	70%×700	490
Groupretainedearningsat31May2020		5,870

W3. Non-controlling interest

	£000	£000
Subsidiary's equity at 31 May 2020	2,050	
Fair value adjustment	150	
Non-controlling interest at 31 May 2020	30% × 2,200	660

(b) The non-controlling interest in the identifiable net assets of UU Ltd on the date of acquisition was £450,000 (30% × £1,500,000). So the goodwill attributable to the non-controlling interest must have been £80,000 (£530,000 – £450,000). Since there has been no impairment, this goodwill is still measured at £80,000. So goodwill at 31 May 2020 rises by £80,000 to £430,000 and the non-controlling interest at that date rises to £740,000.

18.5

(a) Non-controlling interest

	£000	£000
Subsidiary's share capital at 30 September 2020	5,000	
Subsidiary's share premium at 30 September 2020	2,000	
Subsidiary's retained earnings at 30 September 2020	28,370	
Fair value adjustment (37,000 – 33,000)	4,000	
Non-controlling interest at 30 September 2020	40% × 39,370	15,748

(b) Goodwill

	£000	£000
Price paid by parent		29,000
Subsidiary's share capital at 1 October 2019	5,000	
Subsidiary's share premium at 1 October 2019	2,000	
Subsidiary's retained earnings at 1 October 2019	24,700	
Fair value adjustment	4,000	
	60% × 35,700	21,420
Goodwill at 1 October 2019		7,580
Less: Impairment (20%)		1,516
Goodwill at 30 September 2020		6,064

(c) Group retained earnings

	£000	£000
Parent's retained earnings at 30 September 2020		34,225
Subsidiary's retained earnings at 30 September 2020	28,370	
Subsidiary's retained earnings at 1 October 2019	24,700	
	60% × 3,670	2,202
		36,427
Less: Goodwill impairment		1,516
Group retained earnings at 30 September 2020		34,911

Chapter19

19.1

	£
Salesrevenue(£345,450+£186,350)	531,800
Costofsales(£125,700+£71,990)	197,690
Grossprofit	334,110
Operatingexpenses(£56,330+£37,800)	94,130
Profitbeforetax	239,980
Taxation(£32,000+£14,660)	46,660
Profitfortheyear	193,320
Attributabletothenon-controllinginterest(35%of£61,900)	21,665
Attributabletothegroup	171,655

19.2

(a) Theconsolidatedstatementofcomprehensiveincomeisasfollows:

	£
Sales revenue (£359,800 + £154,600 – £10,000)	
504,400 Costofsales(£102,600+£55,550–£10,000+£1,000)	
	149,150
Grossprofit	355,250
Operatingexpenses(£118,480+£19,300)	137,780
Profitbeforetax	217,470
Taxation(£32,000+£16,000)	48,000
Profitfortheyear	169,470
Attributabletothenon-controllinginterest(20%of£63,750)	12,750
Attributabletothegroup	156,720

Notes:

(i) Intra-group sales of £10,000 are cancelled out. Inventories include an unrealised profitof £1,000 (1/4 ×£4,000). When this is eliminated, the cost of sales rises by £1,000.

(ii) Intra-groupdividendsof£28,000(80%of£35,000)arecancelledout.

(b) Movementsingroupretainedearningsfortheyearmaybesummarisedasfollows:

	£
Balanceat31March2019(W1)	84,370
Profitfortheyear	156,720
Dividendspaid	(90,000)
Balanceat31March2020(W2)	151,090

Workings:

W1. Group retained earnings at 31 March 2019

	£	£
Parent's retained earnings at 31 March 2019		66,090
Subsidiary's retained earnings at 31 March 2019	41,110	
Subsidiary's retained earnings at 1 April 2016	18,260	
	80% × 22,850	18,280
Group retained earnings at 31 March 2019†		84,370

† *It is assumed that there were no unrealised profits at 31 March 2019*

W2. Group retained earnings at 31 March 2020

	£	£
Parent's retained earnings at 31 March 2020		110,810
Subsidiary's retained earnings at 31 March 2020	69,860	
Subsidiary's retained earnings at 1 April 2016	18,260	
	80% × 51,600	41,280
		152,090
Less: Unrealised profit		1,000
Group retained earnings at 31 March 2020		151,090

19.3

YY Ltd acquired its holding in ZZ Ltd after four months of the accounting year, so the consolidated statement of comprehensive income should include 8/12ths of the ZZ Ltd figures for the year. Intra- group sales of £7,000 should be subtracted from group sales and group cost of sales but the sale on 31 January 2020 can be ignored since it took place before YY Ltd acquired its holding in ZZ Ltd. There is an unrealised profit of £3,000 (£7,000 − £4,000) which must be eliminated. This causes an increase of £3,000 in cost of sales. Also, goodwill impairment of £10,000 must be included in the group expenses. The consolidated statement of comprehensive income is as follows:

	£
Sales revenue (£150,000 + (8/12 × £84,000) − £7,000)	199,000
Cost of sales (£60,000 + (8/12 × £27,000) − £7,000 + £3,000)	74,000
Gross profit	125,000
Operating expenses (£25,800 + (8/12 × £18,600) + £10,000)	48,200
Profit before tax	76,800
Taxation (£12,000 + (8/12 × £7,200))	16,800
Profit for the year	60,000
Attributable to the non-controlling interest (15% of (8/12 × £31,200))	3,120
Attributable to the group	56,880

19.4

Consolidatedstatementofcomprehensiveincomefortheyearto31March2020

	£000
Salesrevenue(38,462+12,544–1,600)	49,406
Costofsales(22,693+5,268–1,600)	(26,361)
Grossprofit	23,045
Distributioncosts(6,403+2,851)	(9,254)
Administrativeexpenses(3,987+2,466)	(6,453)
Profitfromoperations	7,338
Financecosts(562+180)	(742)
Profitbeforetax	6,596
Taxation(1,511+623)	(2,134)
Profitfortheyear	4,462
Attributabletothenon-controllinginterest(25%of1,156)	(289)
Attributabletothegroup	4,173

Chapter20

20.1

(a) Anassociateisanentityoverwhichtheinvestorhassignificantinfluence.Significant influenceisthepowertoparticipateinthefinancialandoperatingpolicydecisionsofthe investee,withouthavingcontrolorjointcontroloverthosepolicies.Significantinfluenceis normally assumed to exist if the investor owns at least 20% of the investee's ordinary shares.

(b) Undertheequitymethodofaccounting,theinvestmentmadeintheassociateisrecorded initially at cost. In each subsequent year, the investor's share of the associate's profit is addedto the carrying amount of the investment and recognised as income in the investor's financial statements. Dividends received from the associate are subtracted from the carrying amount of the investment.

Only the investor's share of the associate's profitis shown in the investor's statementof comprehensive income and only the investor's share of the associate's net assets is shown inthe investor's statement of financial position. These items are each shown as a single line item and there is no need to account for a non-controlling interest. This differs from the acquisition methodusedforsubsidiaries,wherebyallofasubsidiary'sassets,liabilities,incomeand expenses are incorporated line by line into the consolidated financial statements and then the non-controlling interest (if any) is accounted for.

20.2

(a) A jointarrangementisanarrangementwherebytwoormorepartiesexercisejointcontrolover abusinessenterprise.Jointcontrolexistsonlywhendecisionsrelatingtothearrangement require the unanimous consent of the parties sharing control.

(b) A *jointoperation*does not involve setting up a new entity that is separate from the parties to thearrangement.Instead,thejointoperatorsusetheirownassetsandincurtheirownliabilities for the purposes of the operation. Each joint operator recognises the assets and liabilities that relate to the joint operation in its own financial statements, along with its share of the revenue and expenses arising. Financial statements are not prepared for the joint operation itself.

A *jointventure*usually involves the establishment of a business entity which operates in the same way as any other entity, except that the venturers have joint control over its activities. Suchanentitypresentsitsownfinancialstatements.Jointventuresareaccountedforinthe financial statements of the joint venturers by using the equity method.

20.3

Notes:

1. P Ltd is a 90% subsidiary of M Ltd, so it is necessary to calculate figures for goodwill, group retained earnings and the non-controlling interest (see workings below).
2. QLtdispresumablyanassociateofMLtd.On31July2019,thecompany'stotalequitywas £320,000 (£80,000 + £240,000) so the price paid for goodwill was £20,000 (£100,000 – 25%of £320,000). This is not negative and so is not recognised separately.
3. TheretainedearningsofQ Ltdhaveincreasedby£40,000since31July2019.Thegroup's25% share of this is £10,000. So the investment should be carried at £110,000 (£100,000 + £10,000) and £10,000 should be added to group retained earnings.

Theconsolidatedstatementoffinancialpositionisasfollows:

	£000
Assets	
Non-currentassets	
Property,plantandequipment(2,570+370+80)	3,020
Goodwill(W1)	50
Investmentinassociate(100+10)	110
	3,180
Currentassets(1,150+220)	1,370
	4,550
Equity	
Ordinarysharecapital	1,000
Retainedearnings(W2)	2,574
	3,574
Non-controllinginterest(W3)	56
	3,630
Liabilities	
Currentliabilities(810+110)	920
	4,550

Workings:

W1.Goodwill

	£000	£000
Pricepaidbyparent		410
Subsidiary'ssharecapitalat31July2017	100	
Subsidiary'sretainedearningsat31July2017	220	
Fairvalueadjustment	80	
	90%×400	360
Goodwillat31July2017(and31July2020)		50

W2.Groupretainedearnings

	£000	£000
Parent'sretainedearningsat31July2020		2,420
Subsidiary'sretainedearningsat31July2020	380	
Subsidiary'sretainedearningsat31July2017	220	
	90%×160	144
Associate'sretainedearnings(25%×40)		10
Groupretainedearningsat31July2020		2,574

W3.Non-controllinginterest

	£000	£000
Subsidiary'ssharecapitalat31July2020	100	
Subsidiary'sretainedearningsat31July2020	380	
Fairvalueadjustment	80	
	10%×560	56
Non-controllinginterestat31July2020		56

20.4

Notes:

1. On 30 September 2016, the total equity of L Ltd was £300,000 (£200,000 + £100,000). Therefore the price paid for goodwill was £20,000 (£140,000 – 40% of £300,000). This is not negative and so is not recognised separately.
2. The retained earnings of L Ltd have increased by £220,000 since K Ltd acquired its holding. A 40% share of this increase is £88,000, so the investment in L Ltd should be carried at £228,000 (£140,000 + £88,000). However, unrealised profit of £1,000 (40% of one-quarter of £10,000) reduces the carrying amount of the investment to £227,000.
3. The profit after tax of L Ltd for the year to 30 September 2020 is £110,000, of which a 40% share is £44,000. The unrealised profit reduces this to £43,000.
4. On 30 September 2019, the retained earnings of L Ltd had increased by £160,000 since K Ltd acquired its holding. So the carrying amount of the investment on that date would have been £204,000 (£140,000 + (40% × £160,000)). The carrying amount at 30 September 2020 is therefore (£204,000 + £43,000 – dividend £20,000) = £227,000, as stated above.

Statementofcomprehensiveincomefortheyearto30September2020

	£000
Operatingprofit	600
Shareofprofitofassociate((40%×110)–1)	43
Profitbeforetax	643
Taxation	120
Profitfortheyear	523

Statementoffinancialpositionasat30September2020

	£000
Assets	
Non-currentassets	
Property,plantandequipment	1,600
Investmentinassociate(204+43–20)	227
	1,827
Currentassets	780
	2,607
Equity	
Ordinarysharecapital	1,000
Retainedearnings(W2)	1,297
	2,297
Liabilities	
Currentliabilities	310
	2,607

Statementofchangesinequity(retainedearningsonly)fortheyearto30September2020

	£000
Balanceat30September2019(W1)	774
Profitfortheyear	523
Balanceat30September2020(W2)	1,297

Workings:

W1.Retainedearningsat30September2019

	£000	£000
KLtdretainedearningsat30September2019		710
LLtdretainedearningsat30September2019	260	
LLtdretainedearningsat30September2016	100	
	40%×160	64
Retainedearningsat30September2019		774

W2.Retainedearningsat30September2020

	£000	£000
KLtdretainedearningsat30September2020		1,210
LLtdretainedearningsat30September2020	320	
LLtdretainedearningsat30September2016	100	
	40%×220	88
		1,298
Less:Unrealisedprofit		1
Retainedearningsat30September2020		1,297

Chapter21

21.1

(a) Alan is a related party unless it can be demonstrated that his shareholding does not give him significant influence over the company. If he is a related party, Elaine is also a related party.

(b) YplciscontrolledbyZplc,soYplcisarelatedparty.

(c) ZplcdoesnotcontrolXplcand(presumably)doesnotexertsignificantinfluenceoverthe company or jointly control it. Therefore X plc is not a related party.

(d) Barbara is a member of the key management personnel of Z plc and is a related party. Davidis a close family member of Barbara and so is also a related party. Barbara controls W Ltd, so W Ltd is a related party of Z plc. David does not control V Ltd and there is no indication of joint control. Therefore V Ltd is not a related party of Z plc.

(e) Colin may or may not be a related party. It depends upon whether he is a member of the key management personnel of Z plc. If he is a related party, then so is Fiona.

(f) Thepensionschemeisarelatedparty.

21.2

(a)

1 January 2020 £115,000 (€143,750 ÷ 1.25) is debited to equipment and credited to X. 1 February 2020 £40,000 (€48,000 ÷ 1.20) is debited to purchases and credited to Y.

28February2020 £115,000isdebitedtoXand£125,000(€143,750÷1.15)iscreditedtobank. Thedifferenceof£10,000isdebitedtoexchangedifferences.

15 March 2020 £11,000 (€13,200 ÷ 1.20) is debited to Y and £12,000 (€13,200 ÷ 1.10) is cr-edited to bank. The difference of £1,000 is debited to exchange differences.

15 March 2020 £70,000 (€77,000 ÷ 1.10) is debited to Z and credited to sales. (b)

On31March2020,thereisnoadjustmenttoequipmentorinventory,sincebothofthesearecarried at historical cost. The amount owed to Y (€34,800) is translated to £34,800 (using an exchange rate of £1 = €1.00). This debt was previously carried at £29,000 (€34,800 ÷ 1.20) so there is an adverse exchange difference of £5,800. The amount owed by Z (€77,000) is translated to £77,000, giving rise to a favourable exchange difference of £7,000.

The total exchange difference for the period is £9,800 (£10,000 + £1,000 + £5,800 – £7,000). Thisis an adverse difference and is recognised as an expense in the statement of comprehensive income.

21.3

Statementofcomprehensiveincomefortheyearto30June2019

	Fn	Rate	£
Salesrevenue	67,200	5	13,440
Expenses	40,320	5	8,064
Profitfortheyear	26,880		5,376
Othercomprehensiveincome	-		6,344
	26,880		11,720

Statementoffinancialpositionas at30June2019

	Fn	Rate	£
Assets	112,400	4	28,100
Sharecapital(issued1July2018)	60,000	6	10,000
Retained earnings	26,880		
5,376 Foreignexchangereserve	-	bal.fig.	
6,344			
	86,880		21,720
Liabilities	25,520	4	6,380
	112,400		28,100

Statementofcomprehensiveincomefortheyearto30June2020

	Fn	Rate	£
Salesrevenue	71,820	4.5	15,960
Expenses	41,580	4.5	9,240
Profitfortheyear	30,240		6,720
Othercomprehensiveincome	-		(4,040)
	30,240		2,680

Statementoffinancialpositionasat30June2020

	Fn	Rate	£
Assets	145,920	4.8	30,400
Sharecapital(issued1July2018)	60,000	6	10,000
Retainedearnings	57,120		12,096
Foreignexchangereserve	-	bal.fig.	2,304
	117,120		24,400
Liabilities	28,800	4.8	6,000
	145,920		30,400

Notes:

(i) Retainedearnings(in£)at30June2020are(£5,376+£6,720)=£12,096.

(ii)Thereductionof£4,040intheforeignexchangereserve(from£6,344at30June2019to £2,304 at 30 June 2020) is shown as negative other comprehensive income in the statement of comprehensive income for the year to 30 June 2020.

Chapter22

22.1

ThemainassumptionsmadewhencalculatingtheratiosforRLtdare:

(i) Thefiguresshowninthestatementoffinancialpositionarerepresentativeoftheyearasa whole and so can be used instead of average figures (which are not available in this case).

(ii) Allsalesandpurchasesaremadeoncreditterms.

(iii) Costofsalescanbeusedasareasonableapproximationtopurchas

es. The ratios are as follows:

(a) ROCE=60/279×100%=21.5%

(b) ROE=(35–1)/119×100%=28.6%

(c) Grossprofitmargin=175/410×100%=42.7%

(d) Netprofitmargin=45/410×100%=11.0%

(e) Currentratio=147/76=1.9

(f) Quickassetsratio=(147–82)/76=0.9

(g) Inventoryholdingperiod=82/235×365=127days

(h) Tradereceivablescollectionperiod=58/410×365=52days

(i) Tradepayablespaymentperiod=45/235×365=70days

(j) Capital gearing ratio = (150 + 10)/279 ×100% =

57.3%

(k) Interestcover=60/15=4

(l) Dividendcover=(35–1)/20=1.7

(m) Earningspershare=(35–1)/100×100p=34p.

22.2

Company X will have a high gross profit margin but much of the gross profit will be absorbed by overheadexpensessothatthenetprofitmarginmightbedisappointinglylow.Theinventoryholdingperiodandthetradereceivablescollectionperiodwillbothbecomparativelylong.The companywilloftenhavetopayforsuppliesofclothingwellbeforetheclothingissoldtocustomers and this may cause some liquidity problems. As a consequence, the company may have needed to obtain a source of long-term finance. This would be reflected in the capital gearing ratio and might depress the return obtained on equity.

CompanyYwillhavealowgrossprofitmarginbutthelackofoverheadcostsmayresultina surprisingly high net profit margin. The inventory holding period and trade receivables collection periodwillbothbeshort.Thecompanywilloftenbeabletosellgoodsandreceivepaymentfor them before having to pay its own suppliers, so that liquidity should not be a major problem

22.3

(a) Earningspershare=(90,000–15,000)/1,000,000×100p=7.5p

(b) Dividend cover = (90,000 – 15,000)/55,000 = 1.4

(c) Dividendyield=5.5/70×100%=7.9%

(d) Priceearningsratio=70/7.5=9.3.

22.4

Profitabilityratios		*2019*	*2018*
(a)	ROCE	820/6,508×100%=12.6%	745/5,583×100%=13.3%
(b)	ROE	555/5,508×100%=10.1%	580/5,433×100%=10.7%
(c)	Gross profit margin	907/5,327 ×100% = 17.0%	820/3,725×100%=22.0%
(d)	Netprofitmargin	690/5,327×100%=13.0%	725/3,725×100%=19.5%

These ratios all show a deterioration in the year 2019. The reduction in the gross profit margin was deliberate and was presumably responsible (in part) for the 43%increase in sales, but overall the companywassubstantiallylessprofitableintheyear2019thanin2018.Inabsoluteterms,the company's profit actually fell in the year 2019. It appears that the company's attempts to stimulate sales have been successful but the objective of increasing profits has not been achieved.

Liquidityratios		*2019*	*2018*
(e)	Currentratio	2,623/1,235=2.12	1,726/843=2.05
(f)	Quickassetsratio	(2,623–1,334)/1,235=1.04	(1,726–730)/843=1.18

The current ratio has improved slightly in 2019 but this is mainly due to the large (and deliberate) increase in the company's inventories. The quick assets ratio fell in 2019. It is important to realise thatthecompanyhadvirtuallynocashleftattheendof2019,despiteraisinganextra£850,000 during the year fromlong-termloans Given that the company is nowoffering longer credit to its customers, the liquidity position looks poor.

Efficiencyratios		*2019*	*2018*
(g)	Inv. holding period	1,334/4,420 ×365 = 110 days	730/2,905×365=92days
(h)	Rec.collectionperiod	1,278/5,327×365=88days	596/3,725×365=58days

The increases in these ratios are expected, given the company's policy of holding larger inventories and offering longer credit to customers.

Gearingratio		*2019*	*2018*
(i)	Capitalgearingratio	1,000/6,508×100%=15.4%	150/5,583×100%=2.7%

Thecompanyhasmovedfrombeingaverylow-gearedcompanyin2018tobeingamoderatelylow-geared company in 2019. The interest cover is still adequate but the ordinary dividend is barely coveredbytheprofitaftertax.Ifthecompanyisforcedbyitsliquiditypositiontoincrease borrowingsstillfurtherandbecomemorehigh-geared,itmaybethatthedividendpaidtothe ordinary shareholders will have to be reduced.

Chapter23

23.1

(a) BasicEPSis(£390,000–£80,000)/4,000,000×100p=7.75p.

(b)Ifthecompany'sprofitaftertaxincludes£50,000fromadiscontinuedoperation,asecondbasic EPSfiguremustbepresented,basedontheprofitfromcontinuingoperations.Thisis (£390,000 – £50,000 – £80,000)/4,000,000 ×100p = 6.5p.

23.2

(a) £188,000/100,000=£1.88.

(b) Theweightedaveragenumberofordinarysharesoutstandingduringtheyearis(100,000× 5/12)+(115,000×7/12)=108,750.ThereforebasicEPSis£217,500/108,750=£2.00.

23.3

(a) The bonus issue is treated as if it was made at the start of the year to 31 October 2018. Basic EPS for the year to 31 October 2019 is £341,000/550,000 ×100p = 62p.

(b) Restated basic EPS for the year to 31 October 2018 is £330,000/550,000 ×100p = 60p. This would have been originally stated as £330,000/500,000 ×100p = 66p but is restated so as tobe comparable with the figure for 2019.

23.4

(a) Before the rights issue, the total market value of the company's shares (and so the worth of the company)was£120,000(150,000×80p).Therightsissueconsistedof30,000sharesand raised £15,000 (30,000 ×50p). Therefore the number of issued shares rose to 180,000 and the company's worth increased to £135,000. This gives a theoretical market price after the rights issue of 75p per share (£135,000/180,000).

If the share price had fallen to 75p as the result of a bonus issue, the number of shares out- standing after this issue would have been 160,000 (since 160,000 ×75p = £120,000). So the size of bonus issue that would have caused a fall in market price to 75p per share is an issue of 10,000 shares (a 1 for 15 bonus issue). Therefore the rights issue is treated as a bonus issue of 10,000 shares followed by an issue of 20,000 shares at full price.

Alternatively,thebonuselementis150,000×((80p/75p)–1)=10,000shares.

The weighted average number of ordinary shares outstanding during the year to 30 September 2019is(160,000×9/12)+(180,000×3/12)=165,000.ThereforebasicEPSfortheyearis £52,800/165,000×100p=32p.

(b) RestatedbasicEPSfortheyearto30September2018is£50,000/160,000×100p=31.25p.

23.5

(a) BasicEPSis£640,000/800,000×100p=80p.

(b) If the loan stock had been converted into ordinary shares, profit before tax would have risenby£100,000andprofitaftertaxwouldhaverisenby£81,000to£721,000.Thenumberof extra shares would be 200,000 so that the total number of shares outstanding would become one million. Therefore diluted EPS is £721,000/1,000,000 ×100p = 72.1p.

(c) Basic EPS is still 80p. The extra 200,000 shares that would arise if the loan stock is converted are treated as if issued on 1 October 2019. The weighted average number of ordinary shares outstanding during the year to 31 March 2020 would become (800,000 ×6/12) + (1,000,000 ×6/12)=900,000.Onlyhalfayear'sinterestwouldbesavedsoprofitaftertaxwouldriseby £40,500to£680,500.ThereforedilutedEPSis£680,500/900,000×100p=75.6p.

Chapter24

24.1

(a) Many entities (especially large companies) engage in a wide range of business activities and operate in several economic environments. Each business activity and each environment may besubjecttodifferingrisksandreturns.Thereforeananalysisofanentity'sresultsbybusines s activityor byeconomicenvironment will helpusers tounderstandtheentity's past performance, assess the entity's risks and returns and make more informed judgements. Such an analysis is required by international standard IFRS8.

(b) IFRS8appliestoentitieswhosesharesorsecuritiesarepubliclytraded.

24.2

(a) An operating segment (as defined by IFRS8) is a component of an entity that meets all of the following criteria:
- itisengagedinbusinessactivitiesfromwhichitmayearnrevenuesandincurexpenses
- its operating results are regularly reviewed by the chief operating decision maker to assess its performance and to make resource allocation decisions
- separatefinancialinformationisavailableforit.

(b) IFRS8 states that an operating segment is a reportable segment if it satisfies at least one of a number of quantitative thresholds. In broad terms, the segment's sales must be at least 10% of total sales or its profit must be at least 10% of total profit or its assets must be at least 10% of total assets. (See Chapter 24 for more details).

Iftheexternalrevenueofreportablesegmentsislessthan75%oftheentity'stotalexternal revenue, additional operating segments must be identified as reportable (even though they fail the 10% tests) until at least 75% of total external revenue is included in reportable segments.

24.3

Thefourmainclassesofinformationare:

(a) generalinformation
(b) informationabouteachreportablesegment
(c) reconciliations
(d) entity-wideinformation.

SeeChapter24foralistofthedisclosuresrequiredforeachclass.

24.4

External revenue is £77.4m and internal revenue is £4.6m, so total revenue is £82m. An operating segment will satisfy the 10% test with respect to revenue if it has total revenue of at least £8.2m.

Combined profits are £5.6m and combined losses are £780,000. An operating segment will satisfy the 10% test with respect to segment result if it has a profit or a loss of at least £560,000.

Total assets are £38m. An operating segment will satisfy the 10% test with respect to assets if it has total assets of at least £3.8m. The results of the three 10% tests for each segment are as follows:

	Totalrevenueat least£8.2m	*Profitorlossat least£560,000*	*Assetsat least£3.8m*	*Reportable segment*
SegmentP	Y	Y	Y	Y
SegmentQ	Y	Y	Y	Y
SegmentR	N	N	N	N
SegmentS	N	N	Y	Y

Segment R fails all of the 10% tests and is not a reportable segment. The remaining three segments have external revenue totalling £71.2m. This exceeds 75% of £77.4m so the 75% test is satisfied. The reportable segments are segments P, Q and S.

24.5

All four segments satisfy the 10% test with regard to revenue and therefore all four segments arereportable segments. The required information might be presented as follows:

	Total	*SegmentA*	*SegmentB*	*SegmentC*	*SegmentD*
	£m	£m	£m	£m	£m
Segmentrevenue					
Externalsalesrevenue	3,025	652	764	389	1,220
Inter-segmentsales	781	127	234	87	333
Totalrevenue	3,806	779	998	476	1,553
Segmentprofit	620	159	165	63	233
Unallocatedexpenses	120				
Profitbeforetax	500				
Taxexpense	95				
Profitaftertax	405				
Segmentassets	2,475	530	653	310	982
Unallocatedassets	457				
Totalassets	2,932				
Segmentliabilities	1,038	245	276	119	398
Unallocatedliabilities	658				
Totalliabilities	1,696				
Othersegmentinformation					
Interestincome	85	17	12	-	56
Interestexpense	192	34	51	20	87
Depreciation	551	101	132	65	253
Othernon-cashexpenses	65	17	12	7	29

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