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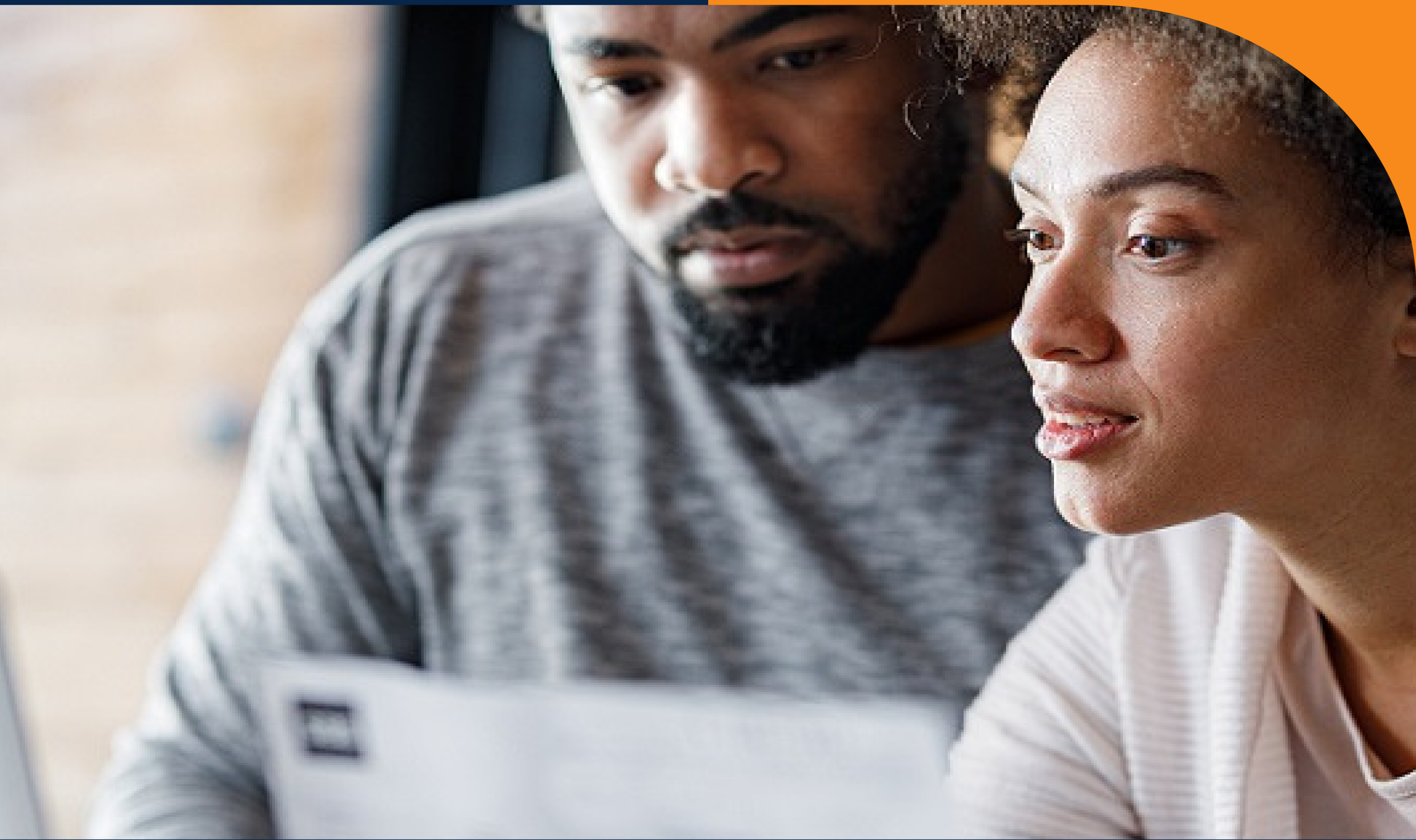

Financial Reporting

STUDY TEXTBOOK

CPA (U)

PAPER 8

FINANCIAL REPORTING

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This study text has been published in close consultation with lecturers and tutors with vast experience in teaching CPA(U) papers in particular Financial Reporting (Paper 8) and has been updated to capture the new changes in the CPA(U) Syllabus that took effect in June 2016 examination sitting. Therefore, this study text contains all the information that you need to pass your exam.

The study text therefore;

- Highlights the most important elements in the CPA(U) Syllabus and the key skills you need
- Emphasizes how each chapter links to the CPA(U) Syllabus and the study guide
- Provide a lot of exam focus points demonstrating what is expected of you in the exam
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- Examine and Text your knowledge in our activity exercises provided at the end of each chapter

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THIS STUDY TEXT INCLUDES THE FULL CPA(U) FINANCIAL REPORTING SYLLABUS

This book has been specially written and designed to help students preparing for their CPA(U) FINANCIAL REPORTING Paper 8 professional examinations and those undertaking a BUSINESS STUDIES and BSC ACCOUNTING AND FINANCE course at the University. It is also useful for lecturers preparing students for those examinations.

This book covers a variety of contents, exercises, model questions, test papers, mixed exercises and answers to equip and prepare students for their examinations.

This book contains

- ✓ Progressive notes targeted to the entire Financial Reporting Syllabus and study Guide.
- ✓ Review exercises and Questions to check your understanding
- ✓ Clear layout and style designed to save your time
- ✓ Plenty of examination Questions from a variety of past papers.

We are grateful to all the examination councils for their permission to reproduce past examination questions.
The suggested solutions to the Illustrative questions have been prepared by the whole entire author Team.

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The Conceptual and Reporting Framework

1.0

THE CONCEPTUAL FRAMEWORK

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- General Introduction.
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- Generally Accepted Accounting Practice.
- The IASB's Conceptual framework.
- Users and Information needs.

1 The Conceptual framework and GAAP

There are advantages and disadvantages to having a conceptual frame work.

1.1 The search for a conceptual framework.

A ***Conceptual framework***, in the field we are concerned with, is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

These theoretical principles provide the basis of development of new accounting standards and the evaluation of those already in existence. The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore a conceptual framework will form **the theoretic basis** for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The **danger of not having a conceptual framework** is demonstrated in the way some countries' standards have developed over the recent years; standards tend to be produced in a haphazard and fire-fighting approach. Where an agreed framework exists, the standard-setting body acts as an architect or designer, rather than a fire-fighter, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principals are tackled more than once in different standards, thereby producing **contradictions and inconsistencies** in basic concepts, such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

In the USA, they have adopted a different approach when publishing accounting standards, preferring instead to adopt rules based approach. The large number of **highly detailed standards** produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. This would be avoided if a cohesive set of principles were in place. The IASB conceptual framework seeks to give guiding principles and illustrative examples to enable standard setters to set a more consistent set of standards.

A conceptual framework can also bolster standard setters **against political pressure** from various ‘lobby groups’ and interested parties. Such pressure would only prevail if it was acceptable under the conceptual framework.

1.2 Advantages and disadvantages of a conceptual framework.

Advantages

a. The situation is avoided whereby standards are developed on a patchwork basis, where a particular accounting problem is recognised as having emerged, and resources were then channeled into **standardizing accounting practice** in that area, without regard to whether that particular issue was acceptable under the conceptual framework.

b. As stated above, the development of certain standards (particularly national standards) has been subject to considerable **political interference** from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be **less open to criticism** that the standard-setter buckled to external pressure.

c. Without conceptual framework, some standards may concentrate on profit or loss whereas some may concentrate on the **valuation of net assets** (statement of financial position).

Disadvantages

a. Financial statements are intended for a **variety of users**, and it is not certain that a single conceptual framework can be devised which will suit the users.

b. Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a **different purpose** (and with different concepts as a basis).

c. It is not clear that a conceptual framework makes the task of **preparing and then implementing** standards any easier than without a framework.

Before we look at the IASB’s attempt to produce a conceptual framework, we need to consider another term of importance to this debate: generally accepted accounting practice, or GAAP.

1.3 Generally Accepted Accounting Practice (GAAP)

GAAP refers to the combination of sources which govern accounting.

In individual countries this is seen primarily as a **combination** of:

- National company law
- National accounting standards
- Local stock exchange requirements

Although those sources are the basis for the GAAP of individual countries, the concept also includes the effects of **non-mandatory sources** such as:

- International accounting standards
- Statutory requirements in other countries

In many countries, like the UK, GAAP does not have any statutory or regulatory authority or definition, unlike other countries, such as the US. The term is mentioned rarely in legislation, and only then in fairly limited terms.

A ***conceptual framework*** for financial reporting can be defined as an attempt to codify existing GAAP in order to reappraise current accounting standards and to produce new standards.

2 The IASB's *Conceptual Framework*

The 2010 *conceptual framework for Financial Reporting* (IASB), following nearly three years of discussions, was revised in 2018.

The aim of the *conceptual framework* is to clarify and offer further guidance on areas of the greatest subjectivity in accounting. In particular, the 2018 revision include the following.

- Revisions to the **definition elements** in the financial statements
- Guidance on **recognition and derecognition**
- Guidance on **measurement basis**
- Principles for **disclosure and presentation** in the financial statements

2.1 Introduction

The introduction of the *conceptual frame work* explains the objectives, usefulness and limitations of general purpose financial statements.

The **objective of general purpose financial reporting** is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.

The types of economic decisions for which financial statements are likely to be used include the following.

- Buying, selling or holding equity and debt instruments;
- Providing or setting loans and other forms of credit; or
- Exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources .

In particular, the conceptual framework draws attention to users' ability to review the **stewardship** of the entity by management in utilizing its economic resources. In order for users of the financial statements to access the stewardship, they need to be able to review the financial performance of the entity (effectively, the income and expenses) as well as other transactions (such as issuing debt, the capital maintenance and equity of the entity).

The concept of stewardship was reintroduced to the *Conceptual Framework* in 2018 as it stresses the requirement of reviewing the performance and management of the entity as a key objective of financial reporting.

2.2 Status

The conceptual framework is not a standard. Nothing in the *Conceptual Framework* overrides any Standard or any requirement in a Standard.

2.2.1 Scope

The *Conceptual Framework* deals with:

Chapter 1	The **objective** of general purpose financial reporting
Chapter 2	**Qualitative characteristics** of useful financial information
Chapter 3	Financial statements and reporting entity
Chapter 4	The **elements** of financial statements
Chapter 5	**Recognition** and **derecognition**
Chapter 6	**Measurement**
Chapter 7	**Presentation and disclosure**
Chapter 8	Concepts of **capital and capital maintenance**

2.2.2 Users and their information needs

Users of accounting information consist of existing and potential investors, lenders and other creditors. You should be able to remember enough from your previous studies to do the following exercise.

Question

Consider the information needs of the above users of financial information listed above.

Answer

(a) **Investors** are the providers of risk capital.

i. Information is required to help make a decision about buying or selling shares, taking up rights issue and voting.
ii. Investors must have information about the level of dividend, past, present and future and any changes in share price.
iii. Investors will also need to know whether the management has been running the company efficiently.
iv. As well as the position indicated by the statement of profit or loss and other comprehensive income, statement of financial position and earnings per share (EPS), investors will want to know about the liquidity position of the company, the company's future prospects and how the company's shares compare with those of its competitors.

(b) **Lenders** need information to help them decide whether to lend to a company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate times and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.

3 The objective of general purpose financial reporting

The *Conceptual Framework* states that:

The purpose of the *Conceptual Frame* work is to:

a. Assist the international Accounting Standards Board (Board) to develop IFRS standards (Standards), which are based on consistent concepts.
b. Assist prepares to develop consistent accounting policies when no standard applies to a particular transaction or other event, or when a standard allows a choice of accounting policy.
c. Assist all parties to understand and interpret Standards.

Essentially, the main aim of the *Conceptual Framework* is to assist the developers of the Standards, preparers and users of the financial statements

Users need information about:

- The **economic resources of the entity**
- The **claims against the entity**
- Changes in the entity's **economic resource and claims**

Information about the entity's **economic resources and the claims against it** helps users to access the entity's liquidity and solvency and its likely needs for additional financing.

Information about a reporting entity's financial performance (the **changes in its economic resources and claims**) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiency and effectively management has used the resources of the entity and is helpful in predicting future returns.

The *Conceptual Framework* makes it clear that this information should be prepared using accrual accounting.

Accrual accounting. The effects of transactions and other events and circumstances on a reporting entity's economic resources and claims are recognised in the periods in which they occur, even if the resulting cash receipts and payments occur in a different period.

Financial statements prepared using accrual accounting (the accruals basis) show users past transactions involving cash and also obligations to pay cash in the future and resources which represent cash to be received in the future.

Information about a reporting entity's cash flows during a period also helps users assess the entity's ability to generate future net cash inflows and gives users a better understanding of its operations.

4. Qualitative characteristics of useful financial information

The *Conceptual Framework* states that qualitative characteristics are attributes that make financial information most useful to users.

Chapter 2 of the *Conceptual Framework* distinguishes between **fundamental** and **enhancing** qualitative characteristics, for analysis purposes. Fundamental qualitative characteristics distinguish useful financial reporting information from information that is not useful or misleading. Enhancing qualitative characteristics distinguish more useful information from less useful information.

The two fundamental qualitative characteristics are **relevance** and **faithful representation**.

4.1 Fundamental qualitative characteristics

4.1.1 Relevance

Relevance. Relevant information is capable of making a difference in the decisions made by users.
Financial information is capable of making a difference in decisions if it has **predictive value**, **confirmatory value** or both.

The relevance of information is affected by its **nature** or its **materiality**.

Materiality. Information is material if omitting it or misstating it could influence decisions that the primary users of general purpose financial statements make on the basis of those reports, which provide information about a specific reporting entity.

4.1.2 Faithful representation

Faithful representation. Financial reports represent **economic phenomena** in words and numbers. To be useful, financial information must not only represent relevant phenomena but must **faithfully represent** the **substance** of the phenomena that it purports to represent.

To be a faithful representation, information must be **complete, neutral** and **free from error**. It is unlikely to be possible to be perfectly complete, neutral, free from error but the aim should be to maximize these qualities, and this is anticipated by the Conceptual Framework which states 'perfection is seldom, if ever, achievable. The Boards' objective is to maximize these qualities to the extent possible.

A **complete** depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A **neutral** depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.
Neutrality is supported by the exercise of prudence.

Prudence is the exercise of caution when making judgements under conditions of uncertainty.

The term prudence was removed from the 2010 Conceptual Framework as it was deemed to be **implied** within the depiction of neutrality, and that the term was being interpreted in different ways. However, it was felt that the exercise of prudence, along with understanding the substance of the transitions, rather than the pure legality of them, was required to be explicitly stated in the 2018 revisions to the *Conceptual Framework.*

Furthermore, the *Conceptual Framework* 2018 revision included a clear definition of the term in order to clarify any potential areas of confusion.

Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

In order for management and the preparers of the financial statements to support their estimations, adequate disclosure and information should be presented. The **basis of estimation** should be clearly stated, and even if there are limitations in the calculation and process, provided it is explained and reasons justified, then the financial statements will still adhere to the characteristic of faithful representation.

4.2 Enhancing qualitative characteristics

4.2.1 Comparability

Comparability. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items.

Therefore, it requires more than one item to be subject to this characteristic, for example, two periods of financial results or comparing companies within the same industry. In order to be able to do this in a meaningful manner, the bases of the preparation of the financial statements should have some degree of consistency.

Consistency although related to comparability, **is not the same.** It refers to the use of the same methods for the same items (i.e. consistency of treatment) either from period within a reporting entity or in a single period across entities.

The disclosure of accounting policies is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

When an entity **changes an accounting policy**, the change is applied retrospectively so that the results from one period to the next can still be usefully compared.

Comparability **is not the same as uniformity**. Entities should change accounting policies if previously used accounting policies become inappropriate or superseded by new accounting standards.

Corresponding information for preceding should be shown to enable comparison over time.

4.2.2 Verifiability

Verifiability. Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

Information can be verified to a model or formula, or by directly observation, such as undertaking an inventory count. Independent verification, such as by a third party, a bank letter, solicitor's information, title deeds or valuation by a specialist (a Royal Institution of Chartered Surveyors member for a building for example) is also helpful. Where any areas of contention or estimates are employed, then the financial statements should state or outline the bases used by management in order for them to rely upon the information.

4.2.3 Timeliness

Timeliness. Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older information is the less useful it is.

Information may become less useful if there is a delay in reporting it. There is a **balance between timeliness and the provision of reliable information.**

If information is reported on a timely basis when not all aspects of the transactions are known, it may not be complete or free from error.

Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

4.2.4 Understandability

Understandability. Classifying, characterizing and presenting information clearly and concisely makes it understandable.

Financial reports are prepared for users who have a **reasonable knowledge of business and economic activities** and who review and analyse the information diligently. Some phenomena are inherently complex, such as financial instruments and cannot be made easy to understand. Excluding information on these might make the information easier to understand, but without it the reports would be incomplete and therefore misleading. Complex matters should not be left out of financial statements as even well-informed and diligent users may sometimes need the aid of an advisor to understand information about complex issues.

The cost constraint on useful financial reporting

This is a pervasive constraint, not a qualitative characteristic. When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a subjective area and there are other difficulties: others, not the intended users, may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but prepares and users should be aware of the constraint.

5 Financial statements and the reporting entity

Going concern is the underlying assumption in preparing financial statements.

5.1 Going concern

Going concern. Financial statements are normally prepared on the assumption that the reporting entity is a going concern, and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the necessity of liquidation not the need to cease trading.

It is assumed that the entity has no intension to liquidate or curtail major operations. If it did, then the financial statements would be prepared on a **different (disclosed) basis** for example, the 'break up' basis.

6 The Elements of Financial Statements

Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements.

These broad classes are the elements of financial statements.

The <u>conceptual framework</u> lays out these elements as shown in the illustration below;

Elements of financial statements

Measurement of financial position
Statement of financial position

- Assets
- Liabilities
- Equity

Measurement of performance in
Statement of profit or loss and other comprehensive income

- Income
- Expenses

- A process of sub-classification then takes place for presentation in the financial statements, e.g. assets are classified by their nature or function in the business to show information in the best way for users to take economic decisions.

- The chart of accounts of an entity would clearly show the various sub-classes for each element.

6.1 Financial Position

We need to define the three terms listed under this heading above.

- **Asset.** A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.
- **Liability**. A present obligation of the entity to transfer an economic resource as a result of past events.
- **Equity**. The residual interest in the assets of the entity after deducting all its liabilities

Whether an item satisfies any of the definitions above will depend on the **substance and economic reality** of the transaction, not merely its legal form.

6.2 Assets

We can look in more detail at the components of the definitions given above.

Potential to produce economic benefits. An economic resource is a right that has the potential to produce economic benefits.

Assets are usually employed to produce goods or services for customers; customers will then pay for these. Cash itself renders a service to the entity due to its command over other resources.

The economic benefits can come in various forms including;

- Cash flows, such as returns on investment resources
- Exchange of goods, such as by trading, selling goods, provision of services
- Reduction or avoidance of liabilities, such as paying loans

6.3 Liabilities

Again we can look more closely at some aspects of the definition of a liability as per the conceptual framework.

For a liability to exist, three criteria must be satisfied:

a) The entity has an obligation
b) The obligation is to transfer economic resource
c) The obligation is a present obligation that exists as a result of past events

An essential characteristic of a liability is that the entity has an **obligation.**

Obligation. A duty or responsibility that the entity has **no practical ability to avoid**

A present obligation **exists as a result of past event**s if the entity has already obtained economic benefits or taken an action, **and** as a consequence, the entity will or may have to transfer an economic resource that would not otherwise have had to transfer.

It is important to distinguish between a present obligation and **future commitment**. A management decision to purchaser assets in future does not, in itself, give rise to a present obligation.

Question

Consider the following situations. In each case, do we have an asset or liability within the definitions given by the *Conceptual Framework*? Give reasons for your answer.

a) Pat Co has purchased a patent for $20,000. The patent gives the company sole use of a particular manufacturing process which will save $3,000 a year for the next five years.
b) Baldwin Co paid Don Brennan $10,000 to set up a car repair shop, on condition priority treatment is given to cars from the company's fleet.
c) Deals on wheels Co provides a warranty with every car sold.

Answer

a) This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).

b) This cannot be classified as an asset. Baldwin Co has no control of the repair shop and it is difficult to argue that there are 'future economic benefits".

c) The warranty provided constitutes a liability; the business has taken on an obligation. it will be recognised when the warranty is issued rather than when a claim is made.

6.4 Equity

Equity is defined above as a **residual,** but it may be sub-classified in the statement of financial position. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, e.g. for the future protection of creditors. The amount shown for equity depends on the **measurement of assets and liabilities**. It has nothing to do with the market value of the entity's shares.

6.5 Performance

Profit is used as a **measure of performance,** or as a basis for other measures (e.g. earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

The elements of income and expense are therefore defined.

- **Income.** Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
- **Expenses.** Decreases in assets, or increases in liabilities, that result in decreases in equity other than those relating to distributions to holders of equity claims.

Income and expenses can be **presented in different ways** in the statement of profit or loss and other comprehensive income, to provide information relevant for economic decision-making. For example, income and expenses which relate to continuing operations are distinguished from the results of discontinued operations.

6.6 Income

Revenue arises in the course of ordinary activities of entity.

'Increases in assets' include those arising on disposal of non-current assets. The definition of income also includes unrealized gains, e.g. on revaluation of marketable securities.

6.7 Expenses

As with income, expenses include losses as well as those expenses that arise in the course of ordinary activities of an entity.

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealized losses**, e.g. the fall of value of an investment.

6.8 Section summary

Make sure you learn the important definitions

- Financial position:
  - Assets
  - Liabilities
  - Equity
- Financial performance
  - Income
  - Expenses

7 RECOGNITION AND DERECOGNITION

Recognition is the process of capturing for inclusion in the statement of financial position or statement(s) of profit or loss and other comprehensive income an item that meets the definition of one of the elements of financial statements-an asset, a liability, equity, income or expenses.

An asset or liability should be recognized if it will be both relevant and provide users of the financial statements with a faithful representation of the transactions of that entity. The conceptual framework takes, therefore, these fundamental qualitative characteristics along with the definitions of the elements of the financial statements as the key components of recognition.

Previously, recognition of elements would have been affected by the probability of whether the event was going to happen and the reliability of the measurement. The IASB has revised this as they believed this set too rigid a criteria as entities may not disclose relevant information which would be necessary for the user of the financial statements because of the difficulty of estimating both likelihood and the amount of the element.

Even if an item is not recognized, then the preparers of the financial statements should consider whether, in order to meet the faithful representation requirement, there should be a description in the notes to the financial statements.

Derecognition is the removal of all or part of a recognized asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or liability.

The conceptual network considers derecognition tobe a factor when the following occurs;

a. Loss of control or part of the recognized asset; or
b. The entity no longer has an obligation for a liability.

8 MEASUREMENT

A number of different measurement bases are used in financial statements. They include;

- Historical Cost
- Value in use
- Fair value
- Current cost

In the *Conceptual Framework,* the guidelines surrounding the measurement of elements is clarified and given more substance.

Measurement. Elements recognised the financial statements are qualified in monetary terms. This requires the selection of a measurement basis.

This involves the selection of a particular **basis of measurement**. A number of these are used to different degrees and in varying combinations in financial statements. They include the following;

Historical cost. The price paid for an asset or for the event which gave rise to the liability. The price will not change.

Current value. The price paid for an asset or the liability value will be updated to reflect any changes since it was acquired or incurred. There are three main bases recognised by the *Conceptual Framework* that make up current value.

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

Value in use. Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and its ultimate disposal.

Current cost. Current cost, like historical cost, is an entry value: it reflects prices in the market in which the entity would acquire assets or incur the liability. Essentially the replacement cost of an asset or liability.

8.1 Historical Cost

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, e.g. inventory is carried at the lower of cost and net realizable value.

Recent standards use the concept of **fair value**, which is defined by IFRS 13 as ‘ the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

8.2 Current Value Accounting

Current value accounting reflects the valuation of the assets or liabilities based on conditions and information available at the measurement date. The 2018 revisions of the Conceptual Framework discuss the bases of measurement , and the factors to be considered when choosing the appropriate measurement method.

8.2.1 Current value

This is calculated by taking the costs to buy an equivalent asset plus any acquisition costs. It differs from the historical cost, as current cost assesses the price to purchase assets at the date of measurement.

8.2.2 Fair value

The definition of fair value stated in IFRS 13 is ‘the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The specifics of fair value in relation to tangible non-current assets, business combinations, biological assets and non-current assets held for sale and discontinued operations have been covered in earlier chapters.

Fair value is most commonly calculated by taking the open market value. Where there is no active market for the asset or liability, then the following should be used as a basis.

- Estimates of future cash flows
- Time value of money (discounting the future cash flows)

In each case, it will be taking into consideration the uncertainty of the market.

Fair value looks at the potential future value of the asset or liability

8.2.3 Value in use

This is calculated by taking the present value of the cash flows or other benefits that the entity will receive during the lifetime of the asset or liability, and deducting any disposal costs. The value of the asset or liability considers the future cash flows (therefore, it does not include the costs of acquiring the item in the first place).

At first glance this seems similar to the fair value basis, however, value in use considers entity specific factors affecting it, and fair value basis looks at the market perspective.

Value in use looks at the likely future value of the entity using the asset or liability.

Full analyzing and detail of the different measurement bases are covered in detail in Chapter 22.

9 Presentation and disclosure

Chapter 7 of the Conceptual Framework covers the high level principles behind the need for a consensus on presentation and disclosure, not just between periods for the entity, but also across different entities.

9.1 Principles of presentation and disclosure

Rather than relying on prescriptive rules regarding presentation and disclosure, the main principles are established which include:

- Classification of assets and liabilities of a similar nature together (whilst keeping dissimilar ones separated), according to their nature, function or method of measurement. This is also avoid the issue of 'offsetting' whereby items of a dissimilar nature are grouped together, for example an asset and liability offset to provide a much smaller number in the financial statements.
- Avoiding unnecessary detail which can obscure the important facts.
- Equally, avoiding a standardized approach (often referred to as 'boilerplate') but instead giving the entity an opportunity to provide details relevant to the organisation and its business.
- Specific details regarding the classification of assets, liabilities, equity, income and expenses.

9.2 Interaction with IAS 1

Financial statements should **present fairly** the financial position, financial performance and cash flows of an entity. **Compliance with IFRS** is presumed to result in financial statements that achieve a fair presentation.

IAS 1 stipulates that financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, equity, income and expenses set out in the *Conceptual framework.*

The following points made by IAS 1 expand on this principle.

a. **Compliance with IFRS** should be disclosed

b. **All relevant IFRS** must be followed if compliance with IFRS is disclosed

c. Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material

IAS states what is required for a fair representation.

a. Selection and application of **accounting policies**

b. **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information

c. **Additional disclosures** where required

10 Concepts of capital and capital maintenance

The concepts of capital and capital maintenance have remained unchanged from the earlier iterations of the *Conceptual Framework.*

There are two concepts of capital under the *Framework*.

- Financial concept of capital
- Physical concept of capital

The Framework states that 'the selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements'.

Quick Quiz

1. Define a 'conceptual framework'.
2. What are the advantages and disadvantages of developing a conceptual framework?
3. The needs of which category of user are paramount when preparing financial statements?
4. Define 'relevance'.
5. In which two ways should users be able to compare an entity's financial statements?
6. Define 'recognition

Answers to Quick Quiz

1. This is a statement of generally accepted theoretical principle, which form the frame of reference for financial reporting.
2. Advantages
    - Standardized accounting practice
    - Less open to criticism

- Concentrate on statement of profit or loss and other comprehensive income or statement of financial position, as appropriate

Disadvantages

- Variety of users, so not all will be satisfied
- Variety of standards for different purposes
- Preparing and implementing standards not necessarily any easier

3. Needs of investors
4. Information has relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming (or correcting) their past evaluations.
5. In these ways;
   - Through time to identify trends
   - With other entities' statements
6. Recognition is the process of capturing for inclusion in the statement of financial position or statement(s) of profit or loss and other comprehensive income an asset, liability, equity, income or expenses.

2.0
THE REGULATORY FRAMEWORK

UNIT 2 OVERVIEW:

- General Introduction.
- Principles-based and rules-based systems.
- The International Accounting Standards Board (IASB).
- Other International Influences.
- GAAPS and Current Accounting Standards.

2.1 INTRODUCTION

The regulatory framework is the most important element in ensuring relevant and faithfully presented financial information and thus meeting the needs of shareholders and other users.

Without a single body overall responsible for producing financial reporting standards (the IASB) and a framework of general principles within which they can be produced (the Conceptual Framework), there would be no means of enforcing compliance with GAAP. Also, GAAP would be unable to evolve in any structured way in response to changes in economic conditions.

2.2 PRINCIPLES-BASED VERSUS RULES-BASED SYSTEMS

The conceptual framework provides the background of principles within which standards can be developed. This system is intended to ensure that standards are not produced which are in conflict with each other and also that any departure from a standard can be judged on the basis of whether or not it is in keeping with the principles set out in the conceptual framework. This is a principles-based system.

In the absence of a reporting framework, a more rules-based approach has to be adopted. This leads to a large mass of regulation designed to cover every eventuality, as in the US. As we have seen over the past few years, a large volume of regulatory measures does not always detect or prevent financial irregularity. One presumed advantage of rules-based systems is that the exercise of judgment is minimized. Auditors who fear litigation tend to prefer rules-based systems. It could be that a rules-based approach is appropriate for controversial areas in accounting.

2.3 THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

2.3.1 Introduction

The international Accounting Standards Board is an independent, privately-funded accounting standard setter based in London.

In March 2001 the IASC foundation was formed as a not-for-profit corporation incorporated in the USA. The IASC Foundation is the parent entity of the IASB. In July 2010 it changed its name to the IFRS Foundation.

From April 2001 the IASM assumed accounting standard setting responsibilities from its predecessor body, the International Accounting Standards Committee (IASC). This restructuring was based upon the recommendations made in the recommendations on Shaping IASC for the Future.

2.3.2 How the IASB is made up

The 15 members of the IASB come from nine countries and have a variety of backgrounds with a mix of auditors, preparers of financial statements, users of financial statements and an academic. The Board consists of 12 full-time members and two part-time members.

2.3.3 Objectives of the IASB

The formal objectives of the IASB, formulated in its mission statement are:

(a) To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in general purpose financial statements.
(b) To promote the use and vigorous application of those standards.
(c) To work actively with national accounting standard setters to bring about convergence of national accounting standards and IFRS to high quality solutions.

2.3.4 Structure of the IASB

The structure of the IASB has the following main features.

(a) The IFRS Foundation is an independent corporation having two main bodies – the Trustees and the IASB. The IFRS foundation holds the copyright of IFRS and all other IASB publications.
(b) The IFRS Foundation trustees appoint the IASB members, exercise oversight and raise the funds needed.
(c) The IASB has sole responsibility for setting accounting standards
(d) There are also two further bodies, the IFRS Advisory Council and the IFRS Interpretations Committee.

Roles and responsibilities

Trustees. The Trustees comprise a group of twenty two individuals, with diverse geographic and functional backgrounds. The trustees appoint the members of the board, the IFRS Interpretations committee and the IFRS Advisory Council. In addition to monitoring the Foundation's effectiveness and raising its funds, the Trustees will approve the budget and have responsibility for constitutional changes. Trustees were appointed so that initially there were six from North America, six from Europe, four from Asia pacific, and three others from any area, as long as geographic balance is maintained. Trustees were selected as follows:

(a) The International Federation of Accountants (IFAC) suggested candidates to fill five of the nineteen trustee seats and international organisations of preparers, users and academics each suggested on candidate.
(b) The remaining trustees are 'at-large' in that they were not selected through the constituency nomination process.

IFRS Advisory Council. The IFRS Advisory Council provides a formal vehicle for further groups and individuals with diverse geographic and functional backgrounds to give advice to the Board and, at times, to advise the Trustees. It comprises about fifty members and meets at least three times a year. It is consulted by the IASB on all major projects and its meetings are open to the public. It advises the IASB on prioritization of its work and on the implications of proposed standards for users and preparers of financial statements.

IFRS Interpretations Committee. The IFRS Interpretations Committee provides timely guidance on the application and interpretation of International Financial Reporting Standards. It deals with newly identified financial reporting issues not specifically addressed in IFRSs, or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.

2.4 OTHER INTERNATIONAL INFLUENCES

There are a few other international bodies worth mentoring. You are not required to follow their workings in detail, but knowledge of them will aid your studies and should help your general reading around the subject area.

2.4.1 IASB and the EC/intergovernmental bodies

The European Commission has acknowledged the role of the IASB in harmonizing world-wide accounting rules and EC representatives attend IASB Board meetings and have joined committees involved in setting IFRSs. This should bring to an end the idea of a separate layer of European reporting rules.

The EC has also set up a committee to investigate where there are conflicts between EU norms and international standards so that compatibility can be achieved. In turn, the IASB has used EC directives in its work.

All listed entities in member states have been required to use IFRSs in their consolidated financial statements since 2005.

The IASB also works closely with the United Nations Working Groups of Experts on International Standards of Accounting and reporting (UN IASR group), and with the working group in Accounting standards of the organisation for economic co-operation and Development (OECD working group). These bodies support harmonization and improvement of financial reporting, but they are not standard-setting bodies and much of their output draws on the work of the IASB (e.g. using the IASB's framework document).

2.4.2 United Nations (UN)

The UN has a commission and centre on transnational reporting corporations through which it gathers information concerning the activities and reporting of multinational companies. The UN processes are highly political and probably reflect the attitudes of the governments of developing countries to multinationals. For example, there is an inter-governmental working group of 'experts' on international standards of accounting and reporting which is dominated by the developing countries.

2.4.3 International Federation of Accountants (IFAC)

The IFAC is a private sector body estimated in 1977 and which now consists of over 100 professional accounting bodies from around 80 different countries. The IFAC's main objective is to co-ordinate the accounting profession on a global scale by issuing and establishing international standards on auditing, management accounting, ethics, education and training. You are already familiar with the international standards on auditing produced by the IAASB, an IFAC body. The IFAC has separate committees working on these topics and also organizes the world congress of accountants, which is held every five years. The IASB is affiliated with IFAC.

2.4.4 Organisation for Economic Co-operation and Development (OECD)

The OECD was established in 1960 by the governments of 21 counties to 'achieve the highest sustainable economic growth and employment and a rising standard of living in member countries while maintaining financial stability and, thus, to contribute to the world economy'. The OECD supports the work of the IASB but also undertakes its own research into accounting standards via ad hoc working groups. For example, in 1972 the OECD issued guidelines for multinational companies on financial reporting and non-financial disclosures. The OECD appears to work on behalf of developed countries to protect them from the extreme proposals of the UN.

2.4.5 International Organisation of Securities Commissions (IOSCO)

IOSCO represents the world's securities markets regulators and has worked closely with the IASB on the development of standards. In 2000 it recommended to all its members that they allow multinational users to submit financial statements based on IFRS.

2.5 GENERALLY ACCEPTED ACCOUNTING PRACTICE (GAAP)

We also need to consider some important terms which you will meet in your financial accounting studies. GAAP, as a term, has sprung up in recent years and signifies all the rules , from whatever source, which govern accounting. The rules may derive from:

(a) Local (national) company legislation
(b) National and international accounting standards
(c) Statutory requirements in other countries (particularly the US)
(d) Stock exchange requirements
A complete regulatory framework encompasses all of these, where they exist.

2.6 TRUE AND FAIR VIEW (OR PRESENTED FAIRLY)

It is a requirement of national legislation (in some countries) that the financial statements should give a true and fair view of (or present fairly, in all material respects) the financial position of the entity as at the end of the financial year.

The terms 'true and fair view' and 'present fairly' in all material respects are not defined in accounting or auditing standards. Despite this, a company's managers may depart from any of the provisions of accounting standards if these are inconsistent with the requirement to give a true and fair view. This is commonly referred to as the 'true and fair override'. It has been treated as an important loophole in the law in different countries and has been the cause of much argument and dissatisfaction within the accounting profession.

2.7 IFRS-ADVANTAGES AND DISADVANTAGES

The advantages and disadvantages of adopting IFRS have to be considered by each adopting country and are being widely debated in the US at the moment.

The main advantages are seen to be:

- A business can present its financial statements on the same basis as its foreign competitors, making comparison easier.
- Cross-border listing will be facilitated, making it easier to raise capital abroad.
- Companies with foreign subsidiaries will have a common, company-wide accounting language.
- Foreign companies which are targets for takeovers or mergers can be more easily appraised.

The disadvantages are perceived to be:
- The cost of implementing IFRS
- The lower level of detail in IFRS

Countries which have national standards which are very prescriptive are worried about the principles-based standards in IFRS which require the application of judgment. This particularly so in the US. US accountants are subject to a high degree of litigation and their defence in court is usually that they complied with the relevant sub-section of one of the hundreds of detailed standards which make up US GAAP. They fear that adoption of IFRS will remove this defence.

Activity 3.1

In accounting terms what do you think are:

(a) The advantages to international harmonization?
(b) The barriers to international harmonization?

Answer

(a) Advantages of global harmonization

The advantages of harmonisation will be based on the benefits to users and preparers of accounts, as follows.

(i) Investors, both individual and corporate, would like to be able to compare the financial results of different companies internationally as well as nationally in making investment decisions.

(ii) Multinational companies would benefit from harmonisation for many reasons including the following;

(1) Better access would be gained to foreign investor funds
(2) Management control would be improved, because harmonisation would aid internal communication of financial information.
(3) Appraisal of foreign entities for take-overs and mergers would be more straightforward.
(4) It would be easier to comply with the reporting requirements of overseas stock exchanges.
(5) Preparation of group accounts would be easier.
(6) A reduction in audit costs might be achieved
(7) Transfer of accounting staff across national border would be easier.

(iii) Governments of developing countries would save time and money if they could adopt international standards and, if these were used internally, governments of developing countries could attempt to control the activities of foreign multinational companies in their own country., These companies could not 'hide' behind foreign accounting practices which are difficult to understand.

(iv) Tax authorities. It will be easier to calculate the tax liability of investors, including multinationals who receive income from overseas sources.

(v) Regional economic groups usually promote trade within a specific geographical region. This would be aided by common accounting practices within the region.

(vi) Large international accounting forms would benefit as accounting and auditing would be much easier if similar accounting practices existed throughout the world.

(b) Barriers to harmonisation

i. Different purposes of financial reporting. In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.
ii. Different legal systems. These prevent the development of certain accounting practices and restrict the options available.
iii. Different user groups. Countries have different ideas about who the relevant user groups are and their respective importance. In the USA investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.
iv. Needs of developing countries. Developing are obviously behind in the standard setting process and they need to develop the basic standards and principles already in place in most developed countries.

v. Nationalism is demonstrated in an unwillingness to accept another country's standard.
vi. Cultural differences result in objectives for accounting systems differing from country to country.
vii. Unique circumstances. Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example hyperinflation, civil war, currency restriction and so on.
viii. The lack of strong accountancy bodies. Many countries do not have strong independent accountancy or business bodies which would press for better standards and greater harmonisation.

2.8 THE IASB AND CURRENT ACCOUNTING STANDARDS

The IASB's predecessor body, the IASC, had issued 41 International Accounting Standards (IASs) and on 1 April 2001 the IASB adopted all of these standards and now issues its own International Financial Reporting Standards (IFRSs). So far thirteen new IFRSs have been issued.

2.9 THE IASB and FASB

The IASB is currently involved in a joint project with the FASB (Financial Accounting Standards Board) to develop a common conceptual framework. This would provide a sound foundation for developing future accounting standards. The aim is that future standards should be principles-based and internationally-converged. This represents a movement away from the rules-based approach which has characterized US accounting standards.

The new framework will build upon the existing IASB and FASB frameworks and take into account subsequent developments.

2.10 EUROPEAN COMMISSION AND IFRSs

All listed entities in member states have been required to use IFRS in their consolidated financial statements since 2005.

To this end the IASB undertook improvements projects, dealing with revisions to IFRS, for example in the area of materiality, presentation, leases, related parties and earnings per share. This has been matched in, for example, the UK by a convergence project, bringing UK GAAP into line with IFRS where these are better.

2.11 SETTING OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

2.11.1 Due process

The overall agenda of the IASB will initially be set by discussion with the IFRS Advisory Council. The process for developing an individual standard would involve the following steps.

Step 1. During the early stages of a project, the IASB may establish an Advisory committee to give advice on issues arising in the project. Consultation with the Advisory Committee and the IFRS Advisory Council occurs throughout the project.

Step 2. IASB may develop and publish discussion papers for public comment.

Step 3. Following the receipt and review of comments, the IASB would develop and publish an exposure draft for public comment.

Step 4. Following the receipt and review of comments, the IASB would issue a final international Financial Reporting Standard.

The period of exposure for public comment is normally 90 days. However, in exceptional circumstances, proposals may be issued with a comment period of 60 days. Draft IFRS Interpretations are exposed for a 60 day comment period.

2.11.2 Co-ordination with national standard setters

Close co-ordination between IASB due process and due process of national standard setters is important to the success of the IASB's mandate.

The IASB is exploring ways in which to integrate its due process more closely with national due process. Such integration may grow as the relationship between the IASB and national standard setters evolves. In particular, the IASB is exploring the following procedure for projects that have international implications.

(a) IASB and national standard setters would co-ordinate their work plans so that when the IASB starts a project, national standard setters would also add it to their own work plans so that they can play a full part in developing international consensus. Similarly, where national standard setters start projects, the IASB would consider whether it needs to develop a new standard or review its existing standards. Over a reasonable period, the IASB and national standard setters should aim to review all standards where significant differences currently exist, giving priority to the areas where the differences are greatest.

(b) National standards setters would not be required to vote for the IASB's preferred solution in their national standards, since each country remains free to adopt IASB standards with amendments or to adopt other standards. However, the existence of an international consensus is clearly one factor that members of national standard setters would consider when they decide how to vote on national standards.

(c) The IASB would continue to publish its own Exposure Drafts and other documents for public comment.

(d) National standard setters would publish their own exposure document at approximately the same time as IASB Exposure Drafts and would seek specific comments on any significant divergences between the two exposure documents. In some instances, national standard setters may include in their exposure documents specific comments on issues of particular relevance to their country or include more detailed guidance than is included in the corresponding IASB document.

(e) National standard setters would follow their own full due process, which they would ideally choose to integrate with the IASB's due process. This integration would avoid unnecessary delays in completing standards and would also minimize the likelihood of unnecessary differences between the standards that result.

2.11.3 IASB liaison members

Seven of the full-time members of the IASB have formal liaison responsibilities with national standard setters in order to promote the convergence of national accounting standards and International Financial Reporting Standards. The IASB envisages a partnership between the IASB and these national standard setters as they work together to achieve convergence of accounting standards world-wide.

In addition all IASB members have contact responsibility with national standards setters not having liaison members and many countries are also represented on the IFRS Advisory Council.

2.12 CURRENT IFRSs/IASs

The current list is as follows.

International Accounting Standards		Date of issue/ revision
IAS 1 (Revised)	Presentation of financial statements	Sep 2007
IAS 2	Inventories	Dec 2003
IAS 7	Statements of cash flows	Dec 1992
IAS 8	Accounting policies, changes in accounting estimates and errors	Dec 2003
IAS 10	Events after the reporting period	Dec 2003
IAS 12	Income taxes	Nov 1993
IAS 16	Property, plant and equipment	Dec 2003
IAS 19	Employee benefits	Dec 2004
IAS 20	Accounting for government grants and disclosure of government assistance	Jan 1995
IAS 21*	The effects of changes in foreign exchange rates	Dec 2003
IAS 23 (revised)	Borrowing costs	Jan 2008
IAS 24*	Related party disclosures	Dec 2003
IAS 26	Accounting and reporting by retirement benefit plans	Jan 1995
IAS 27 (revised) *	Separate financial statements	May 2011
IAS 28*	Investments in associates	Dec 2003
IAS 29	Financial reporting in hyperinflationary economies	Jan 1995
IAS 30*	Disclosure in the financial statements of banks and similar financial institutions.	Jan 1995
IAS 32*	Financial instruments: presentation	Dec 2003
IAS 33	Earnings per share	Dec 2003
IAS 34	Interim financial reporting	Feb 1998
IAS 36	Impairment of assets	Mar 2004
IAS 37	Provisions, contingent liabilities and contingent assets	Sept 1998
IAS 38	Intangible assets	Mar 2004
IAS 40	Investment property	Dec 2003
IAS 41	Agriculture	Feb 2001
IFRS 1	Fist time adoption of International Financial Reporting Standards	June 2003
IFRS 2*	Share-based payment	Feb 2004
IFRS 3 (revised) *	Business combinations	Jan 2008
IFRS 4	Insurance contracts	Mar 2004
IFRS 5	Non-current assets held for sale and discounted operations	Mar 2004
IFRS 6	Exploration for and evaluation of mineral resources	Dec 2004
IFRS 7*	Financial instruments: disclosures	Aug 2005
IFRS 8*	Operating segments	Nov 2006
IFRS 9*	Financial instruments	Nov 2009
IFRS 10*	Consolidated financial statements	May 2011
IFRS 11*	Joint arrangements	May 2011
IFRS 12*	Disclosures of interests in other entities	May 2011
IFRS 13	Fair value measurement	May 2011
IFRS 14	Regulatory Deferral Accounts	Jan 2014
IFRS 15	Revenue from Contracts with Customers	May 2014
IFRS 16	Leases	Jan 2016
IFRS 17	Insurance Contracts	May 2017

**** These standards are not examinable at Level 2, Paper 8 "Financial Reporting" under the CPA(U) Professional Stream.***

2.13 ALTERNATIVE TREATMENTS

Many of the old IASs permitted two accounting treatments for like transactions or events. One treatment was designated as the benchmark treatment (effectively the preferred treatments and the other was known as the alternative treatment. This is no longer the case. The last standard to have a benchmark alternative was IAS 23 which was revised to remove the benchmark treatment. Under the revised standard allowable borrowing costs must be capitalized. However, some standards so still allow more than one policy – for instance IAS 16 allows property, plant and equipment to be carried at cost or revalued amount.

2.14 INTERPRETATION OF IFRSs

The IASB has developed a procedure for issuing interpretations of its standards. In September 1996, the IASC Board approved the information of a standards interpretations committee (SIC) for this task. This has been renamed under the IASB as the IFRS interpretations committee (IFRSIC). The duties of the interpretations committee are:

(a) To interpret the application of international financial Reporting Standards and provide timely guidance on financial reporting issues not specifically addressed in IFRSs or IASs in the context of the IASB's Framework, and undertake other tasks at the request of the Board.
(b) To have regard to the Board's objective of working actively with national standards setters to bring about convergence of national accounting standards and IFRSs to high quality solutions.
(c) To publish, after clearance by the board, Draft Interpretations for public comment and consider comments made within a reasonable period before finalizing an interpretation.
(d) To report to the Board and obtain board approval for final interpretations.

In developing interpretations, the IFRSIC will work closely with similar national committees. If no more than three of its members vote against an interpretation, the IFRSIC will ask the board to approve the interpretation for issue. Interpretations will be formally published after approval by the Board.

2.15 SCOPE AND APPLICATION OF IFRSs

2.15.1 Scope

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are not intended to be applied to immaterial items, nor are they retrospective. Each individual IFRS lays out its scope at the beginning of the standard.

2.15.2 Application

Within each individual country local regulations govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country concerned.
The IASB concentrated on essentials when producing IFRSs. They tried not to make IFRSs too complex, because otherwise they would be impossible to apply on a worldwide basis.

2.16 WORLD-WIDE EFFECT OF IFRSs AND THE IASB

The IASB, and before it the IASC, has now been in existence for around 25 years, and it is worth looking at the effect it has in that time.

As far as Europe is concerned, the consolidated financial statements of many of Europe's top multinationals are now prepared in conformity with national requirements, EC directives and IFRSs. Furthermore, IFRSs are having a growing influence on national accounting requirements and practices. Many of these developments have been given added impetus by the internationalization of capital markets. As mentioned previously, IFRS have been implemented in the EU for listed companies since 2005.

In Japan, the influence of the IASC had, until recently, been negligible. This was mainly because of links in Japan between tax rules and financial reporting. The Japanese Ministry of Finance set up a working committee to consider whether to bring national requirements into line with IFRSs. The Tokyo Stock Exchange has announced that it will accept financial statements from foreign issuers that conform with home country standards, which would include IFRS.

This was widely seen as attempt to attract foreign issuers, in particular companies from Hong Kong and Singapore. As these countries base their accounting on international standards, this action is therefore implicit acknowledgement by the Japanese Ministry of Finance of IFRS requirements.

In America, the securities and exchange commission (SEC) agreed in 1993 to allow foreign issuers (of shares, etc) to follow IFRS treatments on certain issues, including cash flow statements under IAS 7. The overall effect is that, where an IFRS treatment differs from US GAAP, these treatments will now be acceptable. The SEC is now supporting the IASB because it wants to attract foreign listings. In October 2002, under the Norwalk Agreement the FASB and the IASB formally agreed that they would work towards convergence between US GAAP and IFRS and in February 2006 they released a 'roadmap' setting out the convergence projects.

2.17 CRITICISMS OF THE IASB

You need to be able to understand the problems that can arise.

We will begin by looking at some of the general problems created by accounting standards.

2.17.1 Accounting standards and choice

It is sometimes argued that companies should be given a choice in matters of financial reporting on the grounds that accounting standards are detrimental to the quality of such reporting. There are arguments on both sides.
In favour of accounting standards (both national and international), the following points can be made.

- *They reduce or eliminate confusing variations in the methods used to prepare accounts.*
- *They provide a focal point for debate and discussions about accounting practice.*
- *They oblige companies to disclose the accounting policies used in the preparation of accounts.*
- *They are a less rigid alternative to enforcing conformity by means of legislation.*
- *They have obliged companies to disclose more accounting information than they would otherwise have done if accounting standards did not exist, for example IAS 33 Earnings per share.*

Many companies are reluctant to disclose information which is not required by national legislation. However, the following arguments may be put forward against standardization and in favour of choice.

- A set of rules which give backing to one method of preparing accounts might be inappropriate in some circumstances. For example, IAS 16 on depreciation is inappropriate for investment properties (properties not occupied by the entity but held solely for investment), which are covered by IAS 40 on investment property.
- Standards may be subject to lobbying or government pressure (in the case of national standards). For example, in the USA, the accounting standard FAS 19 on the accounts of oil and gas companies led to a powerful lobby of oil companies, which persuaded the SEC (securities and exchange commission) to step in. FAS was then suspended.
- Manu national standards are not based on a conceptual framework of accounting, although IFRSs are.
- There may be a trend towards rigidity, and away from flexibility in applying the rules.

2.17.2 Political problems

Any international body, whatever its purpose or activity, faces enormous political difficulties in attempting to gain international consensus and the IASB is no exception to this. How can the IASB reconcile the financial reporting situation between economies as diverse as third-world developing countries and sophisticated first-world industrial powers?

Developing countries are suspicious of the IASB, believing it to be dominated by the USA. This arises because acceptance by the USA listing authority, the securities and exchange commission (SEC), of IASs is seen as a major hurdle to be overcome. For all practical purposes it is the American market which must be persuaded to accept IFRSs.

Developing countries are being catered for to some extent by the issue of a standard on agriculture, which is generally of much more relevance to such countries.

There are also tensions between the UK/US model of financial reporting and the European model. The UK/US model is based around investor reporting, whereas the European model is mainly concerned with tax rules, so shareholder reporting has a much lower priority.

The break-up of the former USSR and the move in many Eastern European countries to free-market economies has also created difficulties. It is likely these countries will have to 'catch up' to international standards as their economies stabilize.

You must keep up to date with the IASB's progress and the problems it encounters in the financial press.

You should also be able to discuss:

- Due process of the IASB
- Use and application of IFRSs
- Future work of the IASB
- Criticisms of the IASB

A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.

The organisational structure consists of:

– The IFRS Foundation
– The IASB
– The IFRS Advisory Council
– The IFRS interpretations committee

IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysis and other users and regulatory bodies from around the world.

Inventories

3.0
IAS 2 "*INVENTORIES*"

UNIT 3 OVERVIEW:
- General Introduction to IAS 2
- Scope of IAS 2
- Accounting for Inventories under IAS 2

3.1 INTRODUCTION

The use of LIFO is prohibited under the revised IAS 2.

In most businesses the value put on inventory is an important factor in the determination of profit. Inventory valuation is, however a highly subjective exercise and consequently there is a wide variety of different methods used in practice.

3.2 IAS 2 INVENTORIES

IAS 2 lays out the required accounting treatment for inventories (sometimes called stocks) under the historical cost system. The major area of contention is the cost value of inventory to be recorded. This is recognized as an asset of the entity until the related revenues are recognized (i.e. the item is sold) at which point the inventory is recognized as an expense (i.e. cost of sales). Part or all the cost of inventories may also be expensed if a write-down to net realizable value is necessary. The IAS also provides guidance on the cost formulas that are used to assign costs to inventories.

In other words, the fundamental accounting assumption of 'accruals' requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods which remain unsold at the year end must be carried forward in the statement of financial position and matched against future revenues.

3.3 SCOPE

The following items are excluded from the scope of the standard.

- Work in progress under long-term contracts (covered by IFRS 15 Revenue from contracts with customers)
- Financial instruments (i.e. shares, bonds)
- Biological assets

Certain inventories are exempt from the standard's measurement rules, i.e. those held by:

- Producers of agricultural and forest products
- Commodity-broker traders

3.4 KEY DEFINITIONS

The following definitions are important.

- Inventories are assets:

- Held for sale in the ordinary course of business;
- In the process of production for such sale; or
- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

- **Net realizable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. (IAS 2)

- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13)

Inventories can include any of the following.

- Goods purchased and held for resale, e.g. goods held for sale by a retailer, or land and buildings held for resale.
- Finished goods produced
- Work in progress being produced
- Materials and supplies awaiting use in the production process (raw materials)

3.5 MEASUREMENT OF INVENTORIES

The standard states that 'inventories should be measured at the lower of cost and net realizable value.

3.5.1 Cost of inventories

The cost of inventories will consist of all costs of:
- Purchase
- Costs of conversion
- Other costs incurred in bringing the inventories to their present location and condition

3.5.2 Cost of purchase

The standard lists the following as comprising the costs of purchase of inventories:
- Purchase price
- Import duties and other taxes
- Transport, handling and any other cost directly attributable to the acquisition of finished goods, services and materials.
- Trade discounts, rebates and other similar amounts

3.5.3 Costs of conversion

Costs of conversion of inventories consist of two main parts.
(a) Costs directly related to the units of production, e.g. direct materials, direct labour
(b) Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis.

You may have come across the terms 'fixed production overheads' or 'variable production overheads' elsewhere in your studies. The standard defines them as follows.

Key terms:
- **Fixed production overheads** are those indirect costs of production that remain relatively constant regardless of the volume of production e.g. the cost of factory management and administration.

- **Variable production overheads** are those indirect costs of production that vary directly, or nearly directly, with the volume of production, e.g. indirect materials and labour. (IAS 2)

The standard emphasizes that fixed production overheads must be allocated to items of inventory on the basis of the normal capacity of the production facilities. This is an important point.

(a) Normal capacity is the expected achievable production based on the average over several periods/seasons, under normal circumstances.
(b) The above figures should take account of the capacity lost through planned maintenance.
(c) If it approximates to the normal level of activity then the actual level of production can be used.
(d) Low production or idle plant will not result in a higher fixed overhead allocation to each unit.
(e) Unallocated overheads must be recognized as an expense in the period in which they were incurred.
(f) When production is abnormally high, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.
(g) The allocation of variable production overheads to each unit is based on the actual use of production facilities.

3.5.4 Other costs

Any other costs should only be recognized if they are incurred in bringing the inventories to their present location and condition.

The standard lists types of cost which would not be included in cost of inventories. Instead, they should be recognized as an expense in the period they are incurred.

(a) Abnormal amounts of wasted materials, labour or other production costs.
(b) Storage costs (except costs which are necessary in the production process before a further production stage)
(c) Administrative overheads not incurred to bring inventories to their present location and conditions
(d) Selling costs

3.5.5 Techniques for the measurement of cost

Two techniques are mentioned by the standard, both of which produce results which approximate to cost, and so both of which may be used for convenience.

(a) **Standard costs** are set up to take account of normal production values: amount of raw materials used, labour time etc. They are reviewed and revised on a regular basis.

(b) **Retail method**. This is often used in the retail industry where there is a large turnover of inventory items, which nevertheless have similar profit margins. The only practical method of inventory valuation may be to take the total selling price of inventories and deduct an overall average profit margin, thus reducing the value of an approximation of cost. The percentage will take account of reduced price lines. Sometimes different percentages are applied on a department basis.

3.5.6 Cost formulas

Cost of inventories should be assigned by specific identification of their individual costs for:

(a) Items that are not ordinarily interchangeable
(b) Goods or services produced and segregated for specific projects

Specific costs should be attributed to individual items of inventory when they are segregated for a specific project, but not where inventories consist of a large number of interchangeable (i.e. identical or very similar) items. In the latter case the rule is as specified below.

3.5.7 Interchangeable items

The cost of inventories should be assigned by using the first-in, first-out (FIFO) or weighted average cost formulas. The LIFO formula (last in, first out) is not permitted by the revised IAS 2.

You should be familiar with these methods from your earlier studies. Under the weighted average cost method, a recalculation can be made after each purchase, or alternatively only at the period end.

3.5.8 Net realizable value (NRV)

As a general rule assets should not be carried at amounts greater than those expected to be realized from their sale or use. In the case of inventories this amount could fall below cost when items are damaged or become obsolete, or where the costs to completion have increased in order to make the sale.

In fact we can identify the principal situations in which NRV is likely to be less than cost, i.e. where there has been:

(a) An increase in costs or a fall in selling price
(b) A physical deterioration in the condition of inventory
(c) Obsolescence of products
(d) A decision as part of the company's marketing strategy to manufacture and sell products at a loss
(e) Error in production or purchasing

A write down of inventories would normally take place on an item by item basis, but similar or related items may be grouped together. This grouping together is acceptable for, say, items in the same product line, but it is not acceptable to write down inventories based on a whole classification (e.g. finished goods) or a whole business.

The assessment of NRV should take place at the same time as estimates are made of selling price, using the most reliable information available. Fluctuations of price or cost should be taken into account if they relate directly to events after the reporting period, which confirm conditions existing at the end of the period.

The reasons why inventory is held must also be taken into account. Some inventory, for example, may be held to satisfy a firm contract and its NRV will therefore be the contract price. Any additional inventory of the same type held at the period end will, in contrast, be assessed according to general sales prices when NRV is estimated.

Net realizable value must be reassessed at the end of each period and compared again with cost. If the NRV has risen for inventories held over the end of more than one period, then the previous write down must be reversed to the extent that the inventory is then valued at the lower of cost and the new NRV. This may be possible when selling prices have fallen in the past and then risen again.

On occasion a write down to NRV may be of such size, incidence or nature that it must be disclosed separately.

3.5.9 Recognition as an expense

The following treatment is required when inventories are sold.

(a) The carrying amount is recognized as an expense in the period in which the related revenue is recognized.
(b) The amount of any write-down of inventories to NRV and all losses of inventories are recognized as an expense in the period the write-down or loss occurs.

(c) The amount of any reversal of any write-down of inventories, arising from an increase in NRV, is recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

Activity 3.1:

A company has inventory on hand at the end of the reporting period as follows:

	Units	Raw material Cost	Attributable production Overheads	Attributable selling costs	Expected selling
		Shs000	Shs000	Shs000	Shs000
Item A	300	1,600	150	120	1,850
Item B	250	500	100	100	750

Required
Compute the amount at which inventories should be stated in the statement of financial position in accordance with IAS 2

3.6 Consistency – different cost formulas for inventories

IAS 2 allows two cost formulas (FIFO or weighted average cost) for inventories that are ordinarily interchangeable or are not produced and segregated for specific projects. The issue is whether an entity may use different cost formulas for different types of inventories.

IAS 2 provides that an entity should use the same cost formula for all inventories having similar nature and use to the entity. For inventories with different nature or use (for example, certain commodities used in one business segment and the same type of commodities used in another business segment), different cost formulas may be justified. A difference in geographical location of inventories (and in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

Accounting Policies, Changes in Accounting Estimates & Errors

4.0

IAS 8 "*ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS*"

UNIT 4 OVERVIEW:

- Key definitions under IAS 8.
- Accounting Policies.
- Changes in accounting Estimates.
- Errors.

1.1 DEFINITIONS UNDER IAS 8

The following key definitions are given in the standard.

- **Accounting policies** are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

- **A change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset that results from the assessment of the present status of and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

- **Material:** omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.

- **Prior period errors are omissions** from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

  - Was available when financial statements for those periods were authorised for issue, and
  - Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

  Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

- **Retrospective application** is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

- **Retrospective restatement** is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error has never occurred.

- **Prospective application** of a change in accounting policy and of recognizing the effect of a change in an accounting estimate, respectively, are:

  - Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and

- Recognizing the effect of the change in the accounting estimate in the current and future periods affected by the change.

- **Impracticable**. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following apply.
  - The effects of the retrospective application or retrospective restatement are not determinable.
  - The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.
  - The retrospective application retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that: provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and would have been available when the financial statements for that prior period were authorised for issue, from other information.

1.2 ACCOUNTING POLICIES

Accounting policies are determined by applying the relevant IAS, IFRS or IFRS Interpretation and considering any relevant implementation guidance issued by the IASB for that IFRS/Interpretation.

Where there is no applicable IFRS or Interpretation management should use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. Management should refer to:

(a) The requirements and guidance in IFRS and IFRICs dealing with similar and related issues
(b) The definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the Conceptual Framework.

Management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

An entity must select and apply its accounting policies for a period consistently for similar transactions, other events and conditions, unless an IFRS or an IFRIC specifically requires or permits categorization of items for which different policies may be appropriate. If an IFRS or an IFRIC requires or permits categorization of items, an appropriate accounting policy must be selected and applied consistently to each category.

1.2.1 Changes in accounting policies

Changes in accounting policy are applied retrospectively.

1.2.2 Accounting for changes of policy

The same accounting policies are usually adopted from period to period, to allow users to analyse trends over time in profit, cash flows and financial position. Changes in accounting policy will therefore be rare and should be made only if:

(a) The change is required by an IFRS; or
(b) The change will result in a more appropriate presentation of events or transactions in the financial statements of the entity, providing more reliable and relevant information.

The standard highlights two types of event which do not constitute changes in accounting policy.

(a) Adopting an accounting policy for a new type of transaction or event not dealt with previously by the entity.
(b) Adopting a new accounting policy for a transaction or event which has not occurred in the past or which was not material.

In the case of tangible non-current assets, if a policy of revaluation is adopted for the first time then this is treated, not as a change of accounting policy under IAS 8, but as a revaluation under IAS 16 Property, plant and equipment). The following paragraphs do not therefore apply to a change in policy to adopt revaluations.

A change in accounting policy must be applied retrospectively. Retrospective application means that the new accounting policy is applied to transactions and events as if it had always been in use. In other words, at the earliest date such transactions or events occurred, the policy is applied from that date. Prospective application is no longer allowed under the revised IAS 8 unless it is impracticable (see key terms) to determine the cumulative effect of the change.

Activity 4.1

Goal (U) Ltd has always valued inventory on a FIFO (first in, first out) basis. In 2018 it decides to switch to the weighted average method of valuation. Gross profit in the 2017 financial statements was calculated as follows:

		Shs.000
Revenue		869,000
Cost of sales		
Opening inventory	135,000	
Purchases	246,000	
Closing inventory	(174,000)	(207,000)
Gross profit		662,000

The Accounts Assistant has established that the opening inventory for 2017 based on the Weighted Average method would be shs. 122m and closing inventory would be shs 143m. The retained earnings on 1 April was 120m while operating expenses amount to shs 217m.

Required:
Advise management of Goal (U) Ltd on how to treat the change from FIFO to Weighted Average Method for the year ended 31 December 2017.

1.2.3 Adoption of an IFRS

Where a new IFRS is adopted, IAS 8 requires any transitional provisions in the new IFRS itself to be followed. If none are given in the IFRS which is being adopted, then you should follow the general principles of IAS 8.

1.2.4 Disclosure

Certain disclosures are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods.

(a) Reasons for the change/nature of change
(b) Amount of the adjustment for the current period and for each period presented

(c) Amount of the adjustment relating to periods prior to those included in the comparative information
(d) The fact that comparative information has been restated or that it is impracticable to do so

An entity should also disclose information relevant to assessing the impact of new IFRS on the financial statements where these have not yet come into force.

1.3 CHANGES IN ACCOUNTING ESTIMATES

Changes in accounting estimate are not applied retrospectively.

Estimates arise in relation to business activities because of the uncertainties inherent within them. Judgements are made based on the most up to date information and the use of such estimates is a necessary part of the preparation of financial statements. It does not undermine their reliability. Here are some examples of accounting estimates.

(a) A necessary irrecoverable debt allowance
(b) Useful lives of depreciable assets
(c) Provision for obsolescence of inventory

The rule here is that the effect of a change in an accounting estimate should be included in the determination of net profit or loss in one of:
(a) The period of the change, if the change effects that period only
(b) The period of the change and future periods, if the change affects both

Changes may occur in the circumstances which were in force at the time the estimate was calculated, or perhaps additional information or subsequent developments have come to light. An example of a change in accounting estimate which affects only the current period is the bad debt estimate. However, a revision in the life over which an asset is depreciated would affect both the current and future periods, in the amount of the depreciation expense.

Reasonably enough, the effect of a change in an accounting estimate should be included in the same expense classification as was used previously for the estimate. This rule helps to ensure consistency between the financial statements of different periods.

The materiality of the change is also relevant. The nature and amount of a change in an accounting estimate that has a material effect in the current period (or which is expected to have a material effect in subsequent periods) should be disclosed. If it is not possible to quantify the amount, this impracticability should be disclosed.

Activity 4.2
Which of the following is a change in accounting policy as opposed to a change in estimation technique?

1. An entity has previously charged interest incurred in connection with the construction of tangible noncurrent assets to the statement of profit or loss. Following the revision of IAS 23, and in accordance with the revised requirements of that standard, it now capitalises this interest.

2. An entity has previously depreciated vehicles using the reducing balance method at 40% pa. It now uses the straight line method over a period of five years.

3. An entity has previously shown certain overheads within cost of sales. It now shows those overheads within administrative expenses.

4. An entity has previously measured inventory at weighted average cost. It now measures inventory using the first in first out (FIFO) method.

1.4 ERRORS

Prior period errors must be corrected retrospectively.

1.4.1 Introduction

Errors discovered during a current period which relate to a prior period may arise through:

(a) Mathematical mistakes
(b) Misinterpretation of facts
(c) Fraud
(d) Mistakes in the application of accounting policies
(e) Oversights

Most of the time these errors can be corrected through net profit or loss for the current period. Where they are material prior period errors, however, this is not appropriate. The standard considers two possible treatments.

1.4.2 Accounting treatment

Prior period errors: correct retrospectively. There is no longer any allowed alternative treatment. This involves:

(a) Either restating the comparative amounts for the prior period(s) in which the error occurred,
(b) Or, when the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period, so that the financial statements are presented as if the error has never occurred.

Only where it is impracticable to determine the cumulative effect of an error on prior periods can an entity correct an error prospectively.

1.4.3 Various disclosures are required.

(a) Nature of the prior period error
(b) For each prior period, to the extent practicable, the amount of the correction.
    (i) For each financial statement line item affected
    (ii) If IAS 33 applies, for basic and diluted earnings per share
(c) The amount of the correction at the beginning of the earliest prior period presented
(d) If retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected. Subsequent periods need not repeat these disclosures.

Activity 4.3

During 2018, NASSER (U) Ltd discovered that certain items had been included in inventory at 30 June 2017, valued at shs.4.2m, which had in fact been sold before the year end. The following figures for 2017 (as reported) and 2018 (draft) are available.

	2017	2018 (draft)
	Shs.'000	shs.'000
Sales	47,400	67,200
Cost of goods sold	(34,570)	(55,800)
Profit before taxation	12,830	11,400
Income taxes	(3,880)	(3,400)
Profit for the period	8,950	8,000

Retained earnings at 1 July 2017 were shs.13m. The cost of goods sold for 2018 includes the shs.4.2m error in opening inventory. The income tax rate was 30% for 2017 and 2018. No dividends have been declared or paid.

Required:

Show the statement of profit or loss for 2018, with the 2017 comparative and retained earnings.

Borrowing Costs

5.0
IAS 23" *BORROWING COSTS*"

UNIT 5 OVERVIEW:
- Key definitions under IAS 23.
- Accounting for borrowing costs.
- Worked examples on IAS 23.
- Disclosure requirements.

5.1 Introduction

IAS 23 looks at the treatment of borrowing costs, particularly where the related borrowings are applied to the construction of certain assets. These are what are usually called 'self-constructed assets', where an entity builds its own inventory or non-current assets over a substantial period of time.

5.2 Key Definitions

IAS 23 Borrowing costs was revised in March 2007. Previously it gave a choice of methods in dealing with borrowing costs: capitalization or expense. The revised standard requires capitalization.

Only two definitions are given by the standard.

Key term:

(a) **Borrowing costs**. Interest and other costs incurred by an entity in connection with the borrowing of funds.

(b) **Qualifying asset**. An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

The standard lists what may be included in borrowing costs.

- ⇒ Interest on bank overdrafts and short-term and long-term borrowings
- ⇒ Finance charges in respect of leases recognized in accordance with IFRS 16.
- ⇒ Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Depending on the circumstances, any of the following may be qualifying assets.

- *Inventories*
- *Manufacturing plants*
- *Power generation facilities*
- *Intangible assets*
- *Investment properties*

Financial assets and inventories that are manufactured, or otherwise produced over a short period of time are not qualifying assets. Assets that are ready for their intended use or sale when purchased are not qualifying assets.

5.3 Accounting treatment of Borrowing costs

All eligible borrowing costs must be **capitalized**.

Only borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset can be capitalized as part of the cost of that asset. The standard lays out the criteria for determining which borrowing costs are eligible for capitalization.

5.3.1 Borrowing costs eligible for capitalization

- Those borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset must be identified. These are the borrowing costs that would have been avoided had the expenditure on the qualifying asset not been made. This is obviously straightforward where funds have been borrowed for the financing of one particular asset.

- Difficulties arise, however where the entity uses a **range of debt instruments** to finance a wide range of assets, so that there is no direct relationship between particular borrowings and a specific asset. For example, all borrowings may be made centrally and then lent to different parts of the group or entity. Judgement is therefore required particularly where further complications can arise (e.g. foreign currency loans).

- Once the relevant borrowings are identified, which relate to a specific asset, then the **amount of borrowing costs available for capitalization** will be the actual borrowing costs incurred on those borrowings during the period, less any investment income on the temporary investment of those borrowings. It would not be unusual for some or all of the funds to be invested before they are actually used on the qualifying asset.

Activity 5.1

On 1st January 2019 Javas (U) Ltd borrowed Shs.1.5 billion to finance the production of two assets, both of which were expected to take a year to build. Work started during 2019. The loan facility was drawn down and incurred on 1st January 2019, and was utilized as follows, with the remaining funds invested temporarily.

	Asset A	**Asset B**
	Shs "millions"	Shs."millions"
1 January 2019	250	500
1 July 2019	250	500

The loan rate was 9% and Javas Ltd can invest surplus funds at 7%.

Required:
Ignoring compound interest, calculate the borrowing costs which may be capitalized for each of the assets and consequently the cost of each asset as at 31 December 2019.

In a situation where borrowings are obtained generally, but are applied in part to obtaining a qualifying asset, then the amount of borrowing costs eligible for capitalization is found by applying the 'capitalisation rate' to the expenditure on the asset.

Key term

- **The capitalization rate** is the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, excluding borrowings made specifically to obtain a qualifying asset. However, there is a cap on the amount of borrowing costs calculated in this way: it must not exceed actual borrowing costs incurred.

Sometimes one overall weighted average can be calculated for a group or entity, but in some situations it may be more appropriate to use a weighted average for borrowing costs for individual parts of the group or entity.

Activity 5.2

Roko Co had the following loans in place at the beginning and end of 2017.

	1 January 2017 Shs. "millions"	31 December 2017 Shs "millions"
10% Centenary Bank loan repayable 2019	120	120
9.5% Equity Bank loan repayable 2020	80	80
8.9% Stanbic Bank Debenture repayable 2018	–	150

The 8.9% Stanbic bank debenture was issued to fund the construction of a mining plant (the plant meets the definition of a qualifying asset), construction of which the plant began on 1 July 2017.

On 1 January 2017, Roko Co began construction of a hydroelectric Machinery, using existing borrowings. The machinery meets the definition of a qualifying asset. Expenditure drawn down for the construction of the machinery was: Shs30m on 1 January 2017, Shs20m on 1 October 2017.

Required:
Calculate the borrowing costs that can be capitalized for the mining and hydro-electric machine as at 31 December 2017. Determine the cost of the asset in each case.

5.3.2 Carrying amount exceeds recoverable amount

A situation may arise whereby the carrying amount (or expected ultimate cost) of the qualifying asset exceeds its recoverable amount or net realisable value. In these cases, the carrying amount must be written down or written off, as required by other IASs. In certain circumstances again as allowed by other IASs), these amounts may be written back in future periods.

5.4 Commencement of capitalization

Three events or transactions must be taking place for capitalisation of borrowing costs to be started.

(a) Expenditure on the asset is being incurred
(b) Borrowing costs are being incurred
(c) Activities are in progress that are necessary to prepare the asset for its intended use or sale

Expenditure must result in the payment of cash, transfer of other assets or assumption of interest-bearing liabilities. Deductions from expenditure will be made for any progress payments or grants received in connection with the asset. IAS 23 allows the average carrying amount of the asset during a period (including borrowing costs previously capitalized) to be used as a reasonable approximation of the expenditure to which the capitalisation rate is applied in the period. Presumably more exact calculations can be used.

Activities necessary to prepare the asset for its intended sale or use extend further than physical construction work. They encompass technical and administrative work prior to construction eg, obtaining permits. They do not include holding an asset when no production or development that changes the asset's condition is taking place, eg where land is held without any associated development activity.

5.4.1 Suspension of capitalization

If active development is interrupted for any extended periods, capitalisation of borrowing costs should be suspended for those periods.

Suspension of capitalisation of borrowing costs is not necessary for temporary delays or for periods when substantial technical or administrative work is taking place.

5.4.2 Cessation of capitalization

Once substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete, then capitalisation of borrowing costs should cease. This will normally be when physical construction of the asset is completed, although minor modifications may still be outstanding.

The asset may be completed in parts or stages, where each part can be used while construction is still taking place on the other parts. Capitalisation of borrowing costs should cease for each part as it is completed. The example given by the standard is a business park consisting of several buildings.

5.5 Disclosure

The following should be disclosed in the financial statements in relation to borrowing costs.

(a) Amount of borrowing costs **capitalized during the period**.
(b) **Capitalisation rate** used to determine the amount of borrowing costs eligible for capitalisation.

PRACTICE QUESTIONS

QUESTION 5.1 SAVANNAH Ltd

On 1 July, 2016 Savannah Ltd entered into a contract for the construction of a building worth Shs 3.2 billion. The building was completed at the end of June, 2017. During the period, the following payments were made to the contractor:

Date	Amount (Shs '000')
1 July, 2016	200,000
30 September,2016	1,600,000
31 March, 2017	1,200,000
30 June, 2017	200,000
	3,200,000

Savannah Ltd's borrowings as at 30 June, 2017 were as follows:

1. A 10% 4 year loan note with simple interest payable annually, which relates specifically to the project; debt outstanding at 30 June, 2017 amounted to Shs 900 million. Interest of Shs 75 million was incurred on those borrowings during the year, and interest income of Shs 30 million was earned on these funds while they were held in anticipation of payments.
2. A 12.5% 10 year loan note with simple interest payable annually; debt outstanding at 1 July, 2016 amounted to Shs 100 million and remained unchanged during the year.
3. A 10% 10 year loan note with simple interest payable annually; debt outstanding at 1 July, 2016 amounted to Shs 150 million and remained unchanged during the year.
4. Interest expenses equal borrowing costs.

Required:
Determine the borrowing costs to be capitalised for the period ended 30 June, 2017. ***(5 marks)***

QUESTION 5.2 ABC Ltd

(a) IAS 23: Borrowing Costs defines borrowing costs as the interest expense in case of financial instruments, finance charges in case of finance leases or exchange differences arising from foreign currency borrowings and adjusted to interest costs incurred by an entity in connection with the borrowing of funds to be applied to acquire, construct or produce an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (qualifying asset).

Required:
Explain the criteria for recognising and disclosing borrowing costs in the financial statements according to IAS 23. ***(12 marks).***

(b) The directors of ABC Ltd resolved to take a 13% bank loan of Shs 255 million to finance the construction of a milling plant that was expected to take 12 months to build. The loan facility was drawn on 14 January, 2015. ABC Ltd had the following balances on its loan accounts on the specified dates:

	1 January, 2015	31 December, 2015
	Shs'000'	Shs'000'
12% bank loan	85,000	85,000
13% bank loan	-	255,000

The 12% loan was obtained to finance the construction of the milling plant whose estimated cost as per the bill of quantities was Shs 350 million. On 2 February, 2015 Shs 70 million was transferred to the contracted construction firm (XY Ltd) and an additional Shs 150 million was transferred on 3 June, 2015.

Required:
Prepare a schedule of the borrowing costs to be capitalised for the milling plant for the year ended 31 December, 2015 **(8 marks)**
(Total 20 marks)

Source: CPA(U), November 2016, Question 2

QUESTION 5.3 URBAN UGANDA Ltd

The following information appeared in the trial balance of Urban Uganda Ltd (UGL) for the year ending 30 June 2017

	Dr	Cr
	Shs "000"	Shs "000"
Interest paid	450,000	
Long-term borrowings		1,600,000
15% Mortgage Bond		800,000

On 1 July 2016, the UGL started negotiations to purchase a piece of industrial land costing Shs 1 billion on which to erect a warehouse. The deal was finalized on 1 August 2016 at which stage the company was granted a bond of Shs 800 million equal to 80% of the purchase price of the collateral. The interest rate on the bond was 15% throughout the year. The architects had finalized plans by 1 September 2016 and construction began immediately. On 31 March 2017 the warehouse was complete and ready for use. The warehouse was not put into use until 1 June 2017, the date their lease on the originally rented warehouse expired.

Detailed construction records indicate that company employees spent 120,000 hours on the construction of the warehouse. The average charge out rate per employee was Shs 3,500 per hour. Raw materials costing Shs 800 million were used in the construction. Costs were incurred evenly throughout the construction period and it is presumed that the project was financed by the bond proceeds with the required top up drawn from other general borrowings.

The company's policy on borrowing costs is to capitalize the same where appropriate and has approached you as a consultant to provide guidance on the matter.

Required:
Prepare a report to the management of the council with relevant computations and explanatory notes indicating which borrowing costs are to be capitalized or expensed appropriately for the year ended 30 June 2017 in order to comply with the requirements of IAS 23: Borrowing Costs.

QUESTION 5.4

IAS 23: Borrowing Costs requires that borrowing costs directly attributable to the acquisition, construction or production of a 'qualifying asset' are included in the cost of the asset. Other borrowing costs are recognised as an expense.

Required:
In accordance with IAS 23, discuss whether borrowing costs should be capitalised, and if so how and why they should be initially capitalised and subsequently cease to be capitalized.

QUESTION 5.5 FUFA Ltd

FUFA Ltd arranged a loan with Equity Bank Ltd to enable the company build a new football stadium in Luwero District. The company was allowed to borrow up to Shs 780 million to be used in such amounts and at such time as it required the funds. The bank charges interest at the rate of 21% per annum and FUFA Ltd is able to invest any surplus funds at the rate of 15% per annum.

The company borrowed Shs 260 million on 1 January 2016, and immediately invested Shs 130 million. On 1 April 2016 it borrowed a further Shs 312 million of which it invested Shs 182 million. On 31 May 2016 the company spent Shs 156 million. On 31 August 2016 FUFA Ltd borrowed a further Shs 208 million and spent Shs 52 million immediately. On 1 November 2016 work stopped due to an outbreak of Ebola in the area. Work resumed 1 April 2017 and FUFA Ltd spent the rest of the loan in completing the project, which was ready for final inspection by 31 May 2017. The district authority gave approval of the stadium on 1 July 2017, and paid FUFA Ltd the full purchase price of Shs 910 million. The loan was repaid on 31 December 2017.

Required:
Compute the carrying amount of the stadium in FUFA Ltd's financial statements immediately before the sale

ACTIVITY 5.6

IAS 23: Borrowing Costs; provides for the circumstances for the capitalization of interest costs. It also identifies situations for cessation of capitalization and suspension of capitalization of borrowing costs.

Required:
(a) Identify any two conditions to be met for the capitalization of interest costs as given by IAS 23.

(b) Explain any two circumstances that should prevail for the capitalization of costs to cease.

(c) Identify the circumstances for the suspension of borrowing costs.

Statements of Cash Flows

6.0
IAS 7 "*CASH FLOW STATEMENTS*"

UNIT 6 OVERVIEW:

- IAS 7 Statement of cash flows
- Preparing a statement of cash flows
- Interpretation of statements of cash flows

1.1 IAS 7 Statement of cash flows

Statements of cash flows are a useful addition to the financial statements because it is recognized that accounting profit is not the only indicator of a company's performance.

1.2 Introduction

It has been argued that 'profit' does not always give a useful or meaningful picture of a company's operations. Readers of a company's financial statements might even be misled by a reported profit figure.

(a) Shareholders might believe that if a company makes a profit after tax, of say, Shs.100 million then this is the amount which it could afford to pay as a dividend. Unless the company has sufficient cash available to stay in business and also to pay a dividend, the shareholders' expectations would be wrong.

(b) Employees might believe that if a company makes profits, it can afford to pay higher wages next year. This opinion may not be correct: the ability to pay wages depends on the availability of cash.

(c) Survival of a business entity depends not so much on profits as on its ability to pay its debts when they fall due. Such payments might include 'revenue' items such as material purchases, wages, interest and taxation etc, but also capital payments for new non-current assets and the repayment of loan capital when this falls due (for example on the redemption of debentures).

(d) The government revenue agencies e.g. URA may not listen to please by the organisation to extend its tax payment period basing on the high profit reflected on the profit and loss account. URA may not appreciate that the company may not be able to pay because the profitability does not correspond with the liquidity.

(e) Investors, public and government may think that a firm has made profits and that has the ability to pay its debts when they fall due.

From these examples, it may be apparent that a company's performance and prospects depend not so much on the 'profits' earned in a period, but more realistically on liquidity or cash flows.

1.3 Objective of IAS 7

The aim of IAS 7 is to provide information to users of financial statements about the entity's ability to generate cash and cash equivalents, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents, classifying cash flows between **operating**, **investing** and **financing** activities.

1.4 Scope

A statement of cash flows should be presented as an integral part of an entity's financial statements. All types of entity can provide useful information about cash flows as the need for cash is universal, whatever the nature of their revenue-producing activities. Therefore all entities are required by the standard to produce a statement of cash flows.

1.5 Benefits of cash flow information

The use of statements of cash flows is very much in conjunction with the rest of the financial statements. Users can gain further appreciation of the change in net assets, of the entity's financial position (liquidity and solvency) and the entity's ability to adapt to changing circumstances by affecting the amount and timing of cash flows. Statements of cash flows enhance comparability as they are not affected by differing accounting policies used for the same type of transactions or events. Cash flow information of a historical nature can be used as an indicator of the amount, timing and certainty of future cash flows. Past forecast cash flow information can be checked for accuracy as actual figures emerge. The relationship between profit and cash flows can be analysed as can changes in prices over time.

1.6 Definitions

The standard gives the following definitions, the most important of which are cash and cash equivalents.

Key terms:

- **Cash** comprises cash on hand and demand deposits.
- **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.
- **Cash flows** are inflows and outflows of cash and cash equivalents.
- **Operating activities** are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
- **Investing activities** are the acquisition and disposal of non-current assets and other investments not included in cash equivalents.
- **Financing activities** are activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

1.7 Cash and cash equivalents

The standard expands on the definition of cash equivalents: they are not held for investment or other long-term purposes, but rather to meet short-term cash commitments. To fulfill the above definition, an investment's maturity date should normally be within three months from its acquisition date. It would usually be the case then that equity investments (i.e. shares in other companies) are not cash equivalents. An exception would be where preferred shares were acquired with a very close maturity date.

Loans and other borrowings from banks are classified as financing activities. In some countries, however, bank overdrafts are repayable on demand and are treated as part of an entity's total cash management system. In these circumstances an overdrawn balance will be included in cash and cash equivalents. Such banking arrangements are characterized by a balance which fluctuates between overdrawn and credit.

Movements between different types of cash and cash equivalent are not included in cash flows. The investment of surplus cash in cash equivalents is part of cash management, not part of operating, investing or financing activities.

1.8 PRESENTATION OF A STATEMENT OF CASH FLOWS

IAS 7 requires statements of cash flows to report cash flows during the period classified by operating, investing and financing activities.
The manner of presentation of cash flows between operating, investing and financing activities depends on the nature of the entity. By classifying cash flows between different activities in this way users can see the impact on cash and cash equivalent of each one, and their relationships with each other. We can look at each in more detail.

1.8.1 Operating activities

This is perhaps the key part of the statement of cash flows because it shows whether, and to what extent, companies can generate cash from their operations. It is these operating cash flows which must, in the end pay for all cash outflows relating to other activities, i.e. paying loan interest, dividends and so on. Most of the components of cash flows from operating activities will be those items which determine the net profit or loss of the entity, i.e. they relate to the main revenue-producing activities of the entity. The standard gives the following as examples of cash flows from operating activities.

(a) Cash receipts from the sale of goods and the rendering of services
(b) Cash receipts from royalties, fees, commissions and other revenue
(c) Cash payments to suppliers for goods and services
(d) Cash payments to and on behalf of the employees

Certain items may be included in the net profit or loss for the period which do not relate to operational cash flows, for example the profit or loss on the sale of a piece of plant will be included in net profit or loss, but the cash flows will be classed as investing.

1.8.2 Investing activities

The cash flows classified under this heading show the extent of new investment in assets which will generate future profit and cash flows. The standard gives the following examples of cash flows arising from investing activities.
(a) Cash payments to acquire property, plant and equipment, intangibles and other non-current assets, including those relating to capitalized development costs and self-constructed property, plant and equipment.
(b) Cash receipts from sales of property, plant and equipment, intangibles and other non-current assets.
(c) Cash payments to acquire shares or debentures of other entities.
(d) Cash receipts from sales of shares or debentures of other entities
(e) Cash advances and loans made to other parties
(f) Cash receipts from the repayment of advances and loan made to other parties

1.8.3 Financing activities

This section of the statement of cash flows shows the share of cash which the entity's capital providers have claimed during the period. This is an indicator of likely future interest and dividend payments. The standard gives the following examples of cash flows which might arise under this heading.
(a) Cash proceeds from issuing shares
(b) Cash payments to owners to acquire or redeem the entity's shares
(c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other or long-term borrowings
(d) Principal repayments of amounts borrowed under finance leases

NOTE: *Where the reporting entity uses an asset held under a finance lease, the amounts to go in the statement of cash flows as financing activities are repayments of the principal (capital) rather than the interest. The interest paid will be shown under operating activities.*

1.9 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

The standard offers a choice of method for this part of the statement of cash flows.

(a) Direct method: disclose major classes of gross cash receipts and gross cash payments.

(b) Indirect method: net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The direct method is the preferred method because it discloses information, not available elsewhere in the financial statements, which could be of use in estimating future cash flows. The example below shows both methods.

1.9.1 Using the direct method

There are different ways in which the information about gross cash receipts and payments can be obtained. The most obvious way is simply to extract the information from the accounting records. This may be a laborious task, however, and the indirect method below may be easier.

1.9.2 Using the indirect method

This method is undoubtedly easier from the point of view of the preparer of the statement of cash flows. The net profit or loss for the period is adjusted for the following.

(a) Changes during the period in inventories, operating receivables and payables

(b) Non-cash items e.g. depreciation, provisions, profits/losses on the sales of assets

(c) Other items, the cash flows from which should be classified under investing or financing activities.

A proforma of such a calculation, taken from the IAS, is as follows;

	Shs.
Cash flows from operating activities	
Profit before taxation	X
Adjustments for:	
Depreciation	X
Foreign exchange loss	X
Investment income	(X)
Interest expense	X
	X
Increase in trade and other receivables	(X)
Decrease in inventories	X
Decrease in trade payables	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Net cash from operating activities	X

It is important to understand why certain items are added and others subtracted. Note the following:

(a) Depreciation is not a cash expense, but is deducted in arriving at profit. It makes sense, therefore, to eliminate it by adding it back.
(b) By the same logic, a loss on a disposal of a non-current asset (arising through under provision of depreciation) needs to be added back and a profit deducted.
(c) An increase in inventories means less cash – you have spent cash on buying inventory.
(d) An increase in receivables means the company's debtors have not paid as much, and therefore there is less cash.
(e) If we pay off payables, causing the figure to decrease, again we have less cash.

(a) Provision for bad debts.

These are just mere book keeping entries and does not involve payment out of cash. When preparing the profit and loss account an increase in the provision for bad debts is included in the expense hence reducing on the profit. Such increase must be added back to the profit. On the other hand, a decrease in the provision for bad debts is taken as an income which is added on the gross profit and hence increasing the net profit of the year yet the cash flow is not affected. Such decrease must be deducted from the operating profit when preparing the cash flow statement.

1.9.3 Indirect versus direct

The direct method is encouraged where the necessary information is not too costly to obtain, but IAS 7 does not require it. In practice the direct method is more commonly used, since it is quicker and easier.

1.10 Interest and dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period as either operating, investing or financing activities. Dividends paid by the entity can be classified in one of two ways.

(a) As a financing cash flow, showing the cost of obtaining financial resources
(b) *As a component of cash flows from operating activities so that users can assess the entity's ability to pay dividends out of operating cash flows.*

1.11 Taxes on income

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. Taxation cash flows are often difficult to match to the originating underlying transaction, so most of the time all tax cash flows are classified as arising from operating activities.

1.12 Components of cash and cash equivalents

The components of cash and cash equivalents should be disclosed and a reconciliation should be presented, showing the amounts in the statement of cash flows reconciled with the equivalent items reported in the statement of financial position. It is also necessary to disclose the accounting policy used in deciding the items included in cash and cash equivalents, in accordance with IAS 1 Presentation of financial Statements, but also because of the wide range of cash management practices worldwide.

1.13 Other disclosures

All entities should disclose, together with a commentary by management, any other information likely to be of importance, for example:

(a) Restrictions on the use of or access to any part of cash equivalents
(b) The amount of undrawn borrowing facilities which are available
(c) Cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity

1.14 PREPARING A STATEMENT OF CASH FLOW

You need to be aware of the format of the statement as laid out in IAS 7; setting out the format is an essential first stage in preparing the statement, so this format must be learnt. Note that the following items are treated in a way that might seem confusing, but the treatment is logical if you think in terms of cash.

(a) Increase in inventory is treated as negative (in brackets). This is because it represents a cash outflow; cash is being spent on inventory.

(b) An increase in receivables would be treated as negative for the same reasons; more receivables means less cash.

(c) By contrast an increase in payables is positive because cash is being retained and not used to settle accounts payable. There is therefore more of it.

1.14.1 PROFOMA CASH FLOW STATEMENTS (Indirect method) – IAS 7

	Shs	Shs
<u>**Cash flow from operating activities**</u>		
Operating profit/ loss before interest and tax		XX
Adjustment for non-cash items;		
Depreciation charge for the year	XX	
Amortization of intangible and fictitious assets	XX	
Loss / (gain) on disposal	<u>XX/(XX)</u>	<u>XX</u>
		XX
Change in working capital items;		
(Increase) / decrease in inventory	(XX)/XX	
Increase / (decrease) in provision for bad debts	XX/(XX)	
Increase / (decrease) accounts payable / accruals	XX/(XX)	
(Increase) / decrease in accounts receivable	(XX)/XX	
(Increase) / decrease in prepayments	<u>(XX)/XX</u>	
Cash generated from operations		XX
Interest paid		(XX)
Income taxes paid		<u>(XX)</u>
Net cash flow from operating activities		**XX**
<u>**Cash flow from investing activities**</u>		
Acquisition (or purchase) of non-current assets	(XX)	
Proceeds from sale of non-current assets	XX	
Interest received	XX	
Dividends received	<u>XX</u>	
Net cash flows from investing activities		**XX**
Cash flow from financing activities		
Proceeds from issue of shares (including share premium)	XX	
Proceeds from issue of debentures	XX	
Acquisition of long-term debt	XX	
Dividends paid*	(XX)	
Redemption of debentures	(XX)	
Repayment of loan	<u>(XX)</u>	
Net cash flows from financing activities		<u>**XX**</u>
Increase / (Decrease) in cash and cash equivalents		XX/(XX)
Add: Cash and cash equivalents b/d (Note 1)		<u>XX</u>
Cash and cash equivalents c/d (Note 2)		**XX**

∗ This could also be shown as an operating cash flow

NOTES

1. Analysis of cash and cash equivalents
2. When preparing the statement from comparative balance sheets you will usually have to calculate such items as depreciation, loss on sale of asset and profit for the year.
3. Work out the profit if not already given using opening and closing balances of retained earnings, interest expenses, tax charge and dividends.

Retained Earnings A/c: (vertical Format)

	Shs
Closing balances (P & L A/C) / Retained earnings	XX
Add back:	
Dividends (Proposed and paid)	XX
Provision for taxation	XX
Interest expenses	XX
Less:	
Opening balance (P & L a/c) / Retained earnings	(XX)
Profit for the year (PBIT)	**XX**

Where the profit for the year has been given in the statement of changes in equity; then the following adjustments can be made;

	Shs	**Shs**
Profit for the year		XX
Add:		
Taxation	XX	
Interest	XX	XX
		XX
Adjustment for errors in suspense A/c		
Add: - Expenses overstated	XX	
- Income understated	XX	XX
Less: - Expenses understated	XX	
- Income overstated	XX	XX
Profit before income and tax		XX

Activity 6.1 BIG BROTHER LTD

The statement of financial position, statement of changes in equity and other relevant information of Big Brother Ltd, for the year ended 31 October 2017 are as follows:

Statement of Financial Position as at 31 October

	2017		2016	
	Shs '000'	Shs '000	Shs '000'	Shs '000'
Assets:				
Non-current assets		228,000		183,000
Current assets:				
Inventory	216,000		229,500	
Receivables	394,500		306,000	
Prepayments	42,000		24,000	
Cash and cash equivalents	3,000		4,500	
		655,500		564,000
Total assets		**883,500**		**747,000**
Equity and liabilities:				
Capital and reserves:				
Ordinary shares	63,000		54,000	
Share premium	4,500		-	
Retained earnings	24,000		42,000	
		91,500		96,000
Non-current liabilities:				
Bank loan (2)	306,000		261,000	
Bank loan (1)	180,000		135,000	
		486,000		396,000
Current liabilities:				
Trade payables	181,500		145,500	
Installment due on loan (2)	81,000		81,000	
Bank overdraft	7,500			
Taxation	31,500		24,000	
Dividends	4,500		4,500	
		306,000		255,000
Total equity and liabilities		**883,500**		**747,000**

Statement of Changes in Equity

	Share Capital Shs '000'	Share premium Shs '000'	Retained earnings Shs '000'	Total Shs '000'
As at 1 November 2016	54,000	-	42,000	96,000
Profit for year			(13,500)	(13,500)
Dividend			(4,500)	(4,500)
Share issue	9,000	4,500	-	13,500,
As at 31 October 2017	63,000	4, 500	24,000	91,500

Additional information:

1. On 1 May 2017, Big Brother Ltd issued ordinary shares of par value of Shs 1,500 at Shs 2,250 per share.
2. During the year, the company acquired a new plant and equipment which was financed by the loans,
3. The company also disposed of small equipment which was no longer in use and had a net book value of Shs 9 million. Proceeds from the sale of equipment amounted to Shs 12 million.
4. Prepayments of Shs 3 million were incorrectly recorded as expenses.
5. The statement of profit or loss and other comprehensive income includes the following charges for the year:

	31 October 2017	31 October 2016
	Shs '000'	Shs '000'
Depreciation	27,000	22,500
Interest	31,500	25,500
Tax 7,500	6,000	

Required:

Prepare a statement of cash flows for Big Brother Ltd for the year ended 31 October 2017 in accordance with International Accounting Standard (IAS) 7: Statement of Cash Flows, using the indirect method,

1.14.2 PROFOMA CASH FLOW STATEMENTS (direct method) – IAS 7

	Shs	Shs
Cash flow from operating activities		
Cash receipts from customers	XX	
Cash paid to suppliers	(XX)	
Payment to and on behalf of staff	(XX)	
Payment for operating expenses	(XX)	
Cash flow from operations	XX	
Taxation	(XX)	
Interest paid	(XX)	
Net cash flow from operating activities		**XX**
Cash flow from investing activities		
Acquisition (or purchase) of non-current assets	(XX)	
Proceeds from disposal of non-current assets	XX	
Net cash flows from investing activities		XX
Cash flow from financing activities		
Issue of shares (including share premium)	XX	
Acquisition of long-term debt	XX	
Dividends paid	(XX)	
Redemption of debentures	(XX)	
Repayment of loan	(XX)	
Net cash flows from financing activities		XX
Increase / (Decrease) in cash and cash equivalents		XX/(XX)
Add: Cash and cash equivalents b/d		XX
Cash and cash equivalents c/d		**XX**

In the exam you may have a number of issues to deal with in the statement of cash flows. Examples are:

- **Share capital issues**. The proceeds will be split between share capital and share premium.
- **Bonus issues**. These do not involve cash.
- **Revaluation of non-current assets**. This must be taken into account in calculating acquisitions and disposals.
- **Movement on deferred tax**. This must be taken into account in calculating tax paid.
- **Finance leases**. Assets acquired under finance leases must be adjusted for in non-current asset calculations and the amount paid under the finance lease must appear as a cash flow.
- **Non-current assets** can include amounts for restoration/clean up costs which are not cash flows.

Activity 7.2 ZAM ZAM (U) Ltd

The following financial statements relate to Zam Zam (U) Ltd for the year ended 31 March 2017

Statement of Comprehensive Income:

	Shs'000'	Shs'000
Turnover		1,674,000
Cost of sales:		
Opening inventory	489,600	
Purchases	1,118,160	
Closing inventory	(511,200)	
Cost of sales		(1,096,560
Gross profit		577,440
Operating expenses:		
Salary expense	264,600	
Employee statutory expense	29,340	
Advertising expense	12,780	
Depreciation expense	68,400	
Sundry supplies expense	8,280	
Insurance expense	3,780	
Total operating expenses		(387,180
Income from operations		190,260
Interest expense		(36,000)
Income before income taxes		154,260
Income tax		(33,120)
Net Income		121,140

Statement of Financial Position as at 30 September:

		2017 Shs'000'	2016 Shs'000'
Assets:			
Non-current assets:			
Land		111,600	111,600
Building:	Cost	792,000	792,000
	accumulated depreciation	(388,800)	(345,600)
Equipment:	Cost	152,080	133,200
	accumulated depreciation	(94,480)	(49,840)
		572,400	641,360
Current assets:			
Inventory		511,200	489,600
Accounts receivable (net)		256,680	144,720
Prepaid insurance		1,620	1,980
Cash		89,460	66,060
		858,960	702,360

Total assets	1,431,360	1,343,720
Equity and liabilities:		
Share capital	621,900	584,300
Retained earnings	300,060	178,920
	921,960	763,220
Non-current liabilities:		
Loan mortgage	388,800	410,400
Current liabilities:		
Accounts payable	105,660	154,080
Salaries payable	7,560	8,820
Income tax payable	3,420	2,520
Interest payable	3,960	4,680
	120,600	170,100
Total equity and liabilities	1,431,360	1,343,720

Other transactions recorded by Zam Zam (U) Ltd:

(i) Paid a loan installment of Shs 38,880,000 on the loan mortgage.

(ii) Received payments from issue of shares, Shs 37.6 million having a par value of Shs 20 million.

Required:

Prepare a statement of cash flows for Zam Zam (U) Ltd for the year ended 31 March 2017 in accordance with IAS 7: Statement of Cash Flows, using the direct method.

1.14.3 The advantages of cash flow accounting

The advantages of cash flow accounting are as follows.

(a) Survival in business depends on the ability to generate cash. Cash flow accounting directs attention towards this critical issue.

(b) Cash flow is more comprehensive that 'profit' which is dependent on accounting conventions and concepts.

(c) Creditors (long and short-term) are more interested in an entity's ability to repay them than in its profitability. Whereas 'profits' might indicate that cash is likely to be available, cash flow accounting is more direct with its message.

(d) Cash flow reporting provides a better means of comparing the results of different companies than traditional profit reporting.

(e) Cash flow reporting satisfies the needs of all users better.

  (i) For management, it provides the sort of information on which decisions should be taken (in management accounting, relevant costs' to a decision are future cash flows); traditional profit accounting does not help with decision-making.

  (ii) For shareholders and auditors, cash flow accounting can provide a satisfactory basis for stewardship accounting.

  (iii) As described previously, the information needs of creditors and employees will be better served by cash flow accounting.

(f) Cash flow forecasts are easier to prepare, as well as more useful, than profit forecasts.

(g) They can in some respects be audited more easily than accounts based on the accruals concept.

(h) The accruals concept is confusing, and cash flows are more easily understood.

(i) Cash flow accounting should be both retrospective, and also include a forecast for the future. This is of great information value to all users of accounting information.

(j) Forecasts can subsequently be monitored by the publication of variance statements which compare actual cash flows against the forecast.

PRACTICE QUESTIONS

QUESTION 7.1 UGABRO LTD

Ugabro Construction Company Ltd (UCCL) controls a number of construction companies. It prepares its financial statements together with those of the group to 31 March of each year. You are the newly recruited accountant of UCCL and you have been provided with the following group consolidated financial information for the year ended 31 March:

Statement of financial position

	2017		2016	
	Shs 'million'	Shs 'million'	Shs 'million'	Shs 'million'
Assets:				
Non-current assets		4,560		3,660
Current assets:				
Inventory	4,320		4,590	
Receivables	7,890		6,120	
Prepayments	840		480	
Cash and cash equivalents	60	13,110	90	11,280
Total assets		17,670		14,940
Equity and liabilities:				
Capital and reserves:				
Ordinary shares	1,260		1,080	
Share premium	90		-	
Revaluation reserve	900		-	
Retained earnings	480	2,730	840	1,920
Non-current liabilities:				
Long-term borrowings	4,600		4,600	
Non-current portion of lease obligations	580		600	
Bank loan	3,600	8,780	2,700	7,900
Current liabilities:				
Trade payables	3,630		2,910	
Current portion of long-term borrowings	1,620		1,620	
Current portion of lease obligations	40		20	
Bank overdraft	150		-	
Taxation	630		480	
Dividends	90	6,160	90	5,120
Total equity and liabilities		17,670		14,940

Statement of changes in equity

	Share capital	Share premium	Retained earnings	Total
	Shs 'million'	Shs 'million'	Shs 'million'	Shs 'million'
As at 1 April, 2016	1,080	-	840	1,920
Profit/ (loss) for the year			(270)	(270)
Dividends			(90)	(90)
Share issue	180	90		270
As at 31 March, 2017	1,260	90	480	1,830

Additional information:

1. The head office building of UCCL was constructed on a 49 year operating leasehold land of annual installment payments of Shs 20 million.
2. On 1 October, 2016 UCCL issued ordinary shares of par value of Shs 150,000 at Shs 225,000 per share.
3. During the year, UCCL acquired a number of new plant and equipment which were financed by the bank loan. These are yet to be depreciated.
4. Included in the non-current assets are the following items:

	Leasehold land	Plant	Equipment	Motor vehicles	Total
Cost/ valuation	Shs '000'	Shs '000'	Shs '000'	Shs '000'	Shs '000'
Balance 1 April, 2015	980,000	1,200,000	600,000	2,000,000	4,780,000
Acquisitions	-	400,000	-	500,000	900,000
Disposals	-	-	(200,000)	-	(200,000)
Balance 31 March, 2016	980,000	1,600,000	400,000	2,500,000	5,480,000
Acquisitions	-	500,000	400,000		900,000
Revaluation	-	550,000	300,000	50,000	900,000
Impairment	-	(351,000)	-		(351,000)
Disposals	-	-	(25,000)	-	(25,000)
Balance 31 March, 2017	980,000	2,299,000	1,075,000	2,550,000	6,904,000
Depreciation:					
Balance 1 April, 2015	360,000	545,000	40,000	625,000	1,570,000
Depreciation & amortisation	20,000	210,000	77,500	142,500	450,000
Disposals	-	-	(20,000)	-	(20,000)
Balance 31 March, 2016	380,000	755,000	97,500	767,500	2,000,000
Depreciation & amortisation	20,000	210,000	77,500	232,500	540,000
Disposals	-	-	(16,000)	-	(16,000)
Balance 31 March, 2017	400,000	965,000	159,000	1,000,000	2,524,000

5. UCCL also disposed of some equipment which was no longer in use with a net book value of Shs 9 million for Shs 12 million.

6. A review of the plant and equipment acquired during the year revealed that part of the equipment was impaired by Shs 351 million on 28 December, 2016 and as a result, all the non-current assets were revalued leading to a revaluation surplus of Shs 900 million.

7. Prepayments made by UCCL of Shs 60 million were incorrectly recorded as expenses.

8. The statement of profit or loss and other comprehensive income includes the following charges for the year:

	2017	2016
	Shs 'million'	Shs 'million'
Depreciation & amortisation	540	450
Interest	630	510
Tax	150	120

Required:

Prepare:

(a) a statement of cash flows for UCCL group for the year ended 31 March, 2017 in accordance with IAS 7: Statement of Cash Flows, using the indirect method.

(25 marks)

(b) notes to the statement of cash flows in (a) above to include the related parties, property, plant and equipment, leases, going concern, contingent liabilities and borrowings, among others.

(15 marks)

QUESTION 7.2 HUSKY INVESTMENTS

Husky Investments Company Limited. (HICL) has been in operation for 5 years since its incorporation and deals in a wide range of products ranging from household items to manufacturing. The clientele of HICL has increased over time and management wishes to expand its areas of operation. In order to achieve this, they are considering obtaining a loan. They have been advised by their bankers to provide the company's most recent statement of cash flows, among other things, before their loan request could be considered.

The management of HICL have been informed that you have sufficient expertise in matters of financial reporting. They have sought your advice and have made available to you the following extracts from HICL's financial statements for the year ended 31 March:

	2019	2018
Assets:	Shs '000'	Shs '000'
Non-current assets:		
Property, plant & equipment (PPE)	640,000	560,000
Investment in associate	176,000	115,000
Brand name	90,000	120,000
	906,000	795,000
Current assets	729,000	345,000
Total assets	1,635,000	1,140,000
Equity:		
Share capital	550,000	500,000
Retained earnings	498,000	255,000
	1,048,000	755,000
Non-current liabilities:		
Borrowings	138,000	98,000
Provision for employee benefits	100,000	55,000
	238,000	153,000
Current liabilities	349,000	232,000
Total equity & liabilities	1,635,000	1,140,000

Additional information:

1. Analysis of HICL's books of account established the breakdown of PPE as follows:

Item	2019 Shs '000'	2018 Shs '000'
Land	120,000	100,000
Plant	710,000	600,000
Accumulated depreciation	(190,000)	(140,000)

During the year ended 31 March, 2019 HICL disposed of part of plant that had cost Shs 60 million with accumulated depreciation Shs 20 million at a profit of Shs 12 million. A revaluation of land carried out on 31 March, 2019 established that its fair value was the same as its book value.

2. The following is a breakdown of current assets and current liabilities reported in the financial statements:

Current assets:

Asset	2019 Shs '000'	2018 Shs '000'
Cash at bank	402,000	70,000
Accounts receivable	181,000	75,000
Inventories	146,000	200,000
	729,000	345,000

Current liabilities:

Liability	2019 Shs '000'	2018 Shs '000'
Accounts payable	206,000	180,000
Interest payable	21,000	12,000
Current tax payable	122,000	40,000
	349,000	232,000

3. For the year ended 31 march, 2019 the tax authorities assessed HICL Shs 118 million as tax for the year. Interest expense for the year was Shs 10 million, and HICL paid Shs 80 million in dividends.
4. There were neither acquisitions nor disposals of intangible assets during the year.

Required:

(a) Prepare for HICL, a statement of cash flows for the year ended 31 March, 2019 using the indirect method.

QUESTION 7.3 KINGDOM Co

Kingdom is a public listed manufacturing company. Its draft summarised financial statements for the year ended 30 September 2016 (and 2015 comparatives) are:
Statements of profit or loss and other comprehensive income for the year ended 30 September:

	2016	2015
	Shs'000	**Shs'000**
Revenue	44,900	44,000
Cost of sales	(31,300)	(29,000)
Gross profit	13,600	15,000
Distribution costs	(2,400)	(2,100)
Administrative expenses	(7,850)	(5,900)
Investment properties – rentals received	350	400
– fair value changes	(700)	500
Finance costs	(600)	(600)
Profit before taxation	2,400	7,300
Income tax	(600)	(1,700)
Profit for the year	1,800	5,600
Other comprehensive income	(1,300)	1,000
Total comprehensive income	500	6,600

Statements of financial position as at 30 September:

		2016		2015
	Shs'000	**Shs'000**	**Shs'000**	**Shs'000**
Assets				
Non-current assets				
Property, plant and equipment		26,700		25,200
Investment properties		4,100		5,000
		30,800		**30,200**
Current assets				
Inventory	2,300		3,100	
Trade receivables	3,000		3,400	
Bank	nil	5,300	300	6,800
Total assets		**36,100**		**37,000**
Equity and liabilities				
Equity				
Equity shares of Shs1 each		17,200		15,000
Revaluation reserve		1,200		2,500
Retained earnings		7,700		8,700
		26,100		26,200
Non-current liabilities				
12% loan notes		5,000		5,000

Current liabilities				
Trade payables	4,200		3,900	
Accrued finance costs	100		50	
Bank	200		nil	
Current tax payable	500	5,000	1,850	5,800
Total equity and liabilities		**36,100**		**37,000**

The following information is relevant:

(i) On 1 July 2016, Kingdom acquired a new investment property at a cost of Shs1·4 million. On this date, it also transferred one of its other investment properties to property, plant and equipment at its fair value of Shs1·6 million as it became owner-occupied on that date. Kingdom adopts the fair value model for its investment properties.

(ii) Kingdom also has a policy of revaluing its other properties (included as property, plant and equipment) to market value at the end of each year. Other comprehensive income and the revaluation reserve both relate to these properties.

(iii) Depreciation of property, plant and equipment during the year was Shs1·5 million. An item of plant with a carrying amount of Shs2·3 million was sold for Shs1·8 million during September 2016.

Required:
Prepare the statement of cash flows for Kingdom for the year ended 30 September 2016 in accordance with IAS 7 Statement of Cash Flows using the indirect method.

Business Combinations

7.0
IFRS 3 "*BUSINESS COMBINATIONS*"

UNIT 7 OVERVIEW

- Scope
- Key Definitions
- Determining a business Combination
- Method of Accounting
- Measurement Period
- Other Apects

1.1 OBJECTIVE

IFRS 3 seeks to enhance the relevance, reliability and comparability of information provided about business combinations (e.g. acquisitions and mergers) and their effects. It sets out the principles on the recognition and measurement of acquired assets and liabilities, the determination of goodwill and the necessary disclosures.

1.2 KEY DEFINITIONS

1.1.1 Business combination

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also business combinations.

1.1.2 Business

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

1.1.3 Acquisition date

The date on which the acquirer obtains control of the acquiree.

1.1.4 Acquirer

The entity that obtains control of the acquiree.

1.1.5 Acquiree

The business or businesses that the acquirer obtains control of in a business combination.

1.2 SCOPE

IFRS 3 must be applied when accounting for business combinations, but does not apply to:

- The formation of a joint venture.
- The acquisition of an asset or group of assets that is not a business, although general guidance is provided on how such transactions should be accounted for.
- Combinations of entities or businesses under common control (the IASB has a separate agenda project on common control transactions).
- Acquisitions by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss under IFRS 10 Consolidated Financial Statements.

1.3 DETERMINING WHETHER A TRANSACTION IS A BUSINESS COMBINATION

IFRS 3 provides additional guidance on determining whether a transaction meets the definition of a business combination, and so accounted for in accordance with its requirements. This guidance includes:

- Business combinations can occur in various ways, such as by transferring cash, incurring liabilities, issuing equity instruments (or any combination thereof), or by not issuing consideration at all (i.e. by contract alone).

- Business combinations can be structured in various ways to satisfy legal, taxation or other objectives, including one entity becoming a subsidiary of another, the transfer of net assets from one entity to another or to a new entity.

- The business combination must involve the acquisition of a business, which generally has three elements:

(i) **Inputs** – an economic resource (e.g. non-current assets, intellectual property) that creates outputs when one or more processes are applied to it.

(ii) **Process** – a system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs (e.g. strategic management, operational processes, resource management).

(iii) **Output** – the result of inputs and processes applied to those inputs.

1.4 METHOD OF ACCOUNTING FOR BUSINESS COMBINATIONS

1.4.1 Acquisition method

The acquisition method (called the 'purchase method' in the 2004 version of IFRS 3) is used for all business combinations. Steps in applying the acquisition method are:

Step 1: Identification of the 'acquirer'

S**tep 2:** Determination of the 'acquisition date'

Step 3: Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest (NCI, formerly called minority interest) in the acquire.

Step 4: Recognition and measurement of goodwill or a gain from a bargain purchase.

1.4.2 Identifying an acquirer

The guidance in IFRS 10 Consolidated Financial Statements is used to identify an acquirer in a business combination, i.e. the entity that obtains 'control' of the acquiree.

If the guidance in IFRS 10 does not clearly indicate which of the combining entities is an acquirer, IFRS 3 provides additional guidance which is then considered:

- The acquirer is usually the entity that transfers cash or other assets where the business combination is effected in this manner.

- The acquirer is usually, but not always, the entity issuing equity interests where the transaction is effected in this manner, however the entity also considers other pertinent facts and circumstances including:

(i) relative voting rights in the combined entity after the business combination.
(ii) the existence of any large minority interest if no other owner or group of owners has a significant voting interest.
(iii) the composition of the governing body and senior management of the combined entity.
(iv) the terms on which equity interests are exchanged.

- The acquirer is usually the entity with the largest relative size (assets, revenues or profit).

- For business combinations involving multiple entities, consideration is given to the entity initiating the combination, and the relative sizes of the combining entities.

1.4.3 Acquisition date

An acquirer considers all pertinent facts and circumstances when determining the acquisition date, i.e. the date on which it obtains control of the acquiree. The acquisition date may be a date that is earlier or later than the closing date.

1.4.4 Acquired assets and liabilities

IFRS 3 establishes the following principles in relation to the recognition and measurement of items arising in a business combination:

- **Recognition principle**. Identifiable assets acquired, liabilities assumed, and non-controlling interests in the acquiree, are recognised separately from goodwill.

- **Measurement principle**. All assets acquired and liabilities assumed in a business combination are measured at acquisition-date fair value.

1.4.5 Exceptions to the recognition and measurement principles

The following exceptions to the above principles apply:
- **Contingent liabilities** – the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets do not apply to the recognition of contingent liabilities arising in a business combination
- **Income taxes –** the recognition and measurement of income taxes is in accordance with IAS 12 Income Taxes.
- **Employee benefits –** assets and liabilities arising from an acquiree's employee benefits arrangements are recognised and measured in accordance with IAS 19 Employee Benefits(2011).
- **Indemnification assets -** an acquirer recognises indemnification assets at the same time and on the same basis as the indemnified item.
- **Reacquired rights –** the measurement of reacquired rights is by reference to the remaining contractual term without renewals.
- **Share-based payment transactions -** these are measured by reference to the method in IFRS 2 Share-based Payment.
- **Assets held for sale** – IFRS 5 Non-current Assets Held for Sale and Discontinued Operations is applied in measuring acquired non-current assets and disposal groups classified as held for sale at the acquisition date**.**

In applying the principles, an acquirer classifies and designates assets acquired and liabilities assumed on the basis of the contractual terms, economic conditions, operating and accounting policies and other pertinent conditions existing at the acquisition date. For example, this might include the identification of derivative financial instruments as hedging instruments, or the separation of embedded derivatives from host contracts.

However, exceptions are made for lease classification (between operating and finance leases) and the classification of contracts as insurance contracts, which are classified on the basis of conditions in place at the inception of the contract.

Acquired intangible assets must be recognised and measured at fair value in accordance with the principles if it is separable or arises from other contractual rights, irrespective of whether the acquiree had recognised the asset prior to the business combination occurring. This is because there is always sufficient information to reliably measure the fair value of these assets. There is no 'reliable measurement' exception for such assets, as was present under IFRS 3 (2004).

1.4.6 Goodwill

Goodwill is measured as the difference between:

- the aggregate of (i) the value of the consideration transferred (generally at fair value), (ii) the amount of any non-controlling interest (NCI, see below), and (iii) in a business combination achieved in stages (see below), the acquisition-date fair value of the acquirer's previously-held equity interest in the acquiree, and

- the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed (measured in accordance with IFRS 3).

- This can be written in simplified equation form as follows:

Goodwill	=	Consideration transferred	+	Amount of non-controlling interests	+	Fair value of previous equity interests	-	Net assets recognised

In its vertical format this can be determined as;

	Shs	Shs
Fair value of consideration transferred		XX
Plus fair value of NCI at acquisition		XX
Less net acquisition date fair value of identifiable assets acquired and liabilities assumed		
Ordinary share capital	XX	
Share premium	XX	
Retained earnings at acquisition	XX	
Fair value adjustments at acquisition	XX	(XX)
Goodwill		XX

Activity 7.1

On 1 January, 2017 ABC Ltd acquired 134,400 shares in XYZ Ltd in exchange for cash of shs. 473 million when XYZ Ltd's retained earnings stood at shs 10 million. It is the group's policy to value non-controlling interest at fair value and for that matter, the fair value of non-controlling interest at acquisition was shs. 80 million.

The equity section of XYZ Ltd's statement of financial position as at 31 December 2017 is given as below;

	shs "000"
Share capital (shs 1,000 per share)	224,000
Share premium	224,000
Retained Earnings	344,000
	792,000

Additional Information:

(i) When ABC Ltd acquired its shares in XYZ Ltd the fair value of XYZ Ltd's net assets equaled their book values with the exception of a plant whose fair value was shs 30 above its carrying amount.

(ii) Goodwill impairment of shs 40 million was identified by 31 December 2017.

Required

(i) Draft the group structure and compute the percentage of control

(ii) Determine the goodwill that should be recognised in the books of ABC Group as at 31 December 2017.

1.4.7 Negative Goodwill

If the difference above is negative, the resulting **gain is a bargain purchase** in profit or loss, which may arise in circumstances such as a forced seller acting under compulsion.

However, before any bargain purchase gain is recognised in profit or loss, the acquirer is required to undertake a review to ensure the identification of assets and liabilities is complete, and that measurements appropriately reflect consideration of all available information.

Activity 7.2

On 30 June, 2017 Golola Ltd acquired 70% of the equity interest of Tugume Ltd in exchange for cash Shs 170 million. The former owners of Tugume Ltd needed to dispose of their investment in Tugume Ltd by a specified date. Therefore they did not have sufficient time to market Tugume Ltd to multiple potential buyers. The management of Golola Ltd initially measure the separately recognisable identifiable assets acquired and liabilities assumed as of the acquisition date in accordance with the provisions of IFRS 3: Business Combinations. The identifiable assets in Tugume Ltd were measured at Shs 380 million and the liabilities at Shs 80 million. Golola Ltd engaged an independent auditor who determined that the fair value of the 30% non-controlling interest in Tugume Ltd was She 62 million.

Required:

(i) Determine the gain on bargain purchase of the 70% interest in Tugume Ltd.

(ii) By use of journal entries, show how Golola Ltd would record its acquisition of Tugume Ltd in its consolidated financial statements.

1.4.8 Choice in the measurement of non-controlling interests (NCI)

IFRS 3 allows an accounting policy choice, available on a transaction by transaction basis, to measure non-controlling interests (NCI) either at:

- fair value (sometimes called the full goodwill method), or
- the NCI's proportionate share of net assets of the acquiree.

The choice in accounting policy applies only to present ownership interests in the acquiree that entitle holders to a proportionate share of the entity's net assets in the event of a liquidation (e.g. outside holdings of an acquiree's ordinary shares). Other components of non-controlling interests at must be measured at acquisition date fair values or in accordance with other applicable IFRSs (e.g. share-based payment transactions accounted for under IFRS 2 Share-based Payment).

MEASUREMENT PERIOD

If the initial accounting for a business combination can be determined only provisionally by the end of the first reporting period, the business combination is accounted for using provisional amounts. Adjustments to provisional amounts, and the recognition of newly identified asset and liabilities, must be made within the 'measurement period' where they reflect new information obtained about facts and circumstances that were in existence at the acquisition date. [IFRS 3.45] The measurement period cannot exceed one year from the acquisition date and no adjustments are permitted after one year except to correct an error in accordance with IAS 8.

1.5 RELATED TRANSACTIONS AND SUBSEQUENT ACCOUNTING

1.5.1 General principles

In general:

- transactions that are not part of what the acquirer and acquiree (or its former owners) exchanged in the business combination are identified and accounted for separately from business combination

- the recognition and measurement of assets and liabilities arising in a business combination after the initial accounting for the business combination is dealt with under other relevant standards, e.g. acquired inventory is subsequently accounted under IAS 2 Inventories.

When determining whether a particular item is part of the exchange for the acquiree or whether it is separate from the business combination, an acquirer considers the reason for the transaction, who initiated the transaction and the timing of the transaction.

1.5.2 Contingent consideration

Contingent consideration must be measured at fair value at the time of the business combination and is taken into account in the determination of goodwill. If the amount of contingent consideration changes as a result of a post-acquisition event (such as meeting an earnings target), accounting for the change in consideration depends on whether the additional consideration is classified as an equity instrument or an asset or liability:

- If the contingent consideration is classified as an equity instrument, the original amount is not remeasured
- If the additional consideration is classified as an asset or liability that is a financial instrument, the contingent consideration is measured at fair value and gains and losses are recognised in either profit or loss or other

comprehensive income in accordance with IFRS 9 Financial Instruments orIAS 39 Financial Instruments: Recognition and Measurement.

- If the additional consideration is not within the scope of IFRS 9 (or IAS 39), it is accounted for in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets or other IFRSs as appropriate.

Where a change in the fair value of contingent consideration is the result of additional information about facts and circumstances that existed at the acquisition date, these changes are accounted for as measurement period adjustments if they arise during the measurement period (see above).

1.5.3 Acquisition costs

Costs of issuing debt or equity instruments are accounted for under IAS 32 Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement/IFRS 9 Financial Instruments. All other costs associated with an acquisition must be expensed, including reimbursements to the acquiree for bearing some of the acquisition costs. Examples of costs to be expensed include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; and general administrative costs, including the costs of maintaining an internal acquisitions department.

1.6 DISCLOSURE

1.6.1 Disclosure of information about current business combinations

An acquirer is required to disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the end of the period but before the financial statements are authorised for issue.

Among the disclosures required to meet the foregoing objective are the following:

- name and a description of the acquiree
- acquisition date
- percentage of voting equity interests acquired
- primary reasons for the business combination and a description of how the acquirer obtained control of the acquiree
- description of the factors that make up the goodwill recognised
- qualitative description of the factors that make up the goodwill recognised, such as expected synergies from combining operations, intangible assets that do not qualify for separate recognition
- acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration
- details of contingent consideration arrangements and indemnification assets
- details of acquired receivables
- the amounts recognised as of the acquisition date for each major class of assets acquired and liabilities assumed
- details of contingent liabilities recognised
- total amount of goodwill that is expected to be deductible for tax purposes
- details about any transactions that are recognised separately from the acquisition of assets and assumption of liabilities in the business combination
- information about a bargain purchase
- information about the measurement of non-controlling interests
- details about a business combination achieved in stages
- information about the acquiree's revenue and profit or loss
- information about a business combination whose acquisition date is after the end of the reporting period but before the financial statements are authorised for issue

1.6.2 Disclosure of information about adjustments of past business combinations

An acquirer is required to disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods. Among the disclosures required to meet the foregoing objective are the following:

- details when the initial accounting for a business combination is incomplete for particular assets, liabilities, non-controlling interests or items of consideration (and the amounts recognised in the financial statements for the business combination thus have been determined only provisionally).
- follow-up information on contingent consideration.
- follow-up information about contingent liabilities recognised in a business combination.
- a reconciliation of the carrying amount of goodwill at the beginning and end of the reporting period, with various details shown separately.
- the amount and an explanation of any gain or loss recognised in the current reporting period that both:
- relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period, and

- is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements.

Consolidated Financial Statements

8.0 IFRS 10 "*CONSOLIDATED FINANCIAL STATEMENTS*"

UNIT 8 OVERVIEW

- Objective of IFRS 10
- Key definitions
- Accounting Requirements
- Investment entities consolidation exemption.
- Disclosure requirements

1.1 OBJECTIVE OF IFRS 10

The objective of IFRS 10 is to establish principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities.

The Standard:

- requires a parent entity (an entity that controls one or more other entities) to present consolidated financial statements.
- defines the principle of control, and establishes control as the basis for consolidation
- set out how to apply the principle of control to identify whether an investor controls an investee and therefore must consolidate the investee.
- sets out the accounting requirements for the preparation of consolidated financial statements
- defines an investment entity and sets out an exception to consolidating particular subsidiaries of an investment entity*.

KEY DEFINITIONS

1.1.1 Consolidated financial statements

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

1.1.2 Control of an investee

An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

1.1.3 Investment entity

An entity that:

a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services.
b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both, and
c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

1.1.4 Parent
An entity that controls one or more entities

1.1.5 Power
Existing rights that give the current ability to direct the relevant activities

1.1.6 Protective rights
Rights designed to protect the interest of the party holding those rights without giving that party power over the entity to which those rights relate.

1.1.7 Relevant activities
Activities of the investee that significantly affect the investee's returns.

1.1.8 Control
An investor determines whether it is a parent by assessing whether it controls one or more investees. An investor considers all relevant facts and circumstances when assessing whether it controls an investee. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

An investor controls an investee if and only if the investor has all of the following elements:

- power over the investee, i.e. the investor has existing rights that give it the ability to direct the relevant activities (the activities that significantly affect the investee's returns)
- exposure, or rights, to variable returns from its involvement with the investee
- the ability to use its power over the investee to affect the amount of the investor's returns.

Power arises from rights. Such rights can be straightforward (e.g. through voting rights) or be complex (e.g. embedded in contractual arrangements). An investor that holds only protective rights cannot have power over an investee and so cannot control an investee. An investor must be exposed, or have rights, to variable returns from its involvement with an investee to control the investee. Such returns must have the potential to vary as a result of the investee's performance and can be positive, negative, or both.

A parent must not only have power over an investee and exposure or rights to variable returns from its involvement with the investee, a parent must also have the ability to use its power over the investee to affect its returns from its involvement with the investee.

When assessing whether an investor controls an investee an investor with decision-making rights determines whether it acts as principal or as an agent of other parties. A number of factors are considered in making this assessment. For instance, the remuneration of the decision-maker is considered in determining whether it is an agent.

1.2 ACCOUNTING REQUIREMENTS

1.2.1 Preparation of consolidated financial statements

A parent prepares consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances.

However, a parent need not present consolidated financial statements if it meets all of the following conditions:

- it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements.
- its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets).

- it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and
- its ultimate or any intermediate parent of the parent produces financial statements available for public use that comply with IFRSs, in which subsidiaries are consolidated or are measured at fair value through profit or loss in accordance with IFRS 10.

Investment entities are prohibited from consolidating particular subsidiaries (see further information below). Furthermore, post-employment benefit plans or other long-term employee benefit plans to which IAS 19 Employee Benefits applies are not required to apply the requirements of IFRS 10.

1.2.2 Consolidation procedures

Consolidated financial statements:

- combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
- offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (IFRS 3 Business Combinations explains how to account for any related goodwill).
- eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full).

A reporting entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the reporting entity ceases to control the subsidiary. Income and expenses of the subsidiary are based on the amounts of the assets and liabilities recognised in the consolidated financial statements at the acquisition date.

The parent and subsidiaries are required to have the same reporting dates, or consolidation based on additional financial information prepared by subsidiary, unless impracticable. Where impracticable, the most recent financial statements of the subsidiary are used, adjusted for the effects of significant transactions or events between the reporting dates of the subsidiary and consolidated financial statements. The difference between the date of the subsidiary's financial statements and that of the consolidated financial statements shall be no more than three months.

1.2.3 Non-controlling interests (NCIs)

A parent presents non-controlling interests in its consolidated statement of financial position within equity, separately from the equity of the owners of the parent. A reporting entity attributes the profit or loss and each component of other comprehensive income to the owners of the parent and to the non-controlling interests. The proportion allocated to the parent and non-controlling interests are determined on the basis of present ownership interests. The reporting entity also attributes total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.

1.2.4 Changes in ownership interests

Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e. transactions with owners in their capacity as owners). When the proportion of the equity held by non-controlling interests changes, the carrying amounts of the controlling and non-controlling interests area adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent.

If a parent loses control of a subsidiary, the parent:

- derecognises the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
- recognises any investment retained in the former subsidiary when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant IFRSs. That retained interest is remeasured and the remeasured value is regarded as the fair value on initial recognition of a financial asset in accordance with IFRS 9Financial Instruments or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.
- recognises the gain or loss associated with the loss of control attributable to the former controlling interest.

If a parent loses control of a subsidiary that does not contain a business in a transaction with an associate or a joint venture gains or losses resulting from those transactions are recognised in the parent's profit or loss only to the extent of the unrelated investors' interests in that associate or joint venture.

1.3 INVESTMENT ENTITIES CONSOLIDATION EXEMPTION

IFRS 10 contains special accounting requirements for investment entities. Where an entity meets the definition of an 'investment entity' (see above), it does not consolidate its subsidiaries, or apply IFRS 3Business Combinations when it obtains control of another entity.

An entity is required to consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. IFRS 10 provides that an investment entity should have the following typical characteristics:

- it has more than one investment
- it has more than one investor
- it has investors that are not related parties of the entity
- it has ownership interests in the form of equity or similar interests.

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity.

An investment entity is required to measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement.

However, an investment entity is still required to consolidate a subsidiary where that subsidiary provides services that relate to the investment entity's investment activities.

Because an investment entity is not required to consolidate its subsidiaries, intragroup related party transactions and outstanding balances are not eliminated.
Special requirements apply where an entity becomes, or ceases to be, an investment entity.

The exemption from consolidation only applies to the investment entity itself. Accordingly, a parent of an investment entity is required to consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

1.4 DISCLOSURE

There are no disclosures specified in IFRS 10. Instead, IFRS 12 Disclosure of Interests in Other Entities outlines the disclosures required.

Activity 8.1 HEAD GROUPS

HEAD Co. secured a majority equity shareholding in FOOT Co. on 1st January 2017 by making an immediate payment of Shs. 5 per share. The summarised statements of financial position of the two companies at 31 December 2017 are presented as below:

	Head Co.	Foot Co.
Assets	**Shs "000"**	**Shs "000"**
Non-current assets:		
Property, plant and equipment	55,000	31,000
Intangible assets	7,500	-
Investment in Foot Co: *(7.5 million shares @ shs. 5 each)*	37,500	
	100,000	**31,000**
Current Assets:		
Inventory	11,200	8,400
Trade Receivables	7,400	5,300
Bank	3,400	-
	22,000	13,700
Total assets	**122,000**	**44,700**
Equity and liabilities:		
Equity shares of Shs 1 each	50,000	10,000
Retained earnings - *at 1 January 2017*	25,700	12,000
- at 31 December 2017	9,200	6,000
Total Equity	**84,900**	**28,000**
Liabilities:		
Non-current Liabilities:		
Deferred tax	25,000	8,000
Current Liabilities:		
Trade payables	12,100	6,200
Bank overdraft	-	2,500
Total Liabilities	**37,100**	**16,700**
Total Equity and Liabilities	**122,000**	**44,700**

The following information is relevant:

(i) HEAD’s policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose the directors of HEAD Co. considered a share price for FOOT Co. of shs. 4 per share to be appropriate.

(ii) At the date of acquisition, the fair values of FOOT Co’s property, plant and equipment was equal to its carrying amount with the exception of a plant which had a fair value of Shs. 5 million above its carrying amount. At that date the plant had a remaining life of five years. FOOT Co. uses straight-line depreciation for plant assuming a nil residual value.

(iii) Also at the date of acquisition, HEAD Co. valued FOOT Co’s customer relationships as a customer base intangible asset at fair value of Shs. 4 million. FOOT Co. has not accounted for this asset. Trading relationships with FOOT Co’s customers last on average for eight years.

(iv) At 31 December 2017, FOOT Co’s inventory included goods bought from HEAD Co (at cost to FOOT Co) of Shs.2 million. HEAD Co. had marked up these goods by 25% on cost. HEAD Co.’s agreed current account balance owed by FOOT Co. at 31 December 2017 was Shs1·2 million.

(v) Impairment tests were carried out on 31 December 2017 which concluded that consolidated goodwill was not impaired.

(vi) All profits accrued evenly throughout the year.

Required:
Prepare the consolidated statement of financial position for HEAD group of companies as at 31 December 2017.

The consolidated statement of profit or loss and other comprehensive income

OUTLINE:
- The consolidated statement of profit or loss
- The consolidated statement of profit or loss and other comprehensive income

1.5 The consolidated statement of profit or loss

The source of the consolidated statement of profit or loss is the individual statements of profit or loss of the separate companies in the group.

1.6 Consolidated procedure

It is customary in practice to prepare a working paper (known as a consolidated schedule) on which the individual statements of profit or loss are set out side by side and totaled to form the basis of the consolidated statement of profit or loss.

In the consolidated statement of profit or loss, non-controlling interest is brought in as a one-line adjustment at the end of the statement.

1.7 Intra-group trading

Intra-group sales and purchases are eliminated from the consolidated statement of profit or loss.

Like the consolidated statement of financial position, the consolidated statement of profit or loss should deal with the results of the group as those of a single entity. When one company in a group sells goods to another the relevant amount is added to the sales revenue of the first company and to the cost of sales of the second. Yet as far as the entity's dealings with outsiders are concerned no sale has taken place.

The consolidated figures for sales revenue and cost of sales should represent sales to, and purchases from, outsiders. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figures by the value of intra-group sales during the year.

Just as in the case of a consolidated statement of financial position, any unrealized profits on intra-group trading should be excluded from the figure for group profits. This will occur whenever goods sold at a profit within the group remain in the inventory of the purchasing company at the year end. The best way to deal with this is to calculate the unrealized profit on unsold inventories at the year end and reduce consolidated gross profit by this amount. Cost of sales will be the balancing figure.

1.8 Intra-group dividends

In our example so far we have assumed that the Subsidiary company retains all of its after-tax profit. It may be, however, that Subsidiary Company distributes some of its profits as dividends. As before, the non-controlling interest in the subsidiary's profit should be calculated immediately after the figure of after-tax profit. For this purpose, no account need be taken of how much of the non-controlling interest is to be distributed by Subsidiary Company as dividend.

Note that group retained earnings are only adjusted for dividends paid to the parent company shareholders. Dividends paid by the subsidiary to the parent are cancelled on consolidation and dividends paid to the non-controlling interest are replaced by the allocation to the non-controlling interest of their share of the profit for the year of the subsidiary.

1.9 Pre-acquisition profits

Only the post-acquisition profits of the subsidiary are brought into the consolidated profit or loss.

As explained above, the figure for retained earnings carried forward must be the same as the figure for retained earnings in the consolidated statement of financial position. We have seen in previous units that retained earnings in the consolidated statement of financial position comprise:

a) The whole of the parent company's retained earnings
b) A proportion of the subsidiary company's retained earnings. The proportion is the group's share of post-acquisition retained earnings in the subsidiary. From the total retained earnings of the subsidiary we must therefore exclude both the non-controlling share of total retained earnings and the group's share of pre-acquisition retained earnings.

A similar procedure is necessary in the consolidated statement of profit or loss if it is to link up with the consolidated statement of financial position. Previous examples have shown how the non-controlling share of profits is treated in the statement of profit or loss. Their share of profits for the year is deducted from profit after tax, while the figure for profits brought forward in the consolidation schedule includes only the group share of the subsidiary's profits.

In the same way, when considering examples which include pre-acquisition profits in a subsidiary, the figure for profits brought forward should include only the group share of the post-acquisition retained profits. If the subsidiary is acquired during the accounting year, it is therefore necessary to apportion its profit for the year between pre-acquisition and post-acquisition elements. This can be done by simple time apportionment (ie assuming that profits arose evenly throughout the year) but there may be seasonal trading or other affects which imply a different split than by time apportionment.

With a mid-year acquisition, the entire statement of profit or loss of the subsidiary is split between pre-acquisition and post-acquisition amounts. Only the post-acquisition figures are included in the consolidated statement of profit or loss.

1.10 Section summary

The table below summarises the main points about the consolidated statement of profit or loss.

Purpose	To show the results of the group for an accounting period as if it were a single entity.
Sales revenue to profit for year	100% P + 100% S (excluding adjustments for intra-group transactions).
Reason	To show the results of the group which were controlled by the parent company.
Intra-group sales	Strip out intra-group activity from both sales revenue and cost of sales.
Unrealised profit on intra-group sales	Goods sold by P. Increase cost of sales by unrealized profit. Goods sold by S. increase cost of sales by full amount of unrealized profit and decrease non-controlling interest by their share of unrealized profit.
Depreciation	If the value of S's non-current assets have been subjected to a fair value uplift then any additional depreciation must be charged to profit or loss. The non-controlling interest will need to be adjusted for their share.
Transfer of non-current assets	Expenses must be increased by any profit on the transfer and reduced by any additional depreciation arising from the increased carrying value of the asset.
Non-controlling interests	S's profit after tax (PAT) X Less: * unrealized profit (X) * profit on disposal of non-current assets (X) Additional depreciation following FV uplift (X) Add: * * additional depreciation following disposal of non-current assets X X NCI% X *Only applicable if sales of goods and non-current assets made by subsidiary. * *Only applicable if sale of non-current assets made by subsidiary.
Reason	To show the extent to which profits generated through P's control are in fact owned by other parties.

1.11 The consolidated statement of profit or loss and other comprehensive income

The consolidated statement of profit or loss and other comprehensive income is produced using the consolidated statement of profit or loss as a basis.

The only items of other comprehensive income that are included in your syllabus are revaluation gains and losses, so a consolidated statement of profit or loss and other comprehensive income will be easy to produce once you have done the consolidated statement of profit or loss.

1.12 Consolidated statement of profit or loss and other comprehensive income (separate statement)

If we were using the two-statement format we would produce a separate statement of profit or loss and statement of other comprehensive income.

Activity 8.2 CRYSTAL GROUP

On 1 January 2017 Crystal acquired 60,000 of the 100,000 shares in Pebble, its only subsidiary. The draft statements of profit or loss and other comprehensive income of both companies at 30 June 2017 are shown below:

	Crystal	Pebble
	Shs. 000	**Shs. 000**
Revenue	43,000	26,000
Cost of sales	(28,000)	(18,000)
Gross profit	15,000	8,000
Other income – dividend received from Pebble	2,000	_
Distribution costs	(2,000)	(800)
Administrative expenses	(4,000)	(2,200)
Finance costs	(500)	(300)
Profit before tax	10,500	4,700
Income tax expense	(1,400)	(900)
Profit for the year	9,100	3,800
Other comprehensive income:		
Gain on property revaluation (Note (i))	_	2,000
Investment in equity instrument	200	_
Total comprehensive income for the year	9,300	5,800

Additional information:

(i) At the date of acquisition the fair values of Pebble's assets were equal to their carrying amounts with the exception of a building which had a fair value shs.1 million in excess of its carrying amount. At the date of acquisition the building had a remaining useful life of 20 years. Building depreciation is charged to administrative expenses. The building was revalued again at 30 June 2017 and its fair value had increased by an additional shs.1 million.

(ii) Sales from Crystal to Pebble were Shs.6 million during the post-acquisition period. Crystal marks up all sales by 20%.

(iii) Despite the property revaluation, Crystal has concluded that goodwill in Pebble has been impaired by Shs.500,000.

(iv) It is Crystal's policy to value the non-controlling interest at full (fair) value.

(v) Income and expenses can be assumed to have arisen evenly throughout the year.

Prepare the consolidated statement of profit or loss and other comprehensive income for the year ended 30 June 2017.

Revision Questions

PRACTICE QUESTIONS

QUESTION 8.1 JUMA GROUP

The statements of financial position of Juma Co and its investee company, Puma Co as at 31 December 2016 are shown below.

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 2016

	Juma Co	***Puma co***
	shs'millions'	***shs'millions'***
Assets		
Non-current Assets		
Freehold property	1,950	1,250
Plant and Equipment	795	375
Investments	1,500	-
	4,245	1,625
Current Assets		
Inventories	575	300
Trade receivables	330	290
Cash	50	120
	955	710
Total Assets	**5,200**	**2,335**
Equity and Liabilities		
Equity		
Share capital (*shs1,000 each*)	2,000	1,000
Retained Earnings	1,460	885
	3,460	1,885
Non-current liabilities		
12% debentures	500	100
Current liabilities		
Bank overdraft	560	-
Trade payables	680	350
Total liabilities	1,740	450
Total equity and liabilities	**5,200**	**2,335**

Additional information

(a) Juma Co acquired 600,000 ordinary shares in Puma Co on 1 January 2011 for shs1.5billion when the accumulated retained earnings of Puma Co were shs200 million.

(b) At the date of acquisition of Puma Co, the fair value of its freehold property was considered to be shs400 million greater than its value in Puma Co's statement of financial position. Puma Co had acquired the property ten years earlier and the buildings element (comprising 50% of the total value) is depreciated on cost over 50 years.

(c) Puma Co manufactures a component used by Juma Co only. Transfers are made by Puma Co at cost plus 25%. Juma Co held shs100 million of these components in inventories at 31 December 2016.

(d) It is the policy of Juma Co to review goodwill for impairment annually. The goodwill in Puma Co was written off in full some years ago.

(e) It is the group's policy to value the non-controlling interest at acquisition at fair value. The market price of the shares of the non-controlling shareholders just before the acquisition was shs1,650.

Required
Prepare, in a format suitable for inclusion in the annual report of the Juma Group, the consolidated statement of financial position at 31 December 2016.

QUESTION 8.2 TATA GROUP

On 1 October 2017, TATA acquired 75% of MAMA's equity shares by means of a share exchange of two new shares in TATA for every five acquired shares in MAMA. In addition, TATA issued to the shareholders of MAMA a shs100 10% loan note for every 1,000 shares it acquired in MAMA. TATA has not recorded any of the purchase consideration, although it does have other 10% loan notes already in issue. The market value of TATA's shares at 1 October 2017 was shs2 each. The summarised statements of financial position of the two companies as at 31 March 2018 are:

	TATA	MAMA
Assets	shs'000	shs'000
Non-current assets		
Property, plant and equipment	47,400	25,500
Biological assets (notes (i) and (iv))	7,500	3,200
	54,900	28,700
Current assets		
Inventory (note (ii))	20,400	8,400
Trade receivables (note (iii))	14,800	9,000
Bank	2,100	nil
Total assets	**92,200**	**46,100**
Equity and liabilities		
Equity		
Equity shares of shs1 each	40,000	20,000
Retained earnings/(losses) – at 1 April 2017	19,200	(4,000)
– for year ended 31 March 2018	7,400	8,000
	66,600	24,000
Non-current liabilities		
10% loan notes	8,000	nil
Current liabilities		
Trade payables (note (iii))	17,600	13,000
Bank overdraft	nil	9,100
Total equity and liabilities	**92,200**	**46,100**

The following information is relevant:

(i) At the date of acquisition, MAMA produced a draft statement of profit or loss which showed it had made a net loss after tax of shs2 million at that date. TATA accepted this figure as the basis for calculating the pre- and post-acquisition split of MAMA's profit for the year ended 31 March 2018.

Also at the date of acquisition, TATA conducted a fair value exercise on MAMA's net assets which were equal to their carrying amounts (including MAMA's Biological assets) with the exception of an item of plant which had a fair value of shs3 million below its carrying amount. The plant had a remaining economic life of three years at 1 October 2017.

TATA's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose, a share price for MAMA of shs1.20 each is representative of the fair value of the shares held by the non-controlling interest.

(ii) Each month since acquisition, TATA's sales to MAMA were consistently shs4·6 million. TATA had marked these up by 15% on cost. MAMA had one month's supply (shs4·6 million) of these goods in inventory at 31 March 2018. TATA's normal mark-up (to third party customers) is 40%.

(iii) MAMA's current account balance with TATA at 31 March 2018 was shs2·8 million, which did not agree with TATA's equivalent receivable due to a payment of shs900,000 made by MAMA on 28 March 2018, which was not received by TATA until 3 April 2018.

(iv) The Biological assets of TATA and MAMA are carried at their fair values as at 1 April 2017. As at 31 March 2018, these had fair values of shs7·1 million and shs3·9 million respectively.

(v) There were no impairment losses within the group during the year ended 31 March 2018.

Required:
Prepare the consolidated statement of financial position for TATA as at 31 March 2018.

QUESTION 8.3 DFCU GROUP

On 1 October 2016, Dfcu Co secured a majority equity shareholding in Crane Ltd on the following terms:

- an immediate payment of UGX4 per share on 1 October 2016; and a further amount deferred until 1 October 2017 of UGX5·4 million.

- The immediate payment has been recorded in Dfcu Co's financial statements, but the deferred payment has not been recorded. Dfcu Co's cost of capital is 8% per annum.

The summarised statements of financial position of the two companies at 30 September 2017 are:

	Dfcu Co	Crane Ltd
Assets	UGX'000	UGX'000
Non-current assets		
Property, plant and equipment	50,000	31,000
Intangible assets	7,500	
Investments – Crane Ltd (8 million shares at UGX4 each)	32,000	

	89,500	31,000
Current assets		
Inventory	11,200	8,400
Trade receivables	7,400	5,300
Bank	3,400	nil
Total assets	**111,500**	**44,700**
Equity and liabilities		
Equity		
Equity shares of UGX1 each	50,000	10,000
Retained earnings – at 1 October 2016	25,700	12,000
– for year ended 30 September 2017	9,200	6,000
	84,900	28,000
Non-current liabilities		
Deferred tax	15,000	8,000
Current liabilities		
Bank	nil	2,500
Trade payables	11,600	6,200
Total equity and liabilities	**111,500**	**44,700**

The following information is relevant:

(i) Dfcu Co's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose the directors of Dfcu Co considered a share price for Crane Ltd of UGX3·50 per share to be appropriate.

(ii) At the date of acquisition, the fair values of Crane Ltd's property, plant and equipment was equal to its carrying amount with the exception of Crane Ltd's plant which had a fair value of UGX4 million above its carrying amount. At that date the plant had a remaining life of four years. Crane Ltd uses straight-line depreciation for plant assuming a nil residual value.

(iii) At 30 September 2017, Crane Ltd's inventory included goods bought from Dfcu Co (at cost to Crane Ltd) of UGX2·6 million. Dfcu Co had marked up these goods by 30% on cost. Crane Ltd had paid for only 60% of the invoice.

(iv) Impairment tests were carried out on 30 September 2017 which concluded that half of the consolidated goodwill was impaired.

(v) Assume all profits accrue evenly through the year.

Required:
Prepare the consolidated statement of financial position for Dfcu Co as at 30 September 2017.

QUESTION 8.4 PAPAGIANT GROUP

On 1 January 2017, Papagiant Ltd purchased 120 million equity shares in Soniya Ltd. Soniya Ltd's ordinary share capital is comprised of 160 million shares of Shs 300 per share. The summarised statements of comprehensive income for the two companies for the year ended 30 June 2017 are as follows:

	Papagiant Ltd	Soniya Ltd
	Shs million	Shs million
Revenue	135,000	72,000
Cost of sales	(78,000)	(33,000)
Gross profit	57,000	39,000
Distribution costs	(7,080)	(600)
Administration expenses	(8,100)	(6,900)
Finance costs	(450)	(360)
Profit before tax	41,370	31,140
Income tax expense	(12,411)	(9,342)
Profit for the year	28,959	21,798

Additional information:

(i) After acquisition on 1 January 2017, Papagiant Ltd transferred an item of plant with a carrying amount of Shs 1,200 million to Soniya Ltd at Shs 1,500 million. The plant had a remaining life of two and half years. Papagiant Ltd had included the profit on this transfer as a reduction in its depreciation costs. All depreciation is charged to administration expenses. Papagiant Ltd Group depreciates such plants on straight line basis.

(ii) After the acquisition, Soniya Ltd sold goods to Papagiant Ltd for Shs 12,000 million. These goods had cost Soniya Ltd Shs 9,000 million. Shs 3,600 million of the goods sold remained in Papagiant Ltd's closing inventory.

(iii) Goodwill arising from acquisition has not suffered any impairment.

(iv) All items in the statements of comprehensive income above are deemed to accrue evenly.

Required:
Prepare a consolidated statement of comprehensive income of Papagiant Ltd Group for the year ended 30 June 2017.

Accounting for Taxation

9.0
IAS 12 “*INCOME TAXES*”

UNIT 9 OVERVIEW

- Current tax
- Deferred tax
- Taxable temporary differences
- Deductible temporary differences
- Measurement and recognition of deferred tax
- Taxation in company accounts

1.1 SCOPE

- IAS 12 “Income taxes” covers the accounting treatment of both current tax and deferred tax.

1.2 KEY DEFINITIONS

(a) **Current tax**:
This is the amount actually payable to the tax authorities in relation to the trading activities of the entity during the period.

(b) Deferred tax
This is an accounting measure, used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results.

1.3 CURRENT TAXES

1.3.1 Recognition of current tax liabilities and assets

- IAS 12 requires any unpaid tax in respect of the current or prior periods to be recognised as a liability.
- Conversely, any excess tax paid in respect of current or prior periods over what is due should be recognised as an asset.

Activity 9.1: *Current Taxes*

In 2015 ABC (U) Ltd had taxable profits of Shs.120 million. In the previous year (2014) income tax on 2014 profits had been estimated as Shs.30 million. The corporate income tax rate is 30%.

Required.
Calculate tax payable and the change for 2015 if the tax due on 2014 profits was subsequently agreed with URA as:
(a) Shs.35 million, or
(b) Shs.25 million

Any under or over payments are not settled until the following year’s tax payment is due.

Activity 9.2: *Carry forward losses*

In 2014 Mukwano Co paid Shs.50 million in tax on its profits. In 2015 the company made tax losses of Shs.24 million. The income tax Act of Uganda allows carried forward losses to be carried back to offset against current tax of prior years. The tax rate is 30%.

Required:
Show the tax charge and tax liability for 2015.

1.3.2 Measurement

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. They are measured at the amount expected to be paid to (recovered from) the tax authorities.

1.3.3 Recognition of current tax

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period, except in two cases.

(a) Tax arising from a business combination is treated differently (tax assets or liabilities of the acquired subsidiary will form part of the goodwill calculation).
(b) Tax arising from a transaction or event which is recognised directly in equity (in the same or a different period).

The rule in (b) is logical. If a transaction or event is charged or credited directly to equity, rather than to profit or loss, then the related tax should as well be treated the same way. An example of such a situation is where, under IAS 8, an adjustment is made to the opening balance of retained earnings due to either a change in accounting policy that is applied retrospectively, or to the correction of a material prior period error.

1.3.4 Presentation

In the statement of financial position, tax assets and liabilities should be shown separately from other assets and liabilities. Current tax assets and liabilities can be offset, but this should happen only when certain conditions apply.

(a) The entity has a legally enforceable right to set off the recognised amounts.
(b) The entity intends to settle the amounts on a net basis, or to realize the asset and settle the liability at the same time.

The tax expense (income) related to the profit or loss from ordinary activities should be shown in the statement of profit or loss.

1.4 DEFERRED TAX

IAS 12 defines deferred tax as follows;

1.4.1 Deferred tax liabilities

These are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

1.4.2 Deferred tax assets

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

- Deductible temporary differences
- The carry forward of unused tax losses
- The carry forward of unused tax credits
-

1.5 PERMANENT AND TEMPORARY DIFFERENCES

- Usually accounting profits form the basis for computing taxable profits, on which the tax liability for the year is calculated; however, accounting profits and taxable profits are in most cases different.
- *There are two reasons for the differences.*

1.5.1 Permanent differences.

These occur when certain items of revenue or expense are excluded from the computation of taxable profits. For example, entertainment expenditure is not an allowable deduction for tax purposes as per section 18 of the income tax act 340 of the laws of Uganda. This disallowable expenditure creates a permanent difference.

1.5.2 Temporary differences.

These occur when items of revenue or expenses are included in both accounting profits and taxable profits (chargeable income), but not for the same accounting period. For example, an expense which is allowable as a deduction in arriving at taxable profits for 2014 might not be included in the financial accounts until 2015 (due to matching concept of accounting) or later.

However, In the long run (such as after a period of more than 2 years), the total taxable profits and total accounting profits will be the same (except for permanent differences) so that timing differences originate in one period and are capable of reversal in one or more subsequent periods.

Deferred tax is the tax attributable to temporary differences.

1.6 TEMPORARY DIFFERENCES

1.6.1 Carrying Amount Vs Tax Base

Given the background of how temporary differences arise, it means that elements of financial statements will have two values for deferred tax purposes, that is to say, the carrying amount and the tax base; where the carrying amount of an asset or liability is the amount in the statement of financial position, and tax base is the amount considered for tax purposes. Hence, the temporary difference can be computed as;

Temporary Difference = [Carrying Amount] - [Tax Base]

1.6.2 Types of temporary differences

Temporary differences are of two types;

- **Taxable temporary differences**,

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

- **Deductible temporary differences**,

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

1.7 Tax base

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

1.7.1 Tax Base of Assets

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying value of the asset. Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount. So where the carrying amount and the tax base of the asset are different, a temporary difference exists.

Activity 9.3:

State the tax base of each of the following assets and any temporary difference arising.

(a) A machine cost Shs.10m and has a carrying amount of Shs.8m. For tax purposes, depreciation of Shs.3m has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.

(b) Interest receivable has a carrying amount of Shs.1m. The related interest revenue will be taxed on a cash basis.

(c) Trade receivables have a carrying amount of Shs.10m. The related revenue has already been included in taxable profit (tax loss).

(d) A loan receivable has a carrying amount of Shs.1m. The repayment of the loan will have no tax consequences.

1.7.2 Tax Base of Liabilities

In the case of liability, the tax base will be its carrying amount, less any amount that will be deducted for tax purposes in relation to the liability in future periods. For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

Activity 9.4:

State the tax base of each of the following liabilities and any resulting temporary difference.

(a) Current liabilities include accrued expenses with a carrying amount of Shs.1m. The related expense will be deducted for tax purposes on a cash basis.
(b) Current liabilities include interest revenue received in advance, with a carrying amount of Shs.10m. The related interest revenue was taxed on a cash basis.
(c) Current liabilities include accrued expenses with a carrying amount of Shs.2m. The related expense has already been deducted for tax purpose.
(d) Current liabilities include accrued fines and penalties with a carrying amount of Shs.100,000. Fines and penalties are not deductible for tax purposes.
(e) A loan payable has a carrying amount of Shs.1m. the repayment of the loan will have no tax consequences.

IAS 12 gives the following examples of circumstances in which the carrying amount of an asset or liability will be equal to its tax base and no temporary difference will arise.

- **Accrued expenses** which have already been deducted in determining an entity's current tax liability for the current or earlier periods.
- **A loan payable** which is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- **Accrued expenses** which will never be deductible for tax purposes.
- **Accrued income** which will never be taxable.

1.8 TAXABLE TEMPORARY DIFFERENCES

Taxable temporary differences give rise to deferred tax liabilities.

1.8.1 Examples of taxable temporary differences

The following are examples of circumstances that give rise to taxable temporary differences. They will all result in a higher tax charge in one or more future periods.

1.8.2 Transactions that affect the statement of profit or loss

(a) Interest revenue received in arrears and included in accounting profit on the basis of time apportionment. It is included in taxable profit, however, on a cash basis.

(b) Sale of goods revenue is include in accounting profit when the goods are delivered, but only included in taxable profit when cash is received.

(c) Depreciation of an asset is accelerated for tax purposes. When new assets are purchased, allowances may be available against taxable profits which exceed the amount of depreciation chargeable on the assets in the financial accounts for the year of purchase.

(d) Development costs which have been capitalized will be amortised in the statement of profit or loss, but they were deducted in full from taxable profit in the period in which they were incurred.

(e) Prepaid expenses have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

1.8.3 Transactions that affect the statement of financial position

(a) Accounting depreciation of an asset is not deductible for tax purposes. Deduction for tax purposes will be allowed through tax depreciation.

(b) A borrower records a loan at proceeds received (amount due at maturity) less transaction costs. The carrying amount of the loan is subsequently increased by amortisation of the transaction costs against accounting profit. The transaction costs were, however. Deducted for tax purposes in the period when the loan was first recognised.

1.8.4 Fair value adjustments and revaluations

(a) Current investments or financial instruments are carried at fair value. This exceeds cost, but no equivalent adjustment is made for tax purposes.

(b) Property, plant and equipment can be revalued by an entity (under IAS 16), but no equivalent adjustment is made for tax purposes. This also applies to long-term investments. As the tax base remains at the original value, there will be a difference between the carrying amount and the tax base, leading to an increase in the deferred tax provision.

In these cases, the deferred tax provision recognises that additional profit will be realized on the use or eventual disposal of these assets, leading to a higher tax charge.

1.8.5 Rationale of recognizing deferred tax liabilities on taxable temporary differences

The following gives an understanding of the reasoning behind the recognition of deferred tax liabilities on taxable temporary differences.

(a) When an asset is recognised, it is expected that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods.

(b) If the carrying amount of the asset is greater than its tax base, then taxable economic benefits will also be greater than the amount that will be allowed as a deduction for tax purposes.

(c) The difference is therefore a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability.

(d) As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit.

(e) It is then probable that economic benefits will flow from the entity in the form of tax payments, and so the recognition of deferred tax liabilities is required by IAS 12.

Activity 9.5: *Taxable temporary differences*
A company purchased an asset costing Shs.150 million. At the end of 2015 the carrying amount is shs.100 million. The cumulative depreciation for tax purposes is Shs.90 million and the current tax rate is 30%.

Required.
Calculate the deferred tax liability for the asset.

1.8.6 Timing differences

Some temporary differences are often called timing differences, when income or expense is included in accounting profit in one period, but is included in taxable profit in a different period. The main types of taxable temporary differences which are timing differences and which result in deferred tax liabilities are;

- Interest received which is accounted for on an accruals basis, but which for tax purposes is included on a cash basis.
- Accelerated depreciation for tax purposes.
- Capitalized and amortised development costs.

1.8.7 Revalued assets

Under IAS16 assets may be revalued. This changes the carrying amount of the asset but the tax base of the asset is not adjusted. Consequently, the taxable flow of economic benefits to the entity as the carrying value of the asset is recovered will differ from the amount that will be deductible for tax purposes.

The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability or asset.

Activity 9.6

Samona Co buys equipment for shs.50 million on 1 January 2011 and depreciates it on a straight line bases over its expected useful life of five years. It has no other non-current assets.

For tax purposes, the equipment is depreciated at 25% per annum on a straight line basis.
Accounting profit before tax for the years 2011 to 2015 is Shs.20 million per annum.

The tax rate is 40%.

Required:
Show the calculations of current and deferred tax for the years 2011 to 2015.

1.9 DEDUCTIBLE TEMPORARY DIFFERENCES

1.9.1 Definition

All deductible temporary differences give rise to a deferred tax asset.

There is a proviso, however. The deferred tax asset must also satisfy the recognition criteria given in IAS 12. This is that a deferred tax asset should be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which it can be utilized. This is an application of prudence. Before we look at this issue in more detail, let us consider the examples of deductible temporary differences given in the standard.

1.9.2 Transactions that affect the statement of profit or loss

(a) Retirement benefit costs (pension costs) are deducted from accounting profit as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (this may also apply to similar expenses).

(b) Accumulated depreciation of an asset in the financial statements is greater than the accumulated depreciation allowed for tax purposes up to the end of the reporting period.

(c) The cost of inventories sold before the end of the reporting period is deducted from accounting profit when goods/services are delivered, but is deducted from taxable profit when the cash is received.

(d) The NRV of inventory, or the recoverable amount of an item of property, plant and equipment falls and the carrying value is therefore reduced, but that reduction is ignored for tax purposes until the asset is sold.

(e) Research costs (or organisations/other start-up costs) are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.

(f) Income is deferred in the statement of financial position, but has already been included in taxable profit in current/prior periods.

1.9.3 Fair value adjustments and revaluations

Current investments or financial instruments may be carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

1.9.4 Recognition of deductible temporary differences (Rationale)

Let us lay out the reasoning behind the recognition of deferred tax assets arising from deductible temporary differences.

(a) When a liability is recognised, it is assumed that its carrying amount will be settled in the form of outflows of economic benefits from the entity in future periods.

(b) When these resources flow from the entity, part or all may be deductible in determining taxable profits of a period later than that in which the liability is recognised.

(c) A temporary tax difference then exists between the carrying amount of the liability and its tax base.

(d) A deferred tax asset therefore arises, representing the income taxes that will be recoverable in future periods when that part of the liability is allowed as a deduction from taxable profit.

(e) Similarly, when the carrying amount of an asset is less than its tax base, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

Activity 9.7: *Deductible temporary differences*

Toyota Co recognises a liability of Shs.10 million for accrued product warranty costs on 31 December 2015. These product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 25%.

Required:
State the deferred tax implications of this situation.

1.9.5 Taxable profits in future periods

For a deferred tax asset to be recognised, sufficient future taxable profits must be available against which the deductible difference can be utilized.

1.9.6 Unused tax losses and unused tax credits

An entity may have unused tax losses or credits (i.e. which it can offset against taxable profits) at the end of a period. Should a deferred tax asset be recognised in relation to such amounts? IAS 12 states that a deferred tax asset may be recognised in such circumstances to the extent that it is probable future taxable profit will be available against which the unused tax losses/credits can be utilized.

1.10 MEASUREMENT AND RECOGNITION OF DEFERRED TAX

1.10.1 Basis of provision of deferred tax

IAS 12 adopts the full provision method of accounting for deferred tax.

The full provision method has the advantage that it recognises that each timing difference at the end of the reporting period has an effect on future tax payments. If a company claims an accelerated tax allowance on an item of plant, future tax assessments will be bigger than they would have been otherwise. Future transactions may well affect those assessments still further, but that is not relevant in assessing the position at the end of the reporting period.

Activity 9.8

On 1st January 2015, Stevo (U) Ltd started effective trading and in the company's first year, profits of Shs.50m are derived. The depreciation charge for the year is Shs.10m and the tax allowances on those assets amount to Shs.15m. The rate of income tax is 30%.

Required:
State the deferred tax implications of this situation.

1.11 CHANGES IN TAX RATES

Where the corporate rate of income tax fluctuates from one year to another, a problem arises in respect of the amount of deferred tax to be credited (debited) to the statement of profit or loss in later years.

IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply in the period when the asset is realized or liability settled, based on tax rates and laws enacted (or substantively enacted) at the end of the reporting period. In other words, IAS 12 requires the liability method to be used.

Illustration 9.9

Sparkles Co has an asset with a carrying amount of Shs.80 million and a tax base of Shs.50 million. The current tax rate is 30% and the rate is being reduced to 25% in the next tax year. Sparkles plans to dispose of the asset for its carrying amount and will do so after the tax rate falls.

The deferred tax on the temporary difference is therefore shs.30 million x 25% = shs.7.5 million.

1.12 Discounting

Discounting is used to allow for the effect of the time value of money.

IAS 12 states that deferred tax assets and liabilities should not be discounted because of the complexities and difficulties involved. Discounting is applied to other non-current liabilities such as provisions and deferred payments.

1.13 Carrying amount of deferred tax assets

The carrying amount of deferred tax assets should be reviewed at the end of each reporting period and reduced where appropriate (insufficient future taxable profits). Such a reduction may be reversed in future years.

1.14 Recognition

As with current tax, deferred tax should normally be recognised as income or an expense and included in the net profit or loss for the year in the statement of profit or loss. Current and deferred tax will together make up the tax charge. The exception is where the tax arises from a transaction or event which is recognised (in the same or a different period) directly in equity such as a revaluation where the surplus is credited to the revaluation surplus.

The figures shown for deferred tax in the statement of profit or loss will consist of two components.

(a) Deferred tax relating to timing differences

(b) Adjustments relating to changes in the carrying amount of deferred tax assets/liabilities (where there is no change in timing differences), e.g. changes in tax rates/laws, reassessment of the recoverability of deferred tax assets, or a change in the expected recovery of an asset.

Items in (b) will be recognised in profit or loss, unless they relate to items previously charged/credited to equity.

Deferred tax (and current tax) should be charged/credited directly to equity if the tax relates to items also charged/credited directly to equity (in the same or a different period).

Examples of IASs which allow certain items to be credited/charged directly to equity include:

(a) Revaluations of property, plant and equipment (IAS 16), and
(b) The effect of a change in accounting policy (applied retrospectively) or correction of a material error (IAS 8).

Revaluations will appear under 'other comprehensive income' in the statement of profit or loss and other comprehensive income and the tax element will be shown separately as 'income tax relating to components of other comprehensive income'.

Activity 9.10:

Gilbo Co owns a property which has a carrying amount at the beginning of 2015 of Shs.1.5 billion. At the year end it has entered into a contract to sell the property for Shs.1.8 billion. The tax rate is 30%. How will this be shown in the financial statements?

1.15 Why do we recognise deferred tax?

(a) Adjustments for deferred tax are made in accordance with the accruals concept and in accordance with the definition of a liability in the Conceptual Framework, ie a past event has given rise to an obligation in the form of increased taxation which will be payable in the future. The amount can be reliably estimated. A deferred tax asset similarly meets the definition of an asset.

(b) If the future tax consequences of transactions are not recognised, profit can be overstated, leading to overpayment of dividends and distortion of share price and EPS.

1.16 TAXATION IN COMPANY ACCOUNTS

There are two aspects to consider in determining how taxation is presented in the company accounts;
(a) Taxation on profits in the statement of profit or loss.
(b) Taxation payments due, shown as a liability in the statement of financial position.

These are discussed as below;

1.16.1 Taxation in the statement of profit or loss

The tax on profit on ordinary activities is calculated by **aggregating**:
(a) ***Income tax*** *on taxable profits*
(b) ***Transfers to or from deferred taxation***
(c) Any ***under provision or over provision*** *of income tax on profits of previous years*

When income tax on profits is calculated, the calculation is only an estimate of what the company thinks its tax liability will be. In subsequent dealings with the tax authorities, a different income tax charge might eventually be agreed. The difference between the estimated tax on profits for one year and the actual tax charge finally agreed for the year is made as an adjustment to taxation on profits in the following year, resulting in the disclosure of either an under provision or an overprovision of tax.

Activity 9.11

In the accounting year to 31 December 2015, Garden Tea (U) Ltd made an operating profit before taxation of shs.110 million. Income tax on the operating profit has been estimated as Shs.45 million. In the previous year (2014) income tax on 2014 profits had been estimated as Shs.38 million but it was subsequently agreed at Shs.40.5 million.

A transfer to the credit of the deferred taxation account of shs.16 million will be made in 2015.

Required:
(a) Calculate the tax on profits for 20X3 for disclosure in the accounts.
(b) Calculate the amount of tax payable.

1.16.2 Taxation in the statement of financial position

It should already be apparent from the previous examples that the income tax charge in the statement of profit or loss will not be the same as income tax liabilities in the statement of financial position.

In the statement of financial position, there are several items which we might expect to find.
(a) Amounts underprovided/overprovided in the prior year. These will appear as debits/credits to the tax payable account.
(b) If no tax is payable (or very little) then there might be an income tax recoverable asset disclosed in current assets (income tax is normally recovered by offset against the tax liability for the year).
(c) There will usually be a liability for tax assessed as due for the current year.
(d) We may also find a liability on the deferred taxation account. Deferred taxation is shown under non-current liabilities in the statement of financial position.

Activity 9.12

For the year ended 31 July 2015 Watoto Co made taxable trading profits of Shs.1.2 billion on which income tax is payable at 30%.

(a) A transfer of Shs.20 million will be made to the deferred taxation account. The balance on this account was Shs.100 million before making any adjustments for items listed in this paragraph.

(b) The estimated tax on profits for the year ended 31 July 2014 was Shs.80 million, but tax has now been agreed at Shs.84 million and fully paid.
(c) Tax on profits for the year to 31 July 2015 is payable on 1 May 2016.
(d) In the year to 31 July 2015 the company made a capital gain of Shs.60 million on the sale of some property. This gain is taxable at a rate of 30%.

Required.
(a) Calculate the tax charge for the year to 31 July 2015.
(b) Calculate the tax liabilities in the statement of financial position of Watoto Co as at 31 July 2015.

1.17 Presentation of tax assets and liabilities

These should be presented separately from other assets and liabilities in the statement of financial position. Deferred tax assets and liabilities should be distinguished from current tax assets and liabilities. In addition, deferred tax assets/liabilities should not be classified as current assets/liabilities, where an entity makes such a distinction.

There are only limited circumstances where current tax assets and liabilities may be offset. This should only occur if two things apply.
(a) The entity has a legally enforceable right to set off the recognised amounts.
(b) The entity intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

Similar criteria apply to the offset of deferred tax assets and liabilities.

1.18 Presentation of tax expense

The tax expense or income related to the profit or loss for the year should be presented in the statement of profit or loss.

PRACTICE QUESTIONS

QUESTION 9.1 BROTHER LTD

The following information relates to Brother Ltd as at 31 May 2018:

	Note	Carrying Value Shs "000"	Tax Base shs "000"
Non-current assets			
Property, plant and Equipment		200,000	175,000
Receivables			
Trade receivables		50,000	
Interest receivable	1	1,000	
Payables			
Fine		10,000	
Interest payable		2,000	

Note 1
The trade receivables balance in the accounts is made up of the following amounts:

	Shs "000"
Balances	55,000
Doubtful debts provision	(5,000)
	50,000

Additional Information:
(a) The deferred tax balance as at 1 June 2017 was shs. 1.2 million.
(b) Interest is taxed on a cash basis.
(c) Allowances for doubtful debts was not deductible for tax purposes. Amounts in respect of receivables are only deductible on application of a court order to a specific amount.
(d) Fines are not tax deductible.
(e) The corporation tax rate is 30%.

Required
Calculate the deferred tax provision which is required as at 31 May 2018 and the charge to profit or loss for the period.

QUESTION 9.2 KAASA LTD

Kaasa Ltd was incorporated in Uganda. The company deals in value addition of agricultural produce for export. It is seeking technical advice from a qualified accountant in preparation of its financial statements for the year ended 31 December 2017 in order to comply with International Financial Reporting Standards. The company had the following assets and liabilities in its accounts before carrying out the necessary adjustments to prepare its financial statements:

Item as at	31 December 2017 Shs million	January 2017 Shs million
Buildings		140
Goodwill		60
Inventory (*exclusive of inventory from Kayasi Ltd*)	14	
Trade receivables	9	
Trade payables	13	
Cash at bank	40	

The company had made a provision for bad debts of Shs 3 million. Kayasi Ltd, a fully owned subsidiary of Kaasa Ltd, sold goods costing Shs 30 million to its parent on 30 December 2011 for Shs 33 million and all these goods were still held in the inventory at 31 December 2017. Kaasa Ltd depreciates its buildings at 5% per annum. Tax allowance rate is 20% and the company pays corporation tax at 30%.

Required:
Calculate the deferred tax provision required as at 31 December 2017.

QUESTION 9.3 MUTO LTD

You have been invited to participate in the preparation of the final accounts of Muto Ltd for the year ended 31 October 2017. Your role in the financial statements preparation process is to determine the amount of income tax charge to be included in the books of Muto Ltd.
The accounts assistant has provided you with the following information to assist you in executing this task;

(i) The estimated corporation tax on the profits of Muto Ltd for the year to 31 October 2017 is Shs 13.8 million.
(ii) During the year, Shs 17.48 million was paid as full and final settlement for corporation tax on the profits for the year ended 31 October 2016. The statement of financial position as at 31 October 2016 had included Shs 19.32 million in respect of this liability.
(iii) The deferred tax balance as at 31 October 2016 was shs. 54.28 million.
(iv) At 31 October 2016, the carrying values of the net assets of Muto Ltd exceeded their tax base by Shs 257.6 million.
(v) Muto Ltd pays corporation tax at a rate of 30%.

Required
Determine the income tax charge that should be reported in the books of Muto Ltd for the year ended 31 October 2017

Agriculture

10.0
IAS 41 "AGRICULTURE"

UNIT 10 OVERVIEW:
- Scope of IAS 41
- Key terms under IAS 41
- Biological Assets
- Agricultural Produce
- Agriculture and Government Grants

1.1 SCOPE OF IAS 41

IAS 41 Agriculture applies to biological assets and to agricultural produce at the point of harvest.

1.2 KEY TERMS

(i) **Agricultural activity** is the management of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets.

(ii) **Biological transformation** comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.

(iii) **A biological asset** is a living plant or animal.

(iv) **Agricultural produce** is the harvested product of the entity's biological assets.

(v) **Harvest** is the detachment of produce from a biological asset or the cessation of a biological assets life processes.

1.3 APPLICATION OF IAS 41

A famer buys a diary calf	The calf is a biological asset
The calf grows into a mature cow	Growth is a type of biological transformation
The farmer milks the cow	The milk has been harvested. Milk is agricultural produce.

1.4 BIOLOGICAL ASSETS

1.4.1 Recognition criteria

A biological asset should be recognized if;
- It is probable that future economic benefits will flow to the entity from the asset
- The cost or fair value of the asset can be reliably measured
- The entity controls the asset.

1.4.2 Initial Recognition and measurement

Biological assets are initially measured at fair value less estimated costs to sell.

Gains and losses may arise in profit or loss when a biological asset is first recognized for example:

- A loss can arise because estimated selling costs are deducted from fair value.
- A gain can arise when a new biological asset (such as a lamb or a calf) is born.

1.4.3 Subsequent measurement

At each reporting date, biological assets are revalued to fair value less costs to sell.
Gains and losses arising from changes in fair value are recognized in profit or loss for the period in which they arise.
Biological assets are presented separately on the face of the statement of financial position within non-Current assets

1.4.4 Physical and price changes

The fair value of a biological asset may change because of its age or because prices in the market have changed.

IAS 41 recommends separate disclosure of physical and price changes because this information is likely to be of interest to users of the financial statements, however, this disclosure is not mandatory.

1.4.5 Inability to measure fair value

IAS 41 presumes that the fair value of biological assets should be capable of being measured reliably.
This presumption can be rebutted on the initial recognition of a biological asset if market prices are not readily available. If this is the case, the biological asset should be measured at cost less accumulated depreciation and accumulated impairment losses.

Once the assets fair value can be measured reliably, it should be remeasured to fair value less costs to sell.

Activity 10.1

On 1 January 2019, a farmer had a herd of 100 cows, all of which were 2 years old. At this date, the fair value less point of sale costs of the herd was shs100,000,000. On 1 July 2019, the farmer purchased 20 cows (each two and half years old) for shs600,000 each. As at 31 December 2019, three-year-old cows sell at market for shs900,000 each. Market auctioneers have charged a sale levy of 2% for many years.

Required;
Discuss the accounting treatment the above in the financial statements for the year ended 31 December 2019.

1.5 AGRICULTURAL PRODUCE

At the date of harvest, agricultural produce should be recognized and measured at fair value less estimated costs to sell.
Gains and losses on initial recognition are included in profit or loss (operating profit) for the period.

After produce has been harvested, it becomes an item of inventory. Therefore, IAS 41 ceases to apply. The initial measurement value at the point of harvest is the deemed cost for the purpose of IAS 2 inventories, which is applied from then onwards.

1.6 ASSETS OUTSIDE THE SCOPE OF IAS 41.

IAS 41 does not apply to intangible assets (such as production quotas) or to land related to agricultural activity.

- In accordance with IAS 38, intangible assets are measured at cost less amortization or fair value less amortization.
- Land is not a biological asset. It is treated as a tangible non-current asset and accounted for under IAS 16 Property, plant and equipment. When valuing a forest, for example, the trees must be accounted for separately from the land that they grow on.

Activity 10.2

GoodWine is a company that grows and harvests grapes. The grapes are then sold to wine producers. GoodWine measures assets at fair value, when permitted by accounting standards.

GoodWine has one vineyard. On 1 July 2019, the land has a fair value of shs200m and the vines have a fair value of shs50m. On 30 June 2020 GoodWine harvests the grapes from its vine. The fair value of the grapes is shs40m, the fair value of the vines is shs52m and the fair value of the land is shs210m.

All selling costs are negligible and should be ignored.

Required;
Discuss the accounting treatment of the above in the financial statements of GoodWine for the year ended 30 June 2020.

1.7 AGRICULTURE AND GOVERNMENT GRANTS

If a government grant relates to a biological asset measured at its cost less accumulated depreciation and accumulated impairment losses, it is accounted for under IAS 20 Accounting for Government Grants.

If a government grant relates to biological assets measured at fair value less costs to sell, then it is accounted for under IAS 41 Agriculture as follows;

An **unconditional government grant** related to a biological asset measured at its fair value less costs to sell shall be recognised in profit or loss when it becomes receivable.

A **conditional government grant** related to a biological asset measured at its fair value less costs to sell shall be recognized in profit or loss when the conditions attaching to the government grant are met.

(i) If a grant requires an entity to farm in a particular location for five years, and requires the entity to return the entire grant if it farms for a period shorter than five years, then the grant is not recognized in profit or loss until the five years have passed.

(ii) If the terms of the grant allow part of it to be retained according to the time that has elapsed, the entity recognizes that part in profit or loss as time passes.

PRACTICE QUESTIONS

QUESTION 10.1 MASAKA FORESTRY DEALERS LTD

During the financial year ended 30 June, 2017 Masaka Forestry Dealers (U) Ltd planted pine trees in Masaka district that cost them She 300 million. At the end of the financial year the following facts regarding the pine trees were available:

Local values:
The farmers in the region had an average value of Shs 187 million for the pine trees of a similar size.

National values:
The entity read in a national agricultural magazine that the average price of the pine trees of a similar size was Shs 232 million.

Disease:
There had been widespread disease in the pine tree population. As a result there was no active market for the pine, but the situation was expected to clear in three months. After the three months, it should also be clear which types of trees are susceptible to infection and which ones are not. Until that time, nobody is willing to risk trading in infected pine trees.

Precedent:
The last sale by the company of pine trees of a similar size was five months earlier at a price of Shs 179 million. The company was not sure which way the market had gone since then.

Required:

In accordance with IAS 41 advise the company on the correct valuation of the pine trees as at 30 June, 2017.

QUESTION 10.2

A heard of 10 two year old animals was held at 01st January 2017 by CMF Co. One animal 2.5 years of age was purchased on 1 July 2017 for shs1.08 million and one animal was born on 1 July 2017. No animals were sold during the period. Fair values less estimated point of sale costs were as follows;

Animal Details	Shs (per unit)
2 year old animal at 1.01.2017	1.0m
New born animal at 1.07.2017	0.7m
2.5 year old animal at 1.07.2017	1.08m
New born animal at 31.12.2017	0.72m
0.5 year old animal at 31.12.2017	0.8m
2 year old animal at 31.12.2017	1.05m
2.5year old animal at 31.12.2017	1.11m
3 yaer old animal at 31.12.2017	1.20m

Required:

In accordance with IAS 41; prepare a reconciliation of changes in the carrying amount of biological assets between the beginning and the end of financial year ended 31 December 2017.

QUESTION 10.3 MAKERERE UNIVERSITY

Jimmy Farm Ltd established a commercial dairy farm in Mukono district. The trial balance of the farm for the year ended 30 June 2020 is as follows:

	Shs million	Shs million
Cash	700	
Receivables	897	
Inventories	543	
Bearer biological assets	1,325	
Property, plant and Equipment	3,456	
Payables		562
Share capital		4,000
Retained earnings		2,359
Totals	6,921	6,921

Additional information:

(a) The farm had a herd of 500, 2 year-old cows valued at Shs 2.5 million each on 1 July 2019. On 1 October 2019, the farm purchased 50, 1.5 year-old cows at a cost of Shs 1.5 million each. These values have been recognized in the above trial balance.

(b) In March 2020, 100 cows calved and each calf was valued at Shs 0.5 million. The farm has not recognized these calves in its books of account.

(c) Valuation of farm animals on 30 June 2020:

	Shs 'million' per animal
Newborns	0.7
2 year-olds	2.7
1.5 year-olds	1.6
3 year-olds	2.9
2.4 year-olds	2.8
4 month-old calves	1.6

(d) The farm's policy is to depreciate plant, property and equipment at 20% on a reducing balance basis.

Required:

In accordance with IAS 41;

(a) Prepare a reconciliation of changes in the carrying amount of biological assets between the beginning and the end of financial year ended 30 June 2020.

(b) Prepare the farm's statement of financial position as at 30 June 2020.

Government Grants & Assistance

11.0
IAS 20 "*GOVERNMENT GRANTS*"

UNIT 11 OVERVIEW:

- Key definitions under IAS 20.
- Scope of IAS 20.
- Accounting for Government Grants.
- Disclosure requirements.

1.1 GOVERNMENT GRANTS

It is common for entities to receive government grants for various purposes (grants may be called subsidies, premiums, e.t.c). They may also receive other types of assistance which may be in many forms. The treatment of government grants is covered by IAS 20 Accounting for government grants and disclosure of government assistance.

1.2 Scope

IAS 20 does not cover the following situations.

- Accounting for government grants in financial statements reflecting the effects of changing prices
- Government assistance given in the form of 'tax breaks'.
- Government acting as part-owner of the entity.

1.2.1 Definitions

These definitions are given by the standard.

Key terms

- **Government**. Government, government agencies and similar bodies whether local, national or international.
- **Government assistance**. Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.
- **Government grants**. Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.
- **Grants related to assets**. Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.
- **Grants related to income**. Government grants other than those related to assets.
- **Forgivable loans**. Loans which the lender undertakes to waive repayment of under certain prescribed conditions.
- **Fair value**. The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

You can see that there are many different forms of government assistance: both the type of assistance and the conditions attached to it will vary. Government assistance may have encouraged an entity to undertake something it otherwise would not have done.
How will the receipt of government assistance affect the financial statements?

(a) An appropriate method must be found to account for any resources transferred.
(b) The extent to which an entity has benefited from such assistance during the reporting period should be shown.

1.2.2 Government grants

An entity should not recognize government grants (including non-monetary grants at fair value) until it has reasonable assurance that:

- The entity will comply with any conditions attached to the grant
- The entity will actually receive the grant

Even if the grant has been received, this does not prove that the conditions attached to it have been or will be fulfilled.

It makes no difference in the treatment of the grant whether it is received in cash or given as a reduction in a liability to government, ie the manner of receipt is irrelevant.

Any related contingency should be recognized under IAS 37 provisions, contingent liabilities and contingent assets once the grant has been recognized.

In the case of a forgivable loan (as defined in key terms above) from government, it should be treated in the same way as a government grant when it is reasonably assured that the entity will meet the relevant terms for forgiveness.

1.2.2.1 Accounting treatment of government grants

IAS 20 requires grants to be recognized as income over the relevant periods to match them with related costs which they have been received to compensate. This should be done on a systematic basis. Grant should not, therefore be credited directly to equity.

It would be against the accruals assumption to credit grants to income on a receipts basis, so a systematic basis of matching must be used. A receipts basis would only be acceptable if no other basis was available.

It will usually be easy to identify the costs related to a government grant, and thereby the period(s) in which the grant should be recognized as income, i.e. when the costs are incurred. Where grants are received in relation to a depreciating asset, the grant will be recognized over the periods in which the asset is depreciated and in the same proportions.

Activity 11.1
JMV Co received a government grant representing 50% of the cost of a depreciating asset which costs Shs.40 million. How will the grant be recognized if JMV Co depreciates the asset:
(a) Over four years straight line; or
(b) At 40% reducing balance?

In the case of grants for non-depreciable assets, certain obligations may need to be fulfilled, in which case the grant should be recognized as income over the periods in which the cost of meeting the obligation is incurred. For example, if a piece of land is granted on condition that a building is erected on it, then the grant should be recognized as income over the building's life.

There may be a series of conditions attached to a grant, in the nature of a package of financial aid. An entity must take care to identify precisely those conditions which give rise to costs which in turn determine the periods over which the grant will be earned. When appropriate, the grant may be split and the parts allocated on different bases.

An entity may receive a grant as compensation for expenses or losses which it has already incurred. Alternatively, a grant may be given to an entity simply to provide immediate financial support where no future related costs are expected. In cases such as these, the grant received should be recognized as income of the period in which it becomes receivable.

1.2.2.2 Non-monetary government grants

A non-monetary asset may be transferred by government to an entity as a grant, for example a piece of land, or other resources. The fair value of such an asset is usually assessed and this is used to account for both the asset and the grant. Alternatively, both may be valued at a nominal amount.

1.2.2.3 Presentation of grants related to assets

There are two choices here for how government grants related to assets (including non-monetary grants at fair value) should be shown in the statement of financial position.

(a) Set up the grant as deferred income.
(b) Deduct the grant in arriving at the carrying amount of the asset

Activity 11.2

A company receives a 20% grant towards the cost of a new item of machinery, which cost shs.100 million. The machinery has an expected life of four years and a nil residual value. The expected profits of the company, before accounting for depreciation on the new machine or the grant, amount to Shs.50 million per annum in each year of the machinery's life.

Required
Show the results of the company over the four year life of the machinery

1.2.2.4 Presentation of grants related to income

These grants are a credit in profit or loss, but there is choice in the method of disclosure.

(a) Present as a separate credit or under a general heading, e.g. 'other income'
(b) Deduct from the related expense

Some would argue that offsetting income and expenses in the statement of profit or loss is not good practice. Others would say that the expenses would not have been incurred had the grant not been available, so offsetting the two is acceptable. Although both methods are acceptable, disclosure of the grant may be necessary for a proper understanding of the financial statements, particularly the effect on any item of income or expenses which is required to be separately disclosed.

1.2.2.5 Repayment of government grants

If a grant must be repaid it should be accounted for as a revision of an accounting estimate (see IAS 8).

(a) **Repayment of a grant related to income**: apply first against any unamortised deferred income set up in respect of the grant; any excess should be recognized immediately as an expense.
(b) **Repayment of a grant related to an asset**: increase the carrying amount of the asset or reduce the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognized to date in the absence of the grant should be immediately recognized as an expense.

It is possible that the circumstances surrounding repayment may require a review of the asset value and an impairment of the new carrying amount of the asset.

1.2.3 Government assistance

Some forms of government assistance are excluded from the definition of government grants.

(a) Some forms of government assistance cannot reasonably have a value placed on them, eg free technical or marketing advice, provision of guarantees.
(b) There are transactions with government which cannot be distinguished from the entity’s normal trading transactions, e.g. government procurement policy resulting in a portion of the entity’s sales. Any segregation would be arbitrary.

Disclosure of such assistance may be necessary because of its significance; its nature, extent and duration should be disclosed. Loans at low or zero interest rates are a form of government assistance, but the imputation of interest does not fully quantify the benefit received.

1.2.4 Disclosure

Disclosure is required of the following.

- Accounting policy adopted, including method of presentation
- Nature and extent of government grants recognized and other forms of assistance received
- Unfulfilled conditions and other contingencies attached to recognized government assistance

PRACTICE QUESTIONS

QUESTION 11.1

Bakira Ltd is planning to open a sugar processing plant and in preparation for the sugar plant it purchased and paid for machinery Shs 978 million on 2 June, 2017. Due to the scarcity of sugar and youth employment in the area, on 1 November, 2017 Bakira Ltd was offered a Government grant Shs 8.5 billion to defray the following costs:

Item	Shs '000'
Machinery (5 years useful life)	978,000
Plant (8 years useful life)	1,230,000
Land (offered - fair value)	5,240,000
Expenses for ecological measures	1,052,000
	8,500,000

It is the company's policy to account for government grants using the deferred income approach. The expenses for ecological measures were incurred from 1 January, 2017 to 31 March, 2017.

Required:
Show how the grants will be treated in the financial statements showing the relevant entries for the period ending 30 June, 2018. *(10 marks)*

Source: CPA(U), August 2017, Question 1(b)

QUESTION 11.2

(a) IAS 20: Accounting for Government Grants and Disclosure of Government Assistance was formulated to remedy instances where entities would increase their profits using the grants received without disclosure.

Required:
Distinguish between 'government grants' and 'government assistance' as laid out in IAS 20. *(2 marks)*

(b) ABC Ltd, a company operating in the agribusiness sector acquired equipment for Shs 96 million paying by cheque on 1 October, 2017 and received a government grant of Shs 19.2 million towards the cost of the equipment. The company's policy is to treat grants as deferred income. The useful life of the equipment is estimated at 10 years. The company time apportions depreciation where applicable.

Required:
Show the:

(i) *accounting entries to record the equipment and receipt of the government grant on 1 October, 2017.* *(2 marks)*

(ii) *accounting entries to record the depreciation of the equipment and recognition of the grant income as at 31 December, 2017.* *(2 marks)*

(iii) *extracts of the statement of profit or loss and statement of financial position to indicate the disclosure for the asset and the grant upon acquiring the asset as at 31 December, 2017.* *(6 marks)*

Source: CPA(U), August 2016, Question 4

Property, Plant & Equipment

12.0 IAS 16 "*PROPERTY, PLANT AND EQUIPMENT*"

UNIT 12 OVERVIEW:
- Key definitions under IAS 16.
- Recognition of an item of PPE.
- Initial and subsequent measurement of PPE.
- Derecognition of PPE.
- Disclosure requirements.

1.1 KEY DEFITIONS UNDER IAS 16

(a) Carrying amount is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses.

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

(c) Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

(d) Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

(e) Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (*IFRS 13 definition*)

(f) An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

(g) Property, plant and equipment are tangible items that:
- are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- are expected to be used during more than one period.

(h) Useful life is:
- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an entity.

(i) Recoverable amount is the higher of an asset's net selling price and its value in use.

(j) The <u>residual value</u> of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

(k) Entity Specific Value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life, or expects to incur when settling a liability.

1.2 RECOGNITION OF ITEMS OF PPE

An item of property, plant and equipment shall be recognised as an asset if, and only if:

(a) It is probable that future economic benefits associated with the item will flow to the entity, and
(b) The cost of the item can be measure reliably.

These recognition criteria apply to subsequent expenditure as well as costs incurred initially. There are no separate criteria for recognising subsequent expenditure.

Property, plant and equipment can amount to substantial amounts in financial statements, affecting the presentation of the company's financial position and the profitability of the entity, through depreciation and also if an asset is wrongly classified as an expense and taken to profit or loss.

1.2.1 FIRST CRITERION: Future Economic Benefits

The degree of certainty attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should be assured that it will receive the rewards attached to the asset and will incur the associated risks, which will only generally be the case when the rewards and risks have actually passed to the entity. Until then, the asset should not be recognised.

1.2.2 SECOND CRITERION: Cost Measured Reliably

It is generally easy to measure the cost of an asset as the transfer amount on purchase, i.e. what was paid for it. Self-constructed assets can be measured easily by adding together the purchase price of all the constituent parts labour, material etc.) paid to external parties.

1.2.3 Separate items

Most of the time assets will be identified individually, but this will not be the case for smaller items, such as tools, which are sometimes classified as inventory and written off as an expense.
Major components or spare parts, however should be recognised as property, plant and equipment.
For very large and specialised items, an apparently single asset should be broken down into composite parts. This occurs where the different parts have different useful lives and different depreciation rates applied to each part, e.g. an aircraft, where the body and engines are separated as they have different useful lives.

1.2.4 Safety and environmental equipment

These items may be necessary for the entity to obtain future economic benefits from its other assets. For this reason they are recognised as assets. However the original assets plus the safety equipment should be reviewed for impairment.

1.3 MEASUREMENT

1.3.1 Initial measurement

Once an item of property, plant and equipment qualifies for recognition as an asset, it will initially be measured at cost.

1.3.2 Components of Cost

- Cost comprises of the following;
  - ❑ Purchase price, less any trade discounts or rebate
  - ❑ Import duties and non-refundable purchase taxes
  - ❑ Directly attributable costs necessary to bring such an asset to the location and working condition for its intended use.

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date.

- **Examples of directly attributable costs are:**
  a) costs of site preparation;
  b) initial delivery and handling costs;
  c) installation and assembly costs;
  d) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)

- **Examples of directly attributable costs are:**
  a) Professional fees.
  b) costs of employee benefits arising directly from the construction or acquisition of the item of property, plant and equipment; and
  c) Initial estimates of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located.
- NOTE:
  – Directly attributable costs are determined after deducting the net proceeds from selling any items produced when bringing the asset to its location and condition.
  – Income and related expenses of operations that are incidental to the construction or development of an item of property, plant and equipment should be recognised in profit or loss

- **<u>Examples of costs that are not costs of an item of property, plant and equipment are</u>**:

  a) costs of opening a new facility (start-up & pre-production costs);
  b) costs of introducing a new product or service (including costs of advertising and promotional activities);
  c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
  d) administration and other general overhead costs.
  e) Initial operating losses before the asset reaches planned performance

- **<u>Examples of costs that are not costs of an item of property, plant and equipment are</u>**:

  a) All the above costs will be recognised as an expense rather than an asset.

In the case of self-constructed assets (where an entity constructs its own building(s)), the same principles are applied as for acquired assets. If the entity makes similar assets during the normal course of business for sale externally, then the cost of the asset will be the cost of its production under *IAS 2 Inventories*. Abnormal costs (wasted material, labour or other resources) are excluded from the cost of the asset.

- Property, plant and equipment
- Subsequent measurement

1.3.3 Subsequent expenditure

Such costs should be added when

- it is probable that future economic benefits, <u>exceeding</u> the original standard of performance, will flow to the entity
- can be reliably measured.

- The cost of major inspection or overhaul occurring at regular intervals is capitalised where
  - it is identified as a separate component of the asset and
  - the replaced components are fully depreciated.

1.3.4 Exchange of assets

IAS 16 specifies that exchange of items of property, plant and equipment, regardless of whether the assets are similar, are measured at fair value, unless the exchange transaction lacks commercial substance or the fair value of neither of the assets exchanged can be measured reliably. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Expenditure incurred in replacing or renewing a component of an item of property, plant and equipment must be recognised in the carrying amount of the item. The carrying amount of the replaced component of an item of property, plant and equipment is identified in respect of a major inspection to enable the continued use of the item.

1.4 MEASUREMENT AFTER RECOGNITION

An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

(a) Cost Model
(b) Revaluation

(a) Cost Model: After recognition, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

(b) Revaluation Model: After recognition, an item of property, plant and equipment <u>whose fair value can be measured reliably</u> shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet data

- If an item of property, plant and equipment is revalued, the entire class to which that asset belongs shall be revalued.

- A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. Example:
  - *land*
  - *buildings;*
  - *machinery;*
  - *ships;*
  - *aircraft;*
  - *motor vehicles;*
  - *furniture and fixtures; and*
  - *office equipment.*

- The market value of land and buildings usually represents the fair value, assuming existing use and line of business. Such valuations are usually carried out by professional valuers.

- In the case of plant and equipment, fair value can also be taken as the market value. Where a market value is not available, however, depreciated replacement cost should be used. There may be no market value where types of plant and equipment are sold only rarely or because of their specialised nature i.e. they would normally only be sold as part of an on going business.
- The frequency of valuation depends on the **volatility of the fair values** of individual items of property, plant and equipment.
- The more volatile the fair value, the more frequently revaluations should be carried out.
- Where the current fair value is very different from the carrying value then a revaluation should be carried out.
- Items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets.
- If an asset's carrying amount is increased as a result of a revaluation, the increase shall be credited directly to equity under the heading of revaluation surplus. However, the increase

shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

- If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Activity 12.1

Harvest Co has an item of land carried in its books at UGX13, 000,000. Two years ago a slump in land values led the company to reduce the carrying value from UGX15, 000,000. This was taken as an expense in profit or loss. There has been a surge in land prices in the current year, however, and the land is now worth UGX20, 000,000.

Required
Account for the revaluation in the current year

Activity 12.2

PFP Co has an item of land carried in its books at UGX20, 000,000. Two years ago this amount was revalued upwards to UGX25, 000,000. The value of land has now decreased to UGX18, 000,000.

Required
Account for the decrease in revaluation in the current year

Revaluation and Depreciation

– An upward revaluation means that the depreciation charge will increase. Normally, a revaluation surplus is only realised when the asset is sold, but when it is being depreciated, part of that surplus is being realised as the asset is being used.
– The amount of the surplus realised is the difference between depreciation charged on the revalued amount and the (lower) depreciation which would have been charged on the asset's original cost.
– ***This amount can be transferred to retained (i.e. realised) earnings but not through profit or loss***.

Activity 12.3

ABC CO bought an asset for UGX10, 000,000 at the beginning of 2012. It had a useful life of five years. On 1 January 2014 the asset was revalued to UGX12, 000,000. The expected useful life has remained unchanged (i.e. three years remain).

Required
Account for the revaluation and state the treatment for depreciation from 2014 onwards.

Account for the revaluation and state the treatment for depreciation from 2014 onwards.

- Each item of property, plant and equipment shall be depreciated.
- Depreciation charge for each period shall be recognised in profit or loss.
- The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.
- The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.
  - The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
  - The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

1.5 DERECOGNITION

- The carrying amount of an item of property, plant and equipment shall be derecognised:
  - on disposal; or
  - When no future economic benefits are expected from its use or disposal.
- The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised. Gains shall not be classified as revenue.
- If an entity recognises in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately.
- The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

1.6 IMPAIRMENT

- Impairment, as defined by IAS 36, is a situation that occurs when the recoverable amount of an item declines below the carrying amount (NBV).
- The type of events that could lead to an impairment of an asset could be :
  - External
  - Internal
  - Other
- External factors
  - Significant decline in market value
  - Adverse change in: technology, economy, market, legal environment, etc.
- Internal factors
  - Damage or obsolescence
  - Plans to discontinue/restructure operations
  - Economic performance of the machine is worse than expected

- Other factors: cash flows for acquiring an asset or operating or maintaining it are significantly higher than budget

1.7 DISCLOSURES

- The financial statements shall disclose, for each class of property, plant and equipment:
- the measurement bases used for determining the gross carrying amount;
- the depreciation methods used;
- the useful lives or the depreciation rates used;
- the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
- a reconciliation of the carrying amount at the beginning and end of the period showing:
    - additions;
    - assets classified as held for sale;
    - acquisitions through business combinations;
    - increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in equity;
    - impairment losses recognised or reversed in profit or loss;
    - depreciation; and
    - other changes.

- The financial statements shall also disclose:
- the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
- the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction; and
- the amount of contractual commitments for the acquisition of property, plant and equipment
- If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed:
- the effective date of the revaluation;
- whether an independent value was involved;
- the methods and significant assumptions applied in estimating the items' fair values;
- the extent to which the items' fair values were determined by reference to observable prices in an active market or recent market transactions or were estimated using other valuation techniques;
- for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and
- the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

Investment Property

13.0
IAS 40 "*INVESTMENT PROPERTY*"

UNIT 13 OVERVIEW

- Key definitions under IAS 40.
- Recognition of an item of IP.
- Initial and subsequent measurement of IP.
- Transfers from and to IP
- Derecognition of IP.
- Disclosure requirements.

1.1 DEFINITIONS

(a) **Carrying amount** is the amount at which an asset is recognised in the balance sheet.

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

(c) **Fair value** is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

(d) **Investment property** is property (land or a building—or part of a building—or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

(e) **Owner-occupied property** is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

A property interest that is held by a lessee under an operating lease may be classified and accounted for as investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the fair value model for the asset recognised.

- This classification alternative is available on a property-by-property basis. However, once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model and all required disclosures should be made.

1.2 RECOGNITION

Investment property shall be recognised as an asset when, and only when:

(a) It is probable that future economic benefits associated with the investment property will flow to the entity; and

(b) The cost of the investment property can be measured reliably.

1.3 MEASUREMENT

1.3.1 Initial measurement

An investment property shall be measured initially at cost. Transaction costs shall be included in initial measurement.

The initial cost of a property interest held under a lease and classified as an investment property shall be as prescribed for a finance lease, i.e. the asset shall be recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount shall be recognised as a liability.

1.3.2 Subsequent measurement

- An entity can choose as its accounting policy either the fair value model or the cost model and shall apply that policy to all of its investment property.

- After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value, except for when the fair value of the investment property is not reliably determinable on a continuing basis. This arises when, and only when, comparable market transactions are infrequent and alternative reliable estimates of fair value are not available. Then, an entity shall measure that investment property using the cost model in IAS 16. The residual value shall be assumed to be zero. The entity shall apply IAS 16 until disposal of the asset.
- When a property interest held by a lessee under an operating lease is classified as an investment property, treatment is not elective. The fair value model is to be applied.
- A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises.
- The fair value of investment property shall reflect market conditions at the balance sheet date.
- If an entity chooses the cost model, it shall measure all of its investment property in accordance with IAS 16's requirements. If an entity has previously measured an investment property at fair value, it shall continue to measure the property at fair value until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available.

1.4 TRANSFERS

- *Transfers to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by:*
    a) *commencement of owner-occupation, for a transfer from investment property to owner-occupied property;*
    b) *commencement of development with a view to sale, for a transfer from investment property to inventories;*
    c) *end of owner-occupation, for a transfer from owner-occupied property to investment property;*
    d) *Transfers to, or from, investment property shall be made when, and only when, there is a change in use, evidenced by:*

1.4.1 Transfers under the cost model

FROM	TO	TREATMENT
PPE	IP	No change in cost
INVENTORY	IP	No change in cost
IP	PPE	No change in cost
IP	INVENTORY	No change in cost

1.4.2 Transfers under the fair value model

FROM	TO	TREATMENT
PPE at cost	IP	Value IP at date of transfer in accordance with IAS 16
INVENTORY	IP	Change to profit or loss A/c
IP	PPE	No change in value
IP	INVENTORY	No change in value

Activity 13.1

Pillow Limited was in the process of constructing a building when, due to financial difficulties, it could not complete the construction thereof. It has the following options:
Option 1: Sell the building as is (Pillow does, on occasions sell buildings),
Option 2: Hold the building "as is" for capital appreciation; or
Option 3: Borrow from the bank and complete the building, then lease this building out to a tenant.

Required
Explain how Pillow Limited should account for the building under the three options above.

1.5 JOINT USE PROPERTIES

It sometimes happens that land and buildings are partly owner-occupied and partly leased out commonly referred to as joint use properties. These two components may need to be recognised separately;

- the owner-occupied component as property, plant and equipment; and
- the leased out component as investment property.

We would have an:

- investment portion if a portion of the property is used to earn capital appreciation and / or rental income (an investment property); and
- an owner-occupied portion if a portion of the property is used in the production or supply of goods or services and / or for administrative purposes (an owner-occupied property).

Whether to recognise each portion separately is determined as follows;

- if each portion can be sold or leased separately (under finance lease), then each portion is recognised separately (one as an investment property and the other as an owner-occupied property);
- if each portion cannot be sold or leased out separately, then the entire property is recognised as an investment property if the owner-occupied portion is insignificant in relation to the whole property (otherwise the entire property is recognised as property, plant and equipment).

Judgment is required to determine whether a property qualifies as investment property. An entity must thus develop a criteria so that it can exercise its judgment consistently.

Activity 13.2

Sudir Ltd has the following properties in its financial statements;

A. Sudhir Ltd owns two free standing buildings on two separate sites in Kampala, Uganda. The first building is used by Sudhir Ltd for administrative purposes and the second building is leased out to Crane Bank Ltd.
B. Sudhir Ltd owns a building in Mukono town which it uses for administration purposes. The top floor of the 20-storey building is leased to Sanyu Ltd.
C. Sudhir Ltd owns a 20-storey building in Jinja town. It leases out 19 floors and uses the top floor for administration of the building.

Required
Explain how Sudhir Limited should account for the buildings in its financial statements.

1.6 DISPOSALS

An investment property shall be derecognised (eliminated from the balance sheet) on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Gains or losses arising from the retirement or disposal of investment property shall be determined as the difference between the net disposal proceeds and the carrying amount of the asset and shall be recognised in profit or loss in the period of the retirement or disposal.

Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.

1.7 DISCLOSURES

1.7.1 Fair Value Model and Cost model

- An entity shall disclose:
    a) whether it applies the fair value model or the cost model.

b) if it applies the fair value model, whether, and in what circumstances, property interests held under operating leases are classified and accounted for as investment property.
c) when classification is difficult, the criteria it uses to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business
d) the methods and significant assumptions applied in determining the fair value of investment property.
e) the extent to which the fair value of investment property is based on a valuation by an independent valuer. If there has been no such valuation, that fact shall be disclosed.
f) the amounts recognised in profit or loss for:
    i. rental income from investment property;
    ii. direct operating expenses (including repairs and maintenance) arising from investment property that generated rental income during the period;
    iii. direct operating expenses (including repairs and maintenance) arising from investment property that did not generate rental income
    iv. the cumulative change in fair value recognised in profit or loss on a sale of investment property
  a) the existence and amounts of restrictions on the reliability of investment property or the remittance of income and proceeds of disposal.
  b) contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

1.7.2 Fair Value Model

In addition to the common disclosures, an entity that applies the fair value model shall disclose a reconciliation between the carrying amounts of investment property at the beginning and end of the period, showing :

a) additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised in the carrying amount;
b) additions resulting from acquisitions through business combinations;
c) assets classified or included in a disposal group classified as held for sale;
d) net gains or losses from fair value adjustments;
e) the net exchange differences arising on translation of financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;
f) transfers to and from inventories and owner-occupied property; and
g) other changes.

- When a valuation obtained for investment property is adjusted significantly for the purpose of the financial statements, the entity shall disclose a reconciliation between the valuation obtained and the adjusted valuation included in the financial statements, showing separately and any significant adjustments.

- In exceptional cases, when an entity can only measure investment property using the cost model in IAS 16, the reconciliation shall disclose amounts relating to that investment property separately from amounts relating to other investment property. Plus, an entity shall disclose:

a) a description of the investment property;
b) an explanation of why fair value cannot be determined reliably;
c) if possible, the range of estimates within which fair value is highly likely to lie; a
d) on disposal of investment property not carried at fair value:
    i. the fact that the entity has disposed of investment property not carried at fair value;
    ii. the carrying amount of that investment property at the time of sale; and
    iii. the amount of gain or loss recognised.

1.7.3 Cost Model

In addition to the common disclosures, an entity shall disclose:

a) the depreciation methods used;
b) the useful lives or the depreciation rates used;
c) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at beginning and end of the period;
d) a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:
    i. additions, disclosing separately those additions resulting from acquisitions and those resulting from subsequent expenditure recognised as an asset;
    ii. additions resulting from acquisitions through business combinations;

d) a reconciliation of the carrying amount of investment property at the beginning and end of the period, showing the following:
    iii. assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5 and other disposals;
    iv. depreciation;
    v. the amount of impairment losses recognised, and the amount of impairment losses reversed, during the period in accordance with IAS 36;
    vi. the net exchange differences arising on the translation of the financial statements into a different presentation currency, and on translation of a foreign operation into the presentation currency of the reporting entity;
    vii. transfers to and from inventories and owner-occupied property; and
    viii. other changes; and

e) The fair value of investment property. In the exceptional cases, when an entity can only use the cost model because it cannot determine the fair value of the investment property reliably, it shall disclose:
    i. a description of the investment property;
    ii. an explanation of why fair value cannot be determined reliably; and
    iii. if possible, the range of estimates within which fair value is highly likely to lie.

PRACTICE QUESTIONS

QUESTION 13.1 JRK Ltd

JRK Ltd has three investment properties in Masaka town, codenamed 1, 2 and 3. The company's policy is to carry its investment property at fair value. During the year ended 31 May 2018 the company developed Property 1 with a view of selling it by 30 June 2018; Property 2 was to be disposed of without development, while Property 3 was re-occupied by the company's new branch opened in Masaka on 5 April 2018.

Required:
Discuss, with reference to IAS 40: Investment Property, how the three properties should be presented, recognized and measured in the financial statements of JRK Ltd for the year ended 31 May 2018.

QUESTION 13.2

(a) IAS 40: Investment Property defines investment property as property (land or buildings or part of the building or both) held to earn rentals or for capital appreciation or both. It further specifies the conditions for recognition and measurement of assets classified as investment property.

Required:
Discuss the conditions that should be satisfied for an investment property to be recognised as an asset in the financial statements and exceptions of assets that should not be classified under investment property. *(5 marks)*

(b) Nyumbani Ltd acquired two properties of land one for Shs 100 million on 1 January, 2015 and another on 31 December, 2015 for Shs 80 million. During the year ended 31 December, 2016 Nyumbani Ltd constructed its head offices valued at Shs 120 million on the land whose cost was Shs 80 million and nothing has yet been decided on what it should use the land that cost Shs 100 million. The prices of land in Uganda and Kampala in particular are increasing day by day because of high demand and inflation. Experts estimate that the average inflation rate of the prices of land is 15% per annum.

Required:
(i) Discuss the two measurement bases used in ascertaining the value of an investment property in accordance with IAS 40. *(2 marks)*

(ii) Given that the two properties of land are located in Kampala and that Nyumbani Ltd uses fair value measurement in valuing its land, and depreciates its building at the rate of 5% annually on straight line basis; show how the above transactions will be recognised in the financial statements for the year ended 31 December, 2016 giving extracts of the financial statements.

(13 marks)
(Total 20 marks)

Source: CPA(U), May 2017, Question 3

Impairment of Assets

14.0
IAS 36 "*IMPAIRMENT OF ASSETS*"

UNIT 14 OVERVIEW
- IAS 36 Impairment of assets
- Cash generating units
- Goodwill and the impairment of assets
- Accounting treatment of an impairment loss

1.1 Introduction

There is an established principle that assets should not be carried at above their recoverable amount. An entity should write down the carrying amount of an asset to its recoverable amount if the carrying amount of an asset is not recoverable in full. IAS 36 puts in place a detailed methodology for carrying out impairment reviews and related accounting treatments and disclosures.

Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its fair value less costs of disposal and its value in use.

1.2 Scope

IAS 36 applies to all tangible, intangible and financial assets except inventories, assets arising from construction contracts, deferred tax assets, assets arising under IAS 19 Employee benefits and financial assets within the scope of IAS 32 Financial instruments: presentation. This is because those IASs already have rules for recognizing and measuring impairment. Note also that IAS 36 does not apply to non-current assets held for sale, which are dealt with under IRFS 5 Non-current assets held for sale and discontinued operations.

1.3 KEY TERMS

1.3.1 Impairment
This refers to a fall in the value of an asset, so that its' recoverable amount' is now less than its carrying amount in the statement of financial position.

1.3.2 Carrying Amount
Carrying amount is the net value at which the asset is included in the statement of financial position (ie after deducting accumulated depreciation and any impairment losses).

1.3.3 Recoverable Amount
The recoverable amount of an asset should be measured as the higher value of:

(a) The asset's fair value less costs of disposal; and
(b) Its value in use

1.4 FAIR VALUE LESS COST OF DISPOSAL

An asset's fair value less costs of disposal is the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date, less direct disposal costs, such as legal expenses.

(a) If there is an active market in the asset, the fair value should be based on the market price, or on the price of recent transactions in similar assets.
(b) If there is no active market in the asset it might be possible to estimate fair value using best estimates of what market participants might pay in an orderly transaction.

Fair value less costs of disposal cannot be reduced, however, by including within costs of disposal any restructuring or reorganization expenses, or any costs that have already been recognized in the accounts as liabilities.

1.5 VALUE IN USE

The value in use of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its expected useful life.

1.6 IDENTIFYING A POTENTIALLY IMPAIRED ASSET

An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. The concept of materiality applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the entity is required to make a formal estimate of the recoverable amount of the assets concerned.

IAS 36 suggests how indications of a possible impairment of assets might be recognized. The suggestions are based largely on common sense.

(a) External sources of information

(i) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use.
(ii) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.
(iii) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.
(iv) The carrying amount of the entity's net assets being more than its market capitalization

(b) Internal sources of information:

Evidence of obsolescence or physical damage, adverse changes in the use to which the asset is put, or the asset's economic performance. Even if there are no indications of impairment, the following assets must always be tested for impairment annually.

(a) An intangible asset with an indefinite useful life
(b) Goodwill acquired in a business combination

1.7 RECOGNITION AND MEASUREMENT OF AN IMPAIRMENT LOSS

The basic principle underlying IAS 36 is relatively straightforward. If an asset's value in the account is higher than its realistic value, measured as its recoverable amount'; the asset is judged to have suffered an impairment loss. It should therefore be reduced in value, by the amount of the impairment loss. The amount of the impairment loss would be written off against profit immediately.

The rule for assets at historical cost is:

If the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (i.e. the impairment loss) which should be charged as an expense in profit or loss.

The rule for assets held at a revalued amount (such as property revalued under IAS 16) is:

The impairment loss to be treated as a revaluation decrease under the relevant IAS.

In practice this means:

- To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to revaluation surplus.
- Any excess should be charged to profit or loss.

1.8 CASH GENERATING UNITS

When it is not possible to calculate the recoverable amount of a single asset, then that of its cash generating unit should be measured instead.

1.8.1 Use of cash-generating unit

The IAS goes into quite a large amount of detail about the important concept of cash generating units. As a basic rule, the recoverable amount of an asset should be calculated for the asset individually. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows and outflows cannot be attributed to the individual asset.

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash-generating unit should be measured instead.

Key term:
A cash-generating unit is the smallest identifiable group of assets for which independent cash flows can be identified and measured.

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

Cash-generating units should be identified consistently from period to period for the same type of asset unless a change is justified.

The group of net assets less liabilities that are considered for impairment should be the same as those considered in the calculation of the recoverable amount. (for the treatment of goodwill and corporate assets).

1.9 GOODWILL AND THE IMPAIRMENT OF ASSETS

1.9.1 Allocating goodwill to cash-generating units

Goodwill acquired in a business combination does not generate cash flows independently of other assets. It must be allocated to each of the acquirer's cash-generating units (or groups of cash-generating units) that are expected to benefit from the synergies of the combination. Each unit to which the goodwill is so allocated should:

(a) Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes.
(b) Not be larger than a reporting segment determined in accordance with IFRS 8 Operating segments.

It may be impracticable to complete the allocation of goodwill before the first reporting date after a business combination, particularly if the acquirer is accounting for the combination for the first time using provisional values. The initial allocation of goodwill must be completed before the end of the first reporting period after the acquisition date.

1.9.2 Testing cash-generating units with goodwill for impairment

A cash-generating unit to which goodwill has been allocated is tested for impairment annually. The carrying amount of the unit, including goodwill, is compared with the recoverable amount. If the carrying amount of the unit exceed the recoverable amount, the entity must recognize an impairment loss.

The annual impairment test may be performed at any time during an accounting period, but must be performed at the same time every year.

Activity 14.1:

A cash-generating unit comprises of the following:

	Shs.m
Building	30
Plant and equipment	6
Goodwill	10
Current assets	20
	66

Following a recession, an impairment review has estimated the recoverable amount of the cash-generating unit to be Shs.50m.

Required
Allocate the impairment loss

1.10 ACCOUNTING TREATMENT OF AN IMPAIRMENT LOSS

If, and only if, the recoverable amount of an asset is less than its carrying amount in the statement of financial position, an impairment loss has occurred. This loss should be recognized immediately.
(a) The asset's carrying amount should be reduced to its recoverable amount in the statement of financial position.
(b) The impairment loss should be recognized immediately in profit or loss (unless the asset has been revalued in which case the loss is treated as a revaluation decrease).

After reducing an asset to its recoverable amount, the depreciation charge on the asset should then be based on its new carrying amount, its estimated residual value (if any) and its estimated remaining useful life.

An impairment loss should be recognized for a cash-generating unit if (and only if) the recoverable amount for the cash-generating unit is less than the carrying amount in the statement of financial position for all the assets in the unit. When an impairment loss is recognized for a cash-generating unit, the loss should be allocated between the assets in the unit in the following order.

(a) First, to any assets that are obviously damaged or destroyed
(b) Next, to the goodwill allocated to the cash generating unit
(c) Then to all other assets in the cash-generating unit, on a pro rata basis

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

(a) Its fair value less costs of disposal
(b) Its value in use (if determinable)
(c) Zero

Any remaining amount of an impairment loss should be recognized as a liability if required by other IASs.

Activity 14.2

Tullow oil Plc is an international company that extracts natural gas and oil from the Lake Albert region. In the extraction contract signed by Tullow Oil Plc and the government of Uganda, the entity is required to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life. The company is carrying out an exercise to establish whether there has been an impairment of the platform.

(a) Its carrying amount in the statement of financial position is Shs.3 billion.
(b) The company has received an offer of Shs.2.8 billion for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.
(c) The present value of the estimated cash flows from the platform's continued use is Shs.3.3 billion (before adjusting for dismantling costs).
(d) The carrying amount in the statement of financial position for the provision for dismantling and removal is currently Shs.600 million

Required
What would be the value of the drilling platform in the statement of financial position, and what, if anything is the impairment loss?

Activity 14.3:

A company has acquired another business for Shs.450m: tangible assets are valued at Shs.400m and goodwill at Shs.50m.

An asset with a carrying value of Shs.100m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to assess whether there has been an impairment of assets in the acquired business and what the amount of any such loss is.

The recoverable amount of the business (a single cash generating unit) is measured as Shs.310m.

Required
Allocate the impairment loss

1.11 REVERSAL OF AN IMPAIRMENT LOSS

The annual assessment to determine whether there may have been some impairment should be applied to all assets, including assets that have already been impaired in the past.

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be higher than the asset's current carrying value. In other words, there might have been a reversal of some of the previous impairment loss.

(a) The reversal of the impairment loss should be recognised immediately as income in profit or loss.
(b) The carrying amount of the asset should be increased to its new recoverable mount.

An exception to this rule is for goodwill. An impairment loss for goodwill should not be reversed in a subsequent period.

Activity 14.4:

A cash generating unit comprising a factory, plant and equipment etc and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash generating unit falls to Shs.60m, resulting in an impairment loss of Shs.80m, allocated as follows.

	Carrying amounts before impairment Shs.m	Carrying amounts after impairment Shs.m
Goodwill	40	__
Patent (with no market value)	20	__
Tangible non-current assets (market value Shs.60m)	80	60
Total	140	60

After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the cash generating unit increases to Shs.90m. The carrying amount of the tangible non-current assets had the impairment not occurred would have been Shs.70m.

Required:
Calculate the reversal of the impairment loss.

PRACTICE QUESTIONS

QUESTION 14.1 KISANJA CONSTRUCTORS Ltd

At the end of June, 2017 Kisanja Contractors Ltd tested a machine for impairment. The machine was bought five years earlier for Shs 400 million, when its useful life was estimated to be 15 years and the estimated residue value was nil. At 30 June, 2017 after recognising the depreciation charge for the period, the machine's carrying amount was Shs300 million and its remaining useful life was estimated at 10 years. The company uses a pretax rate of 14% and a post-tax rate of 12%. Budgets approved by management reflect expected cash inflows net of estimated costs necessary to maintain the level of economic benefit that is expected to arise from the machine in its current condition. The expected future cash flows which are assumed to occur at the end of each reporting period are as follows:

Year	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Shs"millions"	32	25	36	45	49	51	53	57.3	57.2	57

Required:

(i) Advise the general manager on the accounting treatment of the impairment loss as per IAS36.

(ii) Determine the amount of the impairment loss; and

(iii) Show the double entry figures for the impairment loss to be included in the statement of profit or loss and other comprehensive income and in the statement of financial position for the period ended 30 June, 2017 as per IAS 36

HINT: The discount factors are as follows:

Year	1	2	3	4	5	6	7	8	9	10
Factor 14%	0.877	0.769	0.675	0.592	0.519	0.456	0.400	0.351	0.308	0.270
Factor 12%	0.893	0.797	0.712	0.636	0.567	0.507	0.452	0.404	0.361	0.322

QUESTION 14.2 VICTORIA FISHERIES Ltd

Victoria Fisheries Ltd (VFL) recently acquired a fish processing company at Entebbe for Shs 3 billion. VFL allocated the purchase consideration as follows:

	Shs"millions"
Goodwill	360
Fishing quotas	600
Fishing boats (2 of equal value)	1,500
Other fishing equipment	150
Fish processing plant	300
Net current assets	90
TOTAL	**3,000**

Shortly after the acquisition, one of the fishing boats sank and this reduced the fishing capacity. Due to this reduction in capacity, the value in use of the fishing business as a going concern is estimated at only Shs1·8 billion. The fishing quotas now represent a greater volume than one boat can fish and it is impossible to replace the lost boat. However, the fishing quotas are much in demand and could be sold for Shs 900 million. VFL has been offered Shs 375 million for the fish processing plant. The net current assets consist of accounts receivable and payable.

Required:
Calculate the amounts that would appear in the financial statements of Victoria Fisheries Ltd after accounting for the impairment loss.

Intangible Assets

15.0
IAS 38 "*INTANGIBLE ASSETS*"

UNIT 15 OVERVIEW:
- IAS 38 Intangible assets
- Research and development costs
- Accounting Treatment

1.1 The objectives of the standard

(a) To establish the criteria for when an intangible asset may or should be recognized
(b) To specify how intangible assets should be measured
(c) To specify the disclosure requirements for intangible assets

1.2 Definition of an intangible asset

An intangible asset is an identifiable non-monetary asset without physical substance. The asset must be:

(a) Controlled by the entity as a result of events in the past, and
(b) Something from which the entity expects future economic benefits to flow.

Examples of items that might be considered as intangible assets include;

a) computer software,
b) patents,
c) copyrights,
d) motion picture films,
e) customer lists,
f) franchise and
g) fishing rights.

An item should not be recognized as an intangible asset, however, unless it fully meets the definition in the standard.

1.2.1 Intangible asset: must be identifiable

An intangible asset must be identifiable in order to distinguish it from goodwill. With non-physical items, there may be a problem with 'identifiability'.

(a) If an intangible asset is acquired separately through purchase, there may be a transfer of a legal right that would help to make an asset identifiable.
(b) An intangible asset may be identifiable if it is separable, i.e. if it could be rented or sold separately. However, 'separability' is not an essential feature of an intangible asset.

1.2.2 Intangible asset: control by the entity

Another element of the definition of an intangible asset is that it must be under the control of the entity as a result of a past event. The entity must therefore be able to enjoy the future economic benefits from the asset, and prevent the access of others to those benefits. A legally enforceable right is evidence of such control, but is not always a necessary condition.

(a) Control over technical knowledge or know-how only exists if it is protected by a legal right.
(b) The skill of employees, arising out of the benefits of training costs, are most unlikely to be recognizable as an intangible asset, because an entity does not control the future actions of its staff.
(c) Similarly, market share and customer loyalty cannot normally be intangible assets, since an entity cannot control the actions of its customers.

1.3 Initial Recognition

An intangible asset, should be recognized if, and only if both the following occur.

(a) It is probable that the future economic benefits that are attributable to the asset will flow to the entity.
(b) The cost can be measured reliably.

1.3.1 Intangible asset: expected future economic benefits

An item can only be recognized as an intangible asset if economic benefits are expected to flow in the future from ownership of the asset. Economic benefits may come from the sale of products or services, or from a reduction in expenditures (cost savings).

Management has to exercise its Judgement in assessing the degree of certainty attached to the flow of economic benefits to the entity. External evidence is best.

1.4 Initial Measurement

An intangible asset when recognized must be measured at cost.

(a) If an intangible asset is acquired separately, its cost can usually be measured reliably as its purchase price (including incidental costs of purchase such as legal fees, and any costs incurred in getting the asset ready for use).
(b) When an intangible asset is acquired as part of a business combination (i.e. an acquisition or takeover), the cost of the intangible asset is its fair value at the date of the acquisition.

IFRS 3 explains that the fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognized separately from goodwill.

Quoted market prices in an active market provide the most reliable estimate of the fair value of an intangible asset. If no active market exists for an intangible asset, its fair value is the amount that the entity would have paid for the asset, at the acquisition date, in an orderly transaction between market participants, on the basis of the best information available. In determining this amount, an entity should consider the outcome of recent transactions for similar assets. There are techniques for estimating the fair values of unique intangible assets (such as brand names) and these may be used to measure an intangible asset acquired in a business combination.

In accordance with IAS 20, intangible assets acquired by way of government grant and the grant itself may be recorded initially either at cost (which may be zero) or fair value.

1.5 Exchanges of assets

If one intangible asset is exchanged for another, the cost of the intangible asset is measured at fair value unless:

(a) The exchange transaction lacks commercial substance, or
(b) The fair value of neither the asset received nor the asset given up can be measured reliably.

Otherwise, its cost is measured at the carrying amount of the asset given up.

1.6 Internally generated goodwill

Internally generated goodwill may not be recognized as an asset.

The standard deliberately precludes recognition of internally generated goodwill because it required that, for initial recognition, the cost of the asset rather than its fair value should be capable of being measured reliably and that it should be identifiable and controlled. Thus you do not recognize an asset which is subjective and cannot be measured reliably.

1.7 Research and development costs

Development costs can be recognized as an asset if they meet certain criteria.

1.8 Research

Research activities by definition do not meet the criteria for recognition under IAS 38. This is because, at the research stage of a project, it cannot be certain that future economic benefits will probably flow to the entity from the project. There is too much uncertainty about the likely success or otherwise of the project. Research costs should therefore be written off as an expense as they are incurred.

Examples of research costs

(a) Activities aimed at obtaining new knowledge
(b) The search for, evaluation and final selection of, applications of research findings or other knowledge
(c) The search for alternatives for materials, devices, products, processes, systems or services
(d) The formulation, design evaluation and final selection of possible alternatives for new or improved materials, devices, products, systems or services.

1.9 Development

Development costs may qualify for recognition as intangible assets provided that the following strict criteria can be demonstrated.

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.
(b) Its intention to complete the intangible asset and use or sell it.
(c) Its ability to use or sell the intangible asset.
(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
(e) Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

In contrast with research costs development costs are incurred at a later stage in a project, and the probability of success should be more apparent. Examples of development costs include the following.

(a) The design, construction and testing of pre-production or pre-use prototypes and models
(b) The design of tools. Jigs, moulds and dies involving new technology
(c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production
(d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

1.10 Other internally generated intangible assets

The standard prohibits the recognition of internally generated brands, mastheads, publishing titles and customer lists and similar items are as intangible assets. These all fail to meet one or more (in some cases all) the definition and recognition criteria and in some cases are probably indistinguishable from internally generated goodwill.

1.11 Cost of an internally generated intangible asset

Intangible assets should be initially measured at cost, but subsequently they can be carried at cost or at a revalued amount.

The costs allocated to an internally generated intangible asset should be only costs that can be directly attributed or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use. The principles underlying the costs which may or may not be included are similar to those for other non-current assets and inventory.

The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria. If, as often happens, considerable costs have already been recognized as expenses before management could demonstrate that the criteria have been met, this earlier expenditure should not be retrospectively recognized at a later date as part of the cost of an intangible asset.

Activity 15.1

Deals Ltd is developing a new production process. During 2017, expenditure incurred was Shs.100 million of which Shs.90 million was incurred before 1 December 2017 and Shs.10million between 1 December 2017 and 31 December 2017. Deals Ltd can demonstrate that, at 1 December 2017, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process is estimated to be Shs.50million.

Required
How should the expenditure be treated?

1.12 Recognition of an expense

All expenditure related to an intangible which does not meet the criteria for recognition either as an identifiable intangible asset or as goodwill arising on an acquisition should be expensed as incurred. The IAS gives examples of such expenditure.

- Start up costs
- Training costs
- Advertising costs
- Business relocation costs

Prepaid costs for services, for example advertising or marketing costs for campaigns that have ben prepared but not launched, can still be recognized as a prepayment.

1.13 Measurement of intangible assets subsequent to initial recognition

The standard allows two methods of valuation for intangible assets after they have been first recognized. Applying the cost model, an intangible asset should be carried at its cost, less any accumulated amortisation and less any accumulated impairment losses.

(a) The fair value must be able to be measured reliably with reference to an active market in that type of asset.
(b) The entire class of intangible assets of that type must be revalued at the same time (to prevent selective revaluations).
(c) If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset should be carried at its cost less any accumulated amortisation and impairment losses.
(d) Revaluations should be made with such regularity that the carrying amount does not differ from that which would be determined using fair value at the end of the reporting period.

This treatment is not available for the initial recognition of intangible assets. This is because the cost of the asset must be reliably measured.

The guidelines state that there will not usually be an active market in an intangible asset; therefore the revaluation model will usually not be available. For example, although copyrights, publishing rights and film rights can be sold, each has a unique sale value. In such cases, revaluation to fair value would be inappropriate. A fair value might be obtainable however for assets such as fishing rights or quotas or taxi cab licences.

Where an intangible asset is revalued upwards to affair value, the amount of the revaluation should be credited directly to equity under the heading of a revaluation surplus.

However, if a revaluation surplus is reversal of a revaluation decrease that was previously charged against income, the increase can be recognized as income.

Where the carrying amount of an intangible asset is revalued downwards, the amount of the downward revaluation should be charged as an expense against income, unless the asset has previously been revalued upwards. A revaluation decrease should be first charged against any previous revaluation surplus in respect of that asset.

Activity 15.2

An intangible asset is measured by a company at fair value. The asset was revalued by Shs.400million in 2016, and there is a revaluation surplus of shs.400 million in the statement of financial position. At the end of 2017, the asset is valued again, and a downward valuation of shs.500 million is required.

Required:
State the accounting treatment for the downward revaluation.

1.14 Useful life

An entity should assess the useful life of an intangible asset, which may be finite or indefinite. An intangible asset has an indefinite useful life when there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Many factors are considered in determining the useful life of an intangible asset, including: expected usage; typical product life cycles; technical, technological, commercial or other types of obsolescence; the stability of the industry; expected actions by competitors; the level of maintenance expenditure required; and legal or similar limits on the use of the asset, such as the expiry dates of related leases. Computer software and many other intangible assets normally have short lives because they are susceptible to technological obsolescence. However, uncertainty does not justify choosing a life that is unrealistically short.

The useful life of an intangible asset that arises from contractual or other legal rights should not exceed the period of the rights, but may be shorter depending on the period over which the entity expects to use the asset.

1.15 Amortisation period and amortisation method

An intangible asset with a finite useful life should be amortised over its expected useful life.

(a) Amortisation should start when the asset is available for use.
(b) Amortisation should cease at the earlier of the date that the asset is classified as held for sale in accordance with IFRS 5 Non-current assets held for sale and discontinued operations and the date that the asset is derecognized.
(c) The amortisation method used should reflect the pattern in which the asset's future economic benefits are consumed. If such a pattern cannot be predicted reliably, the straight-line method should be used.
(d) The amortisation charge for each period should normally be recognized in profit or loss.

The residual value of an intangible asset with a finite useful life is assumed to be zero unless a third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset (so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.

The amortisation period and the amortisation method used for an intangible asset with a finite useful life should be reviewed at each financial year-end.

1.16 Intangible assets with indefinite useful lives

An intangible asset with an indefinite useful life should not be amortised. (IAS 36 requires that such an asset is tested for impairment at least annually).

The useful life of an intangible asset that is not being amortised should be reviewed each year to determine whether it is still appropriate to assess its useful life as indefinite. Reassessing the useful life of n intangible asset as finite rather than indefinite is an indicator that the asset may be impaired and therefore it should be tested for impairment.

1.17 Disposals/retirements of intangible assets

An intangible asset should be eliminated from the statement of financial position when it is disposed of or when there is no further expected economic benefit from its future use. On disposal the gain or loss arising from the difference between the net disposal proceeds and the carrying amount of the asset should be taken to profit or loss as a gain or loss on disposal (i.e. treated as income or expense).

PRACTICE QUESTIONS

QUESTION 15.1

XYZ Ltd is developing a new production process. During the year 2015, the company incurred Shs 100 million on the new production process, of which Shs 60 million was incurred before 1 October, 2015 and Shs 40 million was incurred between 1 October, 2015 and 31 December, 2015.

XYZ Ltd demonstrated that at 1 October, 2015 the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process is estimated at Shs 50 million.

Required:
(i) Explain the treatment of the development costs according to IAS 38: Intangible Assets. (4 marks)
(j) Explain the two methods of valuation for intangible assets after they have been first recognised in the financial statements. (4 marks)

QUESTION 15.2

It is the policy of XYZ Ltd to value its intangible assets at fair value. One of the intangible assets was revalued upwards by Shs 50 million on 31 March, 2015 creating a surplus of the same amount which was recognised in the financial tatements for that year. The asset was revalued again on 31 March, 2016 and a downward valuation of Shs 70 million arose

Required:
Describe how the downward and upward revaluation of the intangible asset will be treated in the financial statements of XYZ Ltd.

QUESTION 15.3

Kyakabale Enterprises Ltd (KEL) is a startup company that has been investing in research and development for the last 5 years. KEL has been advised about the possibility of benefiting from intangible assets.

Required:
As a financial reporting specialist:
(i) Advise the management of Kyakabale Enterprises Ltd on the initial recognition criteria of intangible assets as stated under IAS 38: Intangible Assets.

(ii) Describe the measurement after initial recognition of IAS 38 using the cost model and revaluation model.

(iii) Describe when an intangible asset arising from the Research phase and Development phase should be recognised under IAS 38.

(iv) For an intangible asset accounted for at revalued amounts, state what the entity would be required to disclose under the Standard by the class of intangible assets.

Effect of Change in Foreign Exchange Rates

16.0
IAS 21 "*EFFECT OF CHANGE IN FOREIGN EXCHANGE RATES*"

UNIT 16 OVERVIEW

- Scope of IAS 21
- Key Definitions
- Functional Currency
- Presentation Currency
- Functional Currency of a foreign operation
- Accounting for Individual transactions designated in foreign currency
- Treatment of year end balances

1.1 Scope of IAS 21

IAS 21 deals with:

- The definition of functional and presentation currencies
- Accounting for individual transactions in a foreign currency
- Translating the financial statements of a foreign operation

Translating the financial statements of a foreign operation is covered in a later chapter.

1.2 Key Definitions

1.2.1 The functional currency

This is the currency of the primary economic environment where the entity operates. In most cases this will be the local currency.

An entity should consider the following when determining its functional currency.

- *The currency that mainly influences sales prices for goods and services.*
- *The currency of the country whose competitive forces and regulations mainly determine the sales price of goods and services.*
- *The currency that mainly influences labour, material and other costs of providing goods and services.*

The functional currency is the currency an entity will use to record its day-to-day transactions. In addition to the points noted previously, IAS 21 also identifies that an entity should consider the following factors in determining its functional currency:

- *The currency in which funding from issuing debt and equity is generated.*
- *The currency in which receipts from operating activities are usually retained.*

1.2.2 Presentation currency

The presentation currency is the currency in which the entity presents its financial statements. This can be different from the functional currency.

Example 16.1:

Entity A operates in the Uganda. It sells goods throughout Uganda and East Africa with all transactions denominated in Uganda Shillings (UGX). Cash is received from sales in Uganda Shillings (UGX). It raises finance locally from banks in Uganda with all loans denominated in UGX.

Required
What is functional currency of entity A?

Solution 16.1
Looking at the factors listed above it is apparent that the functional currency for entity A is Uganda shillings. It trades in this currency and raises finance in this currency. Therefore Entity A would record its accounting transactions in Uganda shillings as its functional currency.

1.3 Functional Currency of a foreign Operation

One complication in determining functional currency arises if an entity is a foreign operation. For example, if Entity A (from above) has a subsidiary. Entity B located in Kenya, Entity B will also have to determine its functional currency. The question arises as to whether this will be the same as the parent or will be the local currency where Entity B is located.

The factors that must be considered are:

- *Whether the activities of the foreign operation are carried out as an extension of the parent, rather than with a significant degree of autonomy.*
- *Whether transactions with the parent are a high or low proportion of the foreign operation's activities.*
- *Whether cash flows from the foreign operation directly affect the cash flows of the parent and are readily available for remittance to it.*
- *Whether cash flows from the activities of the foreign operation are sufficient to service existing debt obligations without funds being made available by the parent.*

So, continuing with the example above, if Entity B operates as an independent operation, generating income and expenses in its local currency and raising finance in its local currency, then its functional currency would be its local currency and not that of Entity A. However, if Entity B was merely an extension of Entity A, only selling goods imported from Entity A and remitting all profits back to Entity A, then the functional currency should be the same as the parent. In this case Entity B would record its transactions in Uganda shillings and not its local currency (Kenya Shillings, Kshs).

Once a functional currency is determined it is not changed unless there is a change in the underlying circumstances that were relevant when determining the original functional currency.

IAS 21 states that whereas an entity is constrained by the factors listed above in determining its functional currency, it has a completely free choice as to the currency in which it presents its financial statements. If the presentation currency is different from the functional currency, then the financial statements must be translated into the presentation currency. For example, a group may have subsidiaries whose functional currencies are different to that of the parent. These must be translated into the presentation currency so that the consolidation procedure can take place.

1.4 ACCOUNTING FOR INDIVIDUAL TRANSACTIONS DESIGNATED IN A FOREIGN CURRENCY

Where an entity enters into a transaction denominated in a currency other than its functional currency, that transaction must be translated into the functional currency before it is recorded.

The exchange rate used to initially record transactions should be either:

- *The spot exchange rate on the date the transaction occurred, or*
- *An average rate over a period of time, providing the exchange rate has not fluctuated significantly.*

1.4.1 Cash settlement

When cash settlement occurs, such as when cash is received from an overseas credit customer, the settled amount should be translated into the functional currency using the spot exchange rate on the settlement date. If this amount differs from that used when the transaction occurred, there will be an exchange difference.

1.4.2 Exchange differences on settlement

IAS 21 requires that exchange gains or losses on settlement of individual transactions must be recognised in profit or loss in the period in which they arise.

IAS 21 is not definitive in stating where in profit or loss any such gains or losses are classified. It would seem reasonable to regard them as items of operating expense or income. However, other profit or loss headings may also be appropriate.

Example 14.2: Exchange differences on settlement

On 7 May 2014 an entity with a functional currency of dollars ($) sold goods to a German entity for €48,000. On this date, the rate of exchange was $1 = €3.2. On 20 July 2014 the customer paid the outstanding balance. On this date, the rate of exchange was $ 1 = €3.17.

Required
Account for the above transactions in the accounts of the entity

1.5 TREATMENT OF YEAR-END BALANCES

The treatment of any overseas items remaining in the statement of financial position at the year-end will depend on whether they are monetary or non-monetary.

Monetary Items

Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency, e.g. cash, receivables, payables, loans

- Retranslate using the closing rate (year-end exchange rate)

Non-monetary items

Other items in the statement of financial position, e.g. non-current assets, inventory, investments

- Do not retranslate
- If an item is carried at fair value, the fair value should be translated on the date it was determined.

1.6 EXCHANGE DIFFERENCES ON RETRANSLATION OF MONETARY ITEMS

As with exchange differences arising on settlement, IAS 21 requires that exchange differences arising on retranslation of monetary assets and liabilities must be recognised in profit or loss. IAS 21 does not specify the heading(s) under which such exchange gains or losses should be classified. It would seem reasonable to regard them as items of operating income or operating expenses as appropriate.

1.7 SHORTCOMINGS IN IAS 21

There are a number of issues on which IAS 21 is either silent or fails to give adequate guidance.

(a) Under IAS 21 transactions should be recorded at the rate ruling at the date the transaction occurs (i.e. the date when the transaction qualifies for recognition in the accounts0, but in some cases this date is difficult to establish. For example, it could be the order date, the date of invoice or the date on which the goods were received.

(b) IAS 21states that average rates can be used if these do not fluctuate significantly, but what period should be used to calculate average rates? Should the average rate be adjusted to take account of material transactions?

(c) IAS 21 provides only limited guidance where there are two or more exchange rates for a particular currency or where an exchange rate is suspended. It has been suggested that companies should use whichever rate seems appropriate given the nature of the transaction and have regard to prudence if necessary.

(d) IAS 21 makes a distinction between the translation of monetary and non-monetary items, but in practice some items (such as progress payments paid against non-current assets or inventories, and debt securities held as investments) may have characteristics of both.

PRACTICE QUESTIONS

QUESTION 16.1 AUL Co

On 1 July 2016, AUL purchased equipment with a useful life of 10 years from an American supplier for $100,000 when the exchange rate was $1: Shs 2,000. The equipment was delivered and installed on 3 July 2016. AUL paid for the equipment in full on 1 June 2017 when the exchange rate was $1: Shs 2,500.

Required:

Advise AUL on the accounting treatment of the equipment transaction for the year ending 30 June 2017 in order to comply with IFRS.

QUESTION 16.2 MEGA (U) Ltd

On 2 May 2016, Mega (U) Ltd acquired a strategically located commercial property in the city centre of Kigali Rwanda, for Rwf120 million when the exchange rate was shs3.3 to 1 Rwf. On the same day, Mega (U) Ltd incurred Rwf10 million in transaction costs. The property was revalued to Rwf180 million on 31 March 2017 when the exchange rate was shs3.5 to 1 Rwf.

It is the company's policy to apply the fair value model to its properties. The transaction and change in fair value have not yet been included in the draft financial statements of Mega (U) Ltd as at 31 March 2015.

Required:

Advise the management of Mega (U) Ltd on the accounting treatment of the commercial property acquired in Rwanda in the financial statements of the entity for the year ended 31 March 2017.

QUESTION 16.3 Dot Com Ltd

Dot Com Ltd (DCL) is a large company that has several subsidiaries in Uganda and in other countries in the East African region. The company exports most of its products to Europe. During the year ended 1 July 2015, DCL launched a major expansion project in a bid to capture the competitive telecom sector.

The company purchased equipment from Germany on 1 July, 2015 for €42 million on credit. The economic life of the equipment on 1 July, 2015 was estimated to be eight years. On the same day some replacement spare parts were purchased for €2 million from the same supplier on credit. Both the equipment and spare parts were transported in the same consignment. The exchange rate on 1 July, 2015 was Shs 3,100/€. Customs tax on the equipment and spare parts was Shs 42 billion of which Shs 4 billion is recoverable. DCL hired ESCO Associates (EA) to carry out the structural design at cost of Shs 12 billion, which was paid before the year end.
During the installation process some parts were broken and replaced at an additional cost of Shs 24 billion. By 30 June 2016 the amount due to the supplier was outstanding and the exchange rate had moved to Shs 3,180/€.

Required:

(i) *Determine the cost of the equipment that should be recognized on 1 July 2015.*
(ii) *Explain how the replacement parts should be accounted for.*
(iii) *Show how the exchange differences should be recognised in compliance with International Financial Reporting Standards.*

QUESTION 16.4

The main objective of IAS 21: The Effects of Changes in Foreign Exchange Rates is to provide guidance on the translation method and on determining the functional and presentation currencies.

Required:
(i) Define the terms 'functional currency' and 'presentation currency' in accordance with IAS 21.

(ii) A holding or parent company with foreign operations must translate the financial statements of those operations into its own functional currency before they can be consolidated into the group accounts.

Required:
Discuss any two factors that should be considered in determining the functional currency.

(iii) ABC Ltd set up a foreign subsidiary on 30 June, 2015. It subscribed Euros (EUR) 60,000 for share capital when the exchange rate was EUR 2 to USD 1. The subsidiary borrowed EUR 180,000 and bought a non-monetary asset for EUR 240,000. ABC Ltd prepared its financial statements on 31 December, 2015 when the exchange rate was EUR 3 to USD 1. As a result of highly unusual circumstances, the subsidiary sold its asset in February, 2016, repaid its loan and was liquidated. The share capital of EUR 60,000 was also repaid to ABC Ltd in the same month when the exchange rate was EUR 3 to USD 1.

Required:
Prepare the statement of financial position of the subsidiary at 31 December, 2015 denominated in both EUR and USD.

QUESTION 16.5

(a) IAS 21: The Effects of Changes in Foreign Exchange Rates states that a foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.

Required:
Set out the rules that apply when reporting foreign currency transactions at the subsequent reporting periods.

(b) Bin Ltd was incorporated in Uganda on 1 January, 2015. The managing director has approached you to help him file the returns of the company. The following financial statements were prepared by the director for the period ended 31 December, 2015.

Draft statement of financial position:

Assets	USD	USD
Non-current assets:		
Plant at cost	11,400	
Less depreciation	(1,140)	10,260
Motor vehicles	6,650	
Less depreciation	(1,330)	5,320
Current assets:		
Inventories	4,275	
Receivables	5,700	
Bank	475	10,450
Total assets		26,030

Equity and liabilities:		
Equity:		
Ordinary shares	5,130	
Retained earnings	5,700	
8% long-term loan	13,300	
Current liabilities	1,900	
Total equity and liabilities		26,030

Additional information:

1. Depreciation for plant is 10% per annum and for motor vehicles is 20% per annum, on cost.
2. The long-term loan was acquired on 1 January, 2015 together with the amount of share capital. There has not been any repayment of the loan.
3. The following exchange rates to the USD apply:

	Shs
1 January, 2015	2,500
31 December, 2015	3,300
Average rate for December, 2015	3,500

4. The non-current assets were acquired on 1 January, 2015.
5. Assume that inventory turnover is less than one month.

Required:

Translate the above statement of financial position into the functional currency of Bin Ltd in accordance with the provisions of IAS 21.

Revenue from Contracts with Customers

17.0
REVENUE FROM CONTRACTS WITH CUSTOMERS

1.1 OBJECTIVE OF IFRS 15

The objective of IFRS 15 is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer.

Income, as defined by the IASB Conceptual Framework includes both revenues and gains. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends or royalties.

Revenue is usually the largest amount in a statement of profit or loss so it is important that it is correctly stated. Many studies have shown that over half of all financial statement frauds and requirements for restatements of previously published financial information involved revenue manipulation.

1.2 SCOPE OF IFRS 15

Application of the standard is mandatory for annual reporting periods starting from **1 January 2018** onwards. Earlier application is permitted.

IFRS 15 replaces both *IAS 18 Revenue* and *IAS 11Construction contracts*. Its core principle is that revenue is recognised to depict the transfer of goods or services to a customer in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Under IFRS 15 the transfer of goods and services is based upon **the transfer of control**, rather than **the transfer of risks and rewards** as in IAS 18. **Control of an asset** is described in the standard as *the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset*.

For straightforward retail transactions IFRS 15 will have little, if any, effect on the amount and timing of revenue recognition. For contracts such as long-term service contracts and multi-element arrangements it could result in changes either to the amount or to the timing of revenue recognised.

IFRS 15 applies to all contracts with customers except:
- Leases within the scope of IAS 17
- Insurance contracts within the scope of IAS 4
- Financial instruments and other contractual rights and obligations within the scope of IFRS 9, IFRS 10, IFRS 11, IAS 27 or IAS 28
- Non-monetary exchanges between entities in the same line of business

1.3 KEY DEFINITIONS

The following key definitions are given under IFRS 15

(i) Income.
Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.

(ii) Revenue.
Income arising in the course of an entity's ordinary activities.

(iii) Contract.
An agreement between two or more parties that creates enforceable rights and obligations. Contract asset. An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example the entity's future performance).

(iv) Receivable.
An entity's right to consideration that is unconditional – i.e. only the passage of time is required before payment is due.

(v) Contract liability.
An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

(vi) Customer.
A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

(vii) Performance obligation.
A promise in a contract with a customer to transfer to the customer either:

(i) a good or service (or a bundle of goods or services) that is distinct; or
(ii) a series of distinct goods or services that are substantially the same ad that have the same pattern of transfer to the customer.

(viii) Stand-alone selling price.
The price at which an entity would sell a promised good or service separately to a customer.

(ix) Transaction price.
The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.
Note:
Revenue does not include sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an economic benefit flowing to the entity.

1.4 RECOGNITION AND MEASUREMENT

According to IFRS 15, revenue is recognized based on the satisfaction of performance obligations. In applying. Under IFRS 15 revenue is recognised and measured using a five step model.

1.4.1 The five-step model framework

The core principle of IFRS 15 is that an entity will recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This core principle is delivered in a five-step model framework:

According to IFRS 15, an entity recognizes revenue by applying the following steps

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognise revenue when (or as) the entity satisfies a performance obligation.

Application of this guidance will depend on the facts and circumstances present in a contract with a customer and will require the exercise of judgment.

Activity 17.1: *The Five-step Model under IFRS 15*

On 1 January 2018, Computer World Ltd (CWL) received an order from a customer for a computer as well as 12 months of technical support. CWL delivered the computer and transferred its legal title to the customer on the same day. The customer paid shs 4.2 million upfront. The computer sells for shs 3 million without technical support.

Required:
Account for the above transaction in the books of CWL for the year ended 30 June 2018 in compliance with the provisions of IFRS 15.

Step 1: <u>Identify the contract with the customer</u>

1.4.2 Key term - *Contract*

An agreement between two or more parties that creates enforceable rights and obligations. A contract can be agreed in writing, orally, or through other customary business practices.

A contract with a customer will be within the scope of IFRS 15 if all the following conditions are met:

- *the contract has been approved by the parties to the contract;*
- *each party's rights in relation to the goods or services to be transferred can be identified;*
- *the payment terms for the goods or services to be transferred can be identified;*
- *the contract has commercial substance; and*
- *it is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.*

If a contract with a customer does not yet meet all of the above criteria, the entity will continue to re-assess the contract going forward to determine whether it subsequently meets the above criteria. From that point, the entity will apply IFRS 15 to the contract.

The standard provides detailed guidance on how to account for approved contract modifications. If certain conditions are met, a contract modification will be accounted for as a separate contract with the customer. If not, it will be accounted for by modifying the accounting for the current contract with the customer. Whether the latter type of modification is accounted for prospectively or retrospectively depends on whether the remaining goods or services to be delivered after the modification are distinct from those delivered prior to the modification.

Step 2: <u>Identify the performance obligations in the contract</u>

At the inception of the contract, the entity should assess the goods or services that have been promised to the customer, and identify as a performance obligation:

(a) a good or service (or bundle of goods or services) that is distinct; or
(b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A series of distinct goods or services is transferred to the customer in the same pattern if both of the following criteria are met:

(a) each distinct good or service in the series that the entity promises to transfer consecutively to the customer would be a performance obligation that is satisfied over time; and
(b) a single method of measuring progress would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

This is true for cases where a contract contains more than one performance obligation. For example;

(i) An entity may enter into a contract with a customer to sell a car, which includes one year's free servicing and maintenance.
(ii) An entity might enter into a contract with a customer to provide 5 lectures, as well as to provide a textbook on the first day of the course.

According to IFRS 15, the distinct performance obligations within a contract must be identified.

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

(a) the customer can benefit from the good or services on its own or in conjunction with other readily available resources; and
(b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

Factors for consideration as to whether a promise to transfer goods or services to the customer is not separately identifiable include, but are not limited to:

(a) the entity does provide a significant service of integrating the goods or services with other goods or services promised in the contract;
(b) the goods or services significantly modify or customise other goods or services promised in the contract;
(c) the goods or services are highly interrelated or highly interdependent.

Performance obligations may not be limited to the goods or services that are explicitly stated in the contract. An entity's customary business practices, published policies or specific statements may create an expectation that the entity will transfer a good or service to the customer.

An entity must decide if the nature of a performance obligation is:

(a) to provide the specified goods or services itself (i.e. it is the principal), or
(b) to arrange for another party to provide the goods or service (i.e. it is an agent).

If an entity is an agent, then revenue is recognised based on the fee or commission to which it is entitled.

Step 3: **Determine the transaction price**

The transaction price is the amount to which an entity expects to be entitled in exchange for the transfer of goods and services.

Amounts collected on behalf of third parties (such as sales tax) are excluded.

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

When determining the transaction price, an entity shall consider the effects of all of the following:

- *(a)* ***variable consideration***
- *(b)* ***the existence of a significant financing component in the contract***
- *(c)* ***non-cash consideration***
- *(d)* ***consideration payable to a customer.***

1.4.3 Variable consideration

Where a contract contains elements of variable consideration, the entity **will estimate the amount of variable consideration** to which it will be entitled under the contract. Variable consideration can arise, for example, as a result of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. Variable consideration is also present if an entity's right to consideration is contingent on the occurrence of a future event.

The standard deals with the uncertainty relating to variable consideration by limiting the amount of variable consideration that can be recognised. Specifically, variable consideration is only included in the transaction price if, and to the extent that, it is highly probable that its inclusion will not result in a significant revenue reversal in the future when the uncertainty has been subsequently resolved.

However, a different, more restrictive approach is applied in respect of sales or usage-based royalty revenue arising from licences of intellectual property. Such revenue is recognised only when the underlying sales or usage occur.

1.4.4 Financing component

In determining the transaction price, an entity must consider if the timing of payments provides the customer or the entity with a significant financing benefit. If there is a significant financing component, then the consideration receivable needs to be discounted to present value using the rate at which the customer would borrow.

The following may indicate the existence of a significant financing component:

- (a) the difference between the amount of promised consideration and the cash selling price of the promised goods or services
- (b) the length of time between the transfer of the promised goods or services to the customer and the payment date.

1.4.5 Consideration payable to the customer

If consideration is paid to a customer in exchange for a distinct good or service, then it is essentially a purchase transaction and should be accounted for in the same way as other purchases from suppliers.

Assuming that the consideration paid to a customer is not in exchange for a distinct good or service, an entity should account for it as a reduction of the transaction price.

Step 4: <u>Allocate the transaction price to the performance obligations in the contracts</u>

Where a contract has multiple performance obligations, an entity will allocate the transaction price to the performance obligations in the contract by reference to their relative standalone selling prices. If a standalone selling price is not directly observable, the entity will need to estimate it.

IFRS 15 suggests various methods that might be used, including:

(a) Adjusted market assessment approach
(b) Expected cost plus a margin approach
(c) Residual approach (only permissible in limited circumstances).

Any overall discount compared to the aggregate of standalone selling prices is allocated between performance obligations on a relative standalone selling price basis. In certain circumstances, it may be appropriate to allocate such a discount to some but not all of the performance obligations.

Step 5: <u>Recognise revenue when (or as) the entity satisfies a performance obligation</u>

Revenue is recognised as control is passed, either over time or at a point in time.

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. This includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to:

(a) using the asset to produce goods or provide services;
(b) using the asset to enhance the value of other assets;
(c) using the asset to settle liabilities or to reduce expenses;
(d) selling or exchanging the asset;
(e) pledging the asset to secure a loan; and
(f) holding the asset.

An entity recognises revenue over time if one of the following criteria is met:

(a) the customer simultaneously receives and consumes all of the benefits provided by the entity as the entity performs;
(b) the entity's performance creates or enhances an asset that the customer controls as the asset is created; or
(c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time. Revenue will therefore be recognised when control is passed at a certain point in time. Factors that may indicate the point in time at which control passes include, but are not limited to:

(a) the entity has a present right to payment for the asset;
(b) the customer has legal title to the asset;
(c) the entity has transferred physical possession of the asset;
(d) the customer has the significant risks and rewards related to the ownership of the asset; and
(e) the customer has accepted the asset.

1.5 CONTRACT COSTS

The incremental costs of obtaining a contract must be recognised as an asset if the entity expects to recover those costs. However, those incremental costs are limited to the costs that the entity would not have incurred if the contract had not been successfully obtained (e.g. 'success fees' paid to agents). A practical expedient is available, allowing the incremental costs of obtaining a contract to be expensed if the associated amortisation period would be 12 months or less.

Costs incurred to fulfil a contract are recognised as an asset if and only if all of the following criteria are met:

(a) the costs relate directly to a contract (or a specific anticipated contract);
(b) the costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
(c) the costs are expected to be recovered.

These include costs such as direct labour, direct materials, and the allocation of overheads that relate directly to the contract.

The asset recognised in respect of the costs to obtain or fulfil a contract is amortised on a systematic basis that is consistent with the pattern of transfer of the goods or services to which the asset relates.

1.6 COMMON TYPES OF TRANSACTIONS

1.6.1 Warranties

If a customer has the option to purchase a warranty separately from the product to which it relates, it constitutes a distinct service and is accounted for as a separate performance obligation. This would apply to a warranty which provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

If the customer does not have the option to purchase the warranty separately, for instance if the warranty is required by law, that does not give rise to a performance obligation and the warranty is accounted for in accordance with IAS 37.

1.6.2 Principal Versus Agent

An entity must establish in any transaction whether it is acting as principal or agent. It is a principal if it controls the promised good or service before it is transferred to the customer. When the performance obligation is satisfied, the entity recognises revenue in the gross amount of the consideration to which it expects to be entitled for those goods or services.

It is acting as an agent if its performance obligation is to arrange for the provision of goods or services by another party. Satisfaction of this performance obligation will give rise to the recognition of revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services.

Indicators that an entity is an agent rather than a principal include the following:

(a) Another party is primarily responsible for fulfilling the contract.
(b) The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return.
(c) The entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited.
(d) The entity's consideration is in the form of a commission.

(e) The entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

Activity 17.2: *Principal Vs Agent*

An entity operates a website that enables customers to purchase goods from a range of suppliers. The suppliers deliver directly to the customers, who have paid in advance, and the entity receives a commission of 10% of the sales price. The entity's website also processes payments from the customer to the supplier at prices set by the supplier. The entity has no further obligation to the customer after arranging for the products to be supplied.

Required
Is the entity a principal or an agent?

SOLUTION:
The following points are relevant:

(a) Goods are supplied directly from the supplier to the customer, so the entity does not obtain control of the goods.
(b) The supplier is primarily responsible for fulfilling the contract.
(c) The entity's consideration is in the form of commission.
(d) The entity does not establish prices and bears no credit risk.

The entity would therefore conclude that it is acting as an agent and that the only revenue to be recognised is the amounts received as commission.

1.6.3 Repurchase agreements

Under a repurchase agreement an entity sells an asset and promises, or has the option, to repurchase it.

Repurchase agreements generally come in three forms.

(a) An entity has an obligation to repurchase the asset (a forward contract).
(b) An entity has the right to repurchase the asset (a call option).
(c) An entity must repurchase the asset if requested to do so by the customer (a put option).

In the case of a forward or a call option the customer does not obtain control of the asset, even if it has physical possession. The entity will account for the contract as:

(a) A lease in accordance with IAS 17, if the repurchase price is below the original selling price; or
(b) A financing arrangement if the repurchase price is equal to or greater than the original selling price.

In this case the entity will recognise both the asset and a corresponding liability.

If the entity is obliged to repurchase at the request of the customer (a put option), it must consider whether or not the customer is likely to exercise that option.

If the repurchase price is lower than the original selling price and it is considered that the customer does not therefore have significant economic incentive to exercise the option, the contract should be accounted for as an outright sale, with a right of return. If the customer is considered to have a significant economic incentive to exercise the option, the entity should account for the agreement as a lease in accordance with IAS 17.

If the repurchase price is greater than or equal to the original selling price and is above the expected market value of the option, the contract is treated as a financing arrangement.

Activity 17.3: *Contract with a call option*

An entity enters into a contract with a customer for the sale of a tangible asset on 1 January 2018 for shs100m. The contract includes a call option that gives the entity the right to repurchase the asset for shs110m on or before 31 December 2018. This means that the customer does not obtain control of the asset, because the repurchase option means that it is limited in its ability to use and obtain benefit from the asset.

As control has not been transferred, the entity accounts for the transaction as a financing arrangement, because the exercise price is above the original selling price. The entity continues to recognise the asset and recognises the cash received as a financial liability. The difference of shs10m is recognised as interest expense.

If on 31 December 2018 the option lapses unexercised, the customer now obtains control of the asset. The entity will derecognise the asset and recognise revenue of shs110m (the shs100m already received plus the
shs10m charged to interest).

Activity 17.4: *Contract with a put option*

The same contract as above includes instead a put option that obliges the entity to repurchase the asset at the customer's request for shs90m on or before 31 December 2018, at which time the market value is expected to be shs75m.

In this case the customer has a significant economic incentive to exercise the put option because the repurchase price exceeds the market value at the repurchase date. This means that control does not pass to the customer. Since the customer will be exercising the put option, this limits its ability to use or obtain benefit from the asset.

In this situation the entity accounts for the transaction as a lease in accordance with IAS 17. The asset has been leased to the customer for the period up to the repurchase and the difference of shs10m will be accounted for as payments received under an operating lease.

1.6.4 Consignment arrangements

When a product is delivered to a customer under a consignment arrangement, the customer (dealer) does not obtain control of the product at that point in time, so no revenue is recognised upon delivery.

Indicators of a consignment arrangement include:

(a) The product is controlled by the entity until a specified event occurs, such as the product is sold on, or a specified period expires.
(b) The entity can require the return of the product, or transfer it to another party.
(c) The customer (dealer/distributor) does not have an unconditional obligation to pay for the product.

- **Required accounting**

The following apply where it is concluded that control of the inventory has been transferred to the dealer.
(a) The inventory should be recognised as such in the dealer's statement of financial position, together with a corresponding liability to the manufacturer.

(b) Any deposit should be deducted from the liability and the excess classified as a trade payable. Where it is concluded that control of the inventory has not been transferred to the dealer, the following apply.
(c) The inventory should not be included in the dealer's statement of financial position until the transfer of control has taken place.
(d) Any deposit should be included under 'other receivables'.

Activity 17.5: *Consignment Arrangement*

A wholesaler supplies goods to a retailer on a consignment basis. The wholesaler retains title until the goods are sold by the retailer. The retailer does not pay the wholesaler until the goods are sold and any unsold goods can be returned.

In this situation control of the goods is not transferred to the retailer until the goods are sold to the end- user, so it is only at that point that the wholesaler can recognise the revenue.

Activity 17.6:

Motors Co owns a number of car dealerships throughout a geographical area. The terms of the arrangement between the dealerships and the manufacturer are:
(a) Legal title passes when the cars are either used by Daley Co for demonstration purposes or sold to a third party.
(b) The dealer has the right to return vehicles to the manufacturer without penalty. (Daley Co has rarely exercised this right in the past.)
(c) The transfer price is based on the manufacturer's list price at the date of delivery.
(d) Daley Co makes a substantial interest-free deposit based on the number of cars held.

Required
Should the asset and liability be recognised by Daley Co at the date of delivery?

SOLUTION
(a) Legal form is irrelevant
(b) Yes: only because rarely exercised (otherwise 'no')
(c) Yes
(d) Yes: the dealership is effectively forgoing the interest which could be earned on the cash sum

1.6.5 Bill-and-hold arrangements

Under a bill-and-hold arrangement goods are sold but remain in the possession of the seller for a specified period, perhaps because the customer lacks storage facilities. An entity will need to determine at what point the customer obtains control of the product. For some contracts, control will not be transferred until the goods are delivered to the customer. For others, a customer may obtain control even though the goods remain in the entity's physical possession. In this case the entity would be providing custodial services (which may constitute a separate performance obligation) to the customer over the customer's asset.

For a customer to have obtained control of a product in a bill and hold arrangement, the following criteria must all be met:

(a) The reason for the bill-and-hold must be substantive (for example, requested by the customer).
(b) The product must be separately identified as belonging to the customer.
(c) The product must be ready for physical transfer to the customer.
(d) The entity cannot have the ability to use the product or to transfer it to another customer.

Activity 17.7: *Bill and Hold Arrangements*

An entity enters into a contract with a customer on 1 January 2018 for sale of a machine and spare parts. It takes two years to manufacture these and on 31 December 2019 the customer pays for both the machine and the spare parts but only takes physical possession of the machine. The customer inspects and accepts the spare parts but requests that they continue to be stored at the entity's warehouse.

There are now three performance obligations – transfer of the machine, transfer of the spare parts and the custodial services. The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control passes to the customer.

The machine and the spare parts are both performance obligations satisfied at a point in time, and for both of them that point in time is 31 December 2019. In the case of the spare parts, the customer has paid for them, the customer has legal title to them and the customer as control of them as they can remove them from storage at any time.

The custodial services are a performance obligation satisfied over time, so revenue will be recognised over the period during which the spare parts are stored.

1.7 PRESENTATION AND DISCLOSURE

The presentation and disclosure requirements are important in relation to contracts where performance obligations are satisfied over time, where there are likely to be contract assets and liabilities to be accounted for at the end of the reporting period.

1.7.1 Presentation

Contracts with customers will be presented in an entity's statement of financial position as a contract liability, a contract asset or a receivable, depending on the relationship between the entity's performance and the customer's payment.

A contract liability is recognised and presented in the statement of financial position where a customer has paid an amount of consideration prior to the entity performing by transferring control of the related good or service to the customer. When the entity has performed but the customer has not yet paid the related consideration, this will give rise to either a contract asset or a receivable. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time, for instance future performance. A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time. Where revenue has been invoiced a receivable is recognised. Where revenue has been earned but not invoiced, it is recognised as a contract asset.

1.7.2 Disclosure

The objective is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The following amounts should be disclosed unless they have been presented separately in the financial statements in accordance with other standards.

(a) Revenue recognised from contracts with customers, disclosed separately from other sources of revenue
(b) Any impairment losses recognised (in accordance with IFRS 9) on any receivables or contract assets arising from an entity's contracts with customers, disclosed separately from other impairment losses
(c) The opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers

(d) Revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period, and
(e) Revenue recognised in the reporting period from performance obligations satisfied in previous periods (such as changes in transaction price)

Other information that should be provided;

(a) An explanation of significant changes in the contract asset and liability balances during the reporting period
(b) Information regarding the entity's performance obligations, including when they are typically satisfied (upon delivery, upon shipment, as services are rendered etc), significant payment terms (such as when payment is typically due) and details of any agency transactions, obligations for returns or refunds and warranties granted
(c) The aggregate amount of the transaction price allocated to the performance obligations that are not fully satisfied at the end of the reporting period and an explanation of when the entity expects to recognise these amounts as revenue
(d) Judgements, and changes in judgements, made in applying the standard that significantly affect the determination of the amount and timing of revenue from contracts with customers
(e) Assets recognised from the costs to obtain or fulfil a contract with a customer. This would include pre-contract costs and set-up costs. The method of amortisation should also be disclosed.

1.8 PERFORMANCE OBLIGATIONS SATISFIED OVER TIME

Where performance obligations are satisfied over time, an entity must determine what amounts to include as revenue and costs in each accounting period.

1.8.1 Contracts where performance obligations are satisfied over time

A company is building a large tower block that will house offices, under a contract with an investment company. It will take three years to build the block and over that time it will obviously have to pay for building materials, wages of workers on the building, architects' fees and so on. It will receive periodic payments from the investment company at various predetermined stages of the construction. How does it decide, in each of the three years, what to include as income and expenditure for the contract in profit or loss?

Activity 17.8: *Contract*

Suppose that a contract is started on 1 January 2017, with an estimated completion date of 31 December 2018. The final contract price is shs1,500,000. In the first year, to 31 December 2017:
(a) Costs incurred amounted to shs600,000.
(b) Half the work on the contract was completed.
(c) Certificates of work completed have been issued, to the value of shs750,000.
(d) It is estimated with reasonable certainty that further costs to completion in 2018 will be shs600,000.

Required
What is the contract profit in 2017, and what entries would be made for the contract at 31 December 2017?

1.9 SUMMARY OF ACCOUNTING TREATMENT

Statement of profit or loss

(a) Revenue and costs

(i) Sales revenue and associated costs should be recorded in profit or loss as the contract activity progresses.

(ii) Include an appropriate proportion of total contract value as sales revenue in profit or loss.

(iii) The costs incurred in completing that amount of the performance obligation are matched with this sales revenue, resulting in the reporting of results which can be attributed to the proportion of work completed.

(iv) Sales revenue is the value of work carried out to date.

(b) Profit recognised in the contract

(i) It must reflect the proportion of work carried out, which will be equivalent to the amount of performance obligation satisfied.

(ii) It should take into account any known inequalities in profitability in the various stages of a contract.

Statement of financial position

(a) **Contract asset (presented separately under current assets)**

	Shs
Costs to date	XX
Plus: Recognised profit	XX
	XX
Less: Any recognised losses	(XX)
	XX
Less: Receivables (amounts invoiced)	(XX)
Contract Asset (amounts due from customer)	XX

(b) **Receivables**
This comprises of "UNPAID INVOICES"

(c) **Contract Liability**
Where (a) gives a net amount due to the customer this amount should be included as a contract liability, presented separately under current liabilities.

Activity 17.9: *Contract Profit*

P Co has the following contract in progress:

	shsm
Total contract price	750
Costs incurred to date	225
Estimated costs to completion	340
Payments invoiced and received	290

Required
Calculate the amounts to be recognised for the contract in the statement of profit or loss and statement of financial position assuming the amount of performance obligation satisfied is calculated using the proportion of costs incurred method.

PRACTICE QUESTIONS

QUESTION 17.1 XING XING CO

The main business of Xing Xing Co is building work. At the end of September 2017 there is an uncompleted contract on the books, details of which are as follows.

Date commenced	1.4.15
Expected completion date	23.12.17
	Shs'000'
Total contract revenue	290,000
Costs to 30.9.17	210,450
Value of performance obligations satisfied to 30.9.17	230,000
Amounts invoiced for work certified to 30.9.17	210,000
Cash received to 30.9.17	94,000
Estimated costs to completion at 30.9.17	20,600

Xing Xing Co calculates satisfaction of performance obligations based on work certified as a percentage of contract price.

Required
Prepare calculations showing the amount to be included in the statement of profit or loss and statement of financial position at 30 September 2017 in respect of the above contract.

QUESTIONS 17.2 ROKO CO

Roko Co has two contracts in progress, the details of which are as follows.

	Happy (profitable)	*Grumpy (loss-making)*
	shs'000	shs'000
Total contract revenue	300	300
Costs incurred to date	90	150
Estimated costs to completion	135	225
Payments invoiced and received	116	116

Roko Co measures satisfaction of performance obligations based on percentage of work certified as complete.

Required
Show extracts from the statement of profit or loss and other comprehensive income and the statement of financial position for each contract, assuming they are both certified as:

(a) 40% complete; and
(b) 36% complete.

QUESTIONS 17.3 BYANSI LTD

During the reporting period ended 31 March, 2018 Byansi Ltd worked on a contract to construct a building according to specific customer design. The following information relates to the contract:

Commencement date:	1 April, 2017.
Original estimate of completion date:	March, 2019.

Contract price: Shs 480 million.
Proportion of work certified as satisfactorily completed and invoiced up to 31 March, 2018: Shs 339.6 million.
Progress payments from customer: Shs 300 million.

Costs up to 31 March, 2018:

	Shs million
Wages	182
Materials sent to site	72
Other contract costs	36

Plant and equipment transferred to site at book value on 1 April, 2017 was Shs 36 million. The plant and equipment is expected to have a book value of Shs 6 million when the contract is completed. Depreciation is charged on a straight line basis. Inventory of materials on site on 1 March, 2018 was Shs 6 million.

Expected additional costs to complete the contract: wages Shs 20 million, materials (including stock on 31 March, 2018) Shs 24 million, other overheads Shs 16 million.

At 31 March, 2018 it was estimated that work at a cost value of Shs 38 million had been completed but not included in the certificates. Byansi measures satisfaction of performance obligations based on percentage of work certified as complete.

Required:

(i) Determine the expected profit attributable to the contract.

(ii) Prepare extracts of the statement of comprehensive income for the year ended 31 March, 2018.

(iii) Prepare extracts of the statement of financial position as at 31 March, 2018.

QUESTIONS17.4 GAB LTD

Gab Limited, a construction company with its financial period ending 31 May, has the following construction contract in progress that is estimated to run for 4 years. Gab Limited measures satisfaction of performance obligations based on contract percentage of completion calculated using the proportion of cost incurred on the contract to date. The following information is available as at 31 May, 2018:

	Shs '000'
Total contract price	1,789,560
Costs incurred to-date	536,868
Estimated costs to completion	912,600
Progress payment received	693,100
Materials on site	189,250

Required:

Prepare extracts of financial statements for the year ending 31 May, 2018 showing how the above transactions of the contract will be presented.

Leases

18.0
IFRS 16: LEASES

UNIT 18 OVERVIEW:

- Identifying a lease
- Accounting treatment of leases under IFRS 16.
- Deferred tax implications
- Lessor Accounting
- Sale and leaseback transactions

1.1 INTRODUCTION

The new IFRS 16 Leases requires lessees and lessors to provide relevant information in a manner that faithfully represents those transactions.

The accounting treatment in the lessee's books is driven by the *Conceptual Framework's* definitions of assets and liabilities rather than the legal form of the lease. The legal form of a lease is that the title to the underlying asset remains with the lessor during the period of the lease.

1.1.1 Effect of changes in IFRS 16

Companies generally use leasing arrangements as a means of obtaining assets. Consequently, IFRS 16 requires the majority of leased assets and the associated obligations to be recognised in the financial statements. This is a significant change from the previous standard, IAS 17 Leases, which was criticised for allowing 'off balance sheet' financing.

While IFRS 16 has benefits for the users of financial statements in terms of transparency and comparability, it has had a significant impact on the most commonly used financial ratios, such as:

- Gearing, because debt has increased
- Asset turnover, because assets have increased
- Profit margin ratios, because rent expenses are removed and replaced with depreciation and finance costs.

This in turn affects the way in which users interpret and analyse the financial statements. For example, banks often impose loan covenants when making loans to companies. These covenants may need renegotiating if applying IFRS 16 causes a company's liabilities to increase significantly.

1.2 Key Definition *- Lease*

A lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

A lease arises where the customer obtains the right to use the asset. Where it is the supplier that controls the asset used, a service rather than a lease arises.

1.2.1 Identifying a lease

An entity must identify whether a contract contains a lease, which is the case if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

The right to control an asset arises where, throughout the period of use, the customer has:

(a) The right to obtain **substantially all of the economic benefits** from use of the identified asset; and
(b) The **right to direct the use** of the identified asset.

The identified asset is typically explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.

Where a contract contains multiple components, the consideration is allocated to each lease and non-lease component based on relative stand-alone prices (the price the lessor or similar supplier wound charge for the component, or a similar component, separately).

Activity 18.1: *Multiple components*

Under a four year agreement a car seat wholesaler (CarSeat) buys its seats from a manufacturer (ManuFac). Under the terms of the agreement, CarSeat licenses its know-how to ManuFac royalty-free to allow it to construct a machine capable of manufacturing the car seats to CarSeat's specifications.

Ownership of the know-how remains with CarSeat and the machine has an economic life of four years. CarSeat pays an amount per car seat produced to ManuFac; however, the agreement states that a minimum payment will be guaranteed each year to allow ManuFac to recover the cost of its investment in the machinery.

The agreement states that the machinery 'cannot be used to make seats for other customers of ManuFac and that CarSeat can purchase the machinery at any time (at a price equivalent to the minimum guaranteed payments not yet paid).

Required
How should CarSeat account for this arrangement?

1.3 Key Definition – *Lease Term*

This refers to 'the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

(a) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

(b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.'

The lease term is relevant when determining the period over which a leased asset should be depreciated.

Illustration 1:

.A lease contract is for 5 years with lease payments of shs10 million per annum. The lease contract contains a clause which allows the lessee to extend the lease for a further period of 3 years for a lease payment of shs 5,000 per annum (as it is unlikely the lessor would be able to lease the asset to another party). The economic life of the asset is estimated to be approximately 8 years.

The lessee assesses it is highly likely the lease extension would be taken. The lease term is therefore 8 years.

1.4 ACCOUNTING TREATMENT

1.4.1 Recognition:

At the commencement date (the date the lessor makes the underlying asset available for use by the lessee), the lessee recognises:

- A lease liability
- A right-of-use asset.

1.4.2 Lease Liability

The lease liability is initially measured at the **present value of lease payments not paid at the commencement date**, discounted at the interest rate implicit in the lease (or the lessee's incremental **borrowing rate** if not readily determinable)

In this case, the borrowing rate is the rate to borrow over a similar term, with similar security, to obtain an asset of similar value in a similar economic environment.

The lease liability cash flows to be discounted include the following;

- Fixed payments
- Variable payments that depend on an index (e.g. CPI) or rate (e.g. market rent)
- Amounts expected to be payable under residual value guarantees (e.g. where a lessee guarantees to the lessor that an asset will be worth a specified amount at the end of the lease)
- Purchase options (if reasonably certain to be exercised).

Other variable payments (e.g. payments that arise due to level of use of the asset) are accounted for as period costs in profit or loss as incurred.

The lease liability is **subsequently measured** by;

- Increasing it by interest on the lease liability
- Reducing it by lease payments made.

1.4.3 Right-of-use asset

The right-of-use asset is initially' measured at its **cost**, which includes:

- The amount of the initial measurement of the lease liability (the present value of lease payments not paid at the commencement date)
- Payments made at/before the lease commencement date (less any lease incentives received)
- Initial direct costs (e.g. legal costs) incurred by the lessee
- An 'estimate of dismantling and restoration costs (where an obligation exists).

The right-of-use asset is normally measured subsequently at cost less accumulated depreciation and impairment losses in accordance with the cost model of IAS 16 Property, Plant and Equipment

The right-of-use asset is depreciated from the commencement date to the earlier of the end of its useful life or end of the lease term (end of its useful life if ownership is expected to be transferred).

Alternatively the right-of-use asset is accounted for in accordance with:

(a) The revaluation model of IAS 16 (optional where the right-of-use asset relates to a class of ,property, plant and equipment measured under the revaluation model, and where elected, must apply to all right-of-use assets relating to that class).

(b) The fair value model of IAS 40 Investment Property (compulsory if the right-of-use asset meets the definition of investment property and the lessee uses the fair value model for its investment property)

Right-of-use assets are presented either as a separate line item in the statement of financial position or by disclosing which line items include right-of-use assets.

Activity 18.2: *Lessee Accounting*

A company enters into a 4-year lease commencing on 1 January 2017 (and intends to use the asset for 4 years). The terms are 4 payments of shs50 million, commencing on 1 January 2017, and annually thereafter. The interest rate implicit in the lease is 7.5% and the present value of lease payments not paid at 1 January 2017 (i.e. 3 payments of shs50 million) discounted 'at that rate is shs130,026,000.

Legal costs to set up the lease incurred by the company were shs402,000.

Required
Show the lease liability from 1 January 2017 to 31 December 2021 and explain the treatment of the right-of-use asset.

1.4.4 Optional recognition exemptions

IFRS 16 provides an optional exemption from the full requirements of the standard for:

(a) Short-term leases (leases with a lease term of 12 months or fewer)
(b) Leases for which the underlying asset is low value (e.g. tablet and personal computers, small items of office furniture and telephones).

If the entity elects to take the exemption, lease payments are recognised as an expense on a straight-line basis over the lease term or another systematic basis (if more representative of the pattern of the lessee's benefits)

The assessment of whether an underlying assets of low value is performed on an absolute basis based on the value if the asset when it is new. It is not a question of materiality: different lessees should come to the same conclusion about whether assets are low value, regardless of the entity's size.

Illustration 2:

An entity leases a second-hand car which has a market value of shs 2 million. When new it would have cost shs15 million.

The lease would not qualify as a lease of a low-value asset because the car would not have been low value when new.

1.4.5 Re-measurement

The lease liability is remeasured (if necessary) for any reassessment of amounts payable. The revised lease payments are discounted using the original discount interest rate where the change relates to an expected payment on a residual value guarantee or payments linked to an index or rate (and a revised discount rote where there is a change in lease term, purchase option or payments linked to a gloating interest rate). The change in the lease liability is recognised as an adjustment to the right-of-use asset [or in profit or loss if the right-of-use asset is reduced to zero).

Activity 18.3: *Lessee Accounting*

Lassie plc leased an item of equipment on the following terms:

Commencement date	1 January 2017
Lease term	5 years
Annual lease payments (commencing 1 January 2017)	shs200 million (rising annually by CPI as at 31 December)
Interest rate implicit in the lease	6.2%

The present value of lease payments not paid at 1 January 2017 was 690 million. The price to purchase the asset outright would have been shs1.2 billion.

Inflation measured by the Consumer Price Index (CPI) for the year ending 31 December 2017 was 2%. As a result the lease payments commencing 1 January 2018 rose to shs204million. The present value of lease payments for the remaining 4 years of the lease becomes approximately shs747.3 million using the original discount rate of 6.2%.

Required
Discuss how Lassie plc should account for the lease and re-measurement in the year ended 31 December 2017.

1.5 DEFERRED TAX IMPLICATIONS

1.5.1 Issue

Under a lease, the lessee recognises a right-of-use asset and a corresponding lease liability. This net figure represents the carrying amount.

If an entity is granted tax relief as lease rentals are paid, a temporary difference arises, **as the fax base of the lease is zero**.

This results in a **deferred tax asset**. Tax deductions are allowed on the lease rental payment made, which, at the beginning of the lease, is lower than the combined depreciation expense and finance cost recognised for accounting. Therefore, the future tax saving on the additional accounting deduction is recognised now in order to apply the accruals concept.

1.5.2 Measurement

The deferred tax asset temporary difference is measured as: Carrying amount:

Carrying Amount:	shs	Shs
Right-of-use asset (carrying amount)	XX	
Lease liability	(XX)	(XX)
Tax Base		0
Temporary difference		(XX)
Deferred tax asset at X%		XX

Activity 18.4: *Deferred tax implication*

On 1 January 2017, Katosi Ltd leased a machine under a five year lease. The useful life of the asset to Katosi Ltd was four years and there is no residual value.

The annual lease payments are shs6 million payable in arrears each year on 31 December. The present value of the lease payments was shs2.4 million using the interest rate implicit in the lease of approximately 8% per annum. At the end of the lease term legal title remains with the lessor. Katosi Ltd incurred shs0.4 million of direct costs of setting up the lease.

The directors have not leased an asset before and are unsure how to account for it and whether there are any deferred tax implications. The company can claim a tax deduction for the annual lease payments and lease set-up costs. Assume a tax rate of 30%.

Required
Discuss, with suitable computations, the accounting treatment of the above transaction in Katosi Ltd's financial statements for the year ended 31 December 2017..

1.6 LESSOR ACCOUNTING

1.6.1 Classification of Leases for Lessor Accounting

The approach to lessor accounting classifies leases into two types:

(a) Finance leases (where a lease receivable is recognised in the statement of financial position); and
(b) Operating leases (which are accounted for as rental income).

Key Terms:

(a) **Finance lease**: a lease that transfers substantially all the risks and rewards incidental to terms ownership of an underlying asset.
(b) **Operating lease**: a lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

IFRS 16 identifies five examples of situations which would normally lead to a lease being classified as a finance lease:

(a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
(b) The lessee has the option to purchase the underlying asset at a price expected to be sufficiently lower than fair value at the exercise date that it is reasonably certain, at the inception date that the option will be exercised.
(c) The lease term is for a moor part of the economic life of the underlying asset even if title is not transferred.
(d) The present value of the lease payments at the inception date amounts to at least substantially all of the fair value of the underlying asset.
(e) The underlying asset is of such specialised nature that only the lessee can use it without major modifications.

Additionally the following situations which could lead to :a lease being classified as a finance lease:

(a) Any losses on cancellation are borne by the lessee.
(b) Gains/losses on changes in residual value accrue to the lessee.
(c) The lessee can continue to lease for a secondary term at a rent substantially lower than market rent.

1.6.2 Finance Leases – *Recognition & Measurement*

At the commencement date (the date the lessor makes the underlying asset available for use by the lessee), the lessor derecognises the underlying asset and recognises a receivable at an amount equal to the net investment in the lease.

The net investment in the lease is the sum of;

Present value of lease payments receivable by the lessor	X
Present value of any unguaranteed residual value accruing to the lessor	X
	X

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

Finance income is recognised over the lease term based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.

The derecognition and impairment requirements of IFRS 9 Financial Instruments are applied to the net investment in the lease.

Activity 18.5:

A lessor enters into a 3 year leasing arrangement commencing on 1 January 2015. Under the terms of the lease, the lessee commits to pay shs80m per annum commencing on 31 December 2017. A residual guarantee clause requires the lessee to pay shs40m (or shs40m less the asset's residual value, if lower) at the end of the lease term if the lessor is unable to sell the asset for more than shs40m.

The lessor expects to sell the asset based on current expectations for shs50m at the end of the lease.
The interest rate implicit in the lease is 9.2%. The present value of lease payments receivable by the lessor discounted at this rate is shs232,502,000.

Required
Show the net investment in the lease from 1 January 2015 to 31 December 2017 and explain what happens to the residual value guarantee on 31 December 2017.

Activity 18.6

Able Leasing Co arranges financing arrangements for its customers for bespoke equipment acquired from manufacturers. Able Leasing leased an item of equipment to a customer commencing on 1 January 2015. The expected economic life of the asset is eight years.

The terms of the lease were 8 annual payments of shs4 million, commencing on 31 December 2015. The lessee guarantees that the residual value of the assets at the end of the lease will be shs2 million (although Able Leasing expects to be able to sell it for its parts for shs3 million). The present value of the lease payments including the residual value guarantee (discounted at the interest rate implicit in the lease of 6.2%) was shs25.9 million. This was equivalent to the purchase price.

Required
Discuss the accounting treatment of the above lease in the financial statements of Able Leasing Co for the year ended 31 December 2015, including relevant calculations.

1.6.3 Manufacturer or dealer lessors

A lessor which is a manufacturer or dealer of the underlying asset needs to recognise entries for finance leases in a similar way to items sold outright (as well as the lease receivable):

	shs
Revenue — fair value of underlying asset (or present value of lease payments if lower)	XX
Cost of sales — cost (or carrying amount) of the underlying asset less present value of the unguaranteed residual value	(XX)
Gross profit	XX

Activity 18.7: *Manufacturer or dealer lessor*

Amanufacurer lessor leases out equipment under 10 year finance lease. The equipment cost shs 32 million to manufacture. The normal selling price of the leased asset is shs 42 million and the present value of lease payments is shs 38 million. The present value of the unguranteed residual value at the end of the lease is shs 2.2 million.

Required
Discuss, with suitable computations, the accounting treatment of the above transaction.

1.6.4 Operating Leases – *Recognition & Measurement*

Lease payments from operating leases are recognised as income on either a straight-line basis or another systematic basis (if more representative of the pattern in which benefit from use of the underlying asset is diminished).

Any initial direct costs incurred in obtaining the lease are added to the carrying amount of the underlying asset. IAS 16 Property, Plant acid Equipment or IAS 38 Intangible Assets then applies to the depreciation or amortisation of the underlying asset as appropriate.

Activity 18.8: *Manufacturer or dealer lessor*

.A lessor leases a property to a lessee under an operating lease for 5 years at an annual rate of shs100 million. However, the contract states that the first 6 months are 'rent-free'.

Required
Discuss, with suitable computations, the accounting treatment of the above transaction.

1.7 SALE AND LEASEBACK TRANSACTIONS

A sale and leaseback transaction arises where an entity (the seller-lessee) transfers ('sells') an asset to another entity (the buyer-lessor) and then leases it back.

The entity applies the requirements *of IFRS 15 Revenue from Contracts with Customers* to determine whether in substance a sale occurs (i.e. whether a performance obligation is satisfied or not).

Fair Value Measurement

19.0
IFRS 13 "*FAIR VALUE MEASUREMENT*"

UNIT 19 OVERVIEW:
- Introduction and key definitions.
- Objective and Scope of IFRS 13.
- Measurement: *Valuation Techniques and Approaches*.
- Measuring Liabilities.
- Disclosure requirements.

1.1 OBJECTIVE OF IFRS 13

IFRS 13 sets out to:

(a) Define the fair value
(b) Set out in a single IFRS a framework for measuring fair value
(c) Require disclosure about fair value measurements

1.2 DEFINITIONS – *FAIR VALUE*

IFRS 13 defines fair value as the '***price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date***'.

The previous definition used in IFRS was the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The price which would be received to sell the asset or paid to transfer (not settle) the liability is described as the exit price and this is the definition used in US GAAP. Although the concept of the arm's length transaction has now gone, the market based current exit price retains the notion of an exchange between unrelated, knowledgeable and willing parties.

1.3 SCOPE

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures. The measurement and disclosure requirements do not apply in the case of:

(a) Share-based payment transactions within the scope of IFRS 2 Share-based payment
(b) Leasing transactions within the scope of IAS 17 Leases; and
(c) Net realizable value as in IAS 2 Inventories or value in use as in IAS 36 Impairment of assets.

Disclosures are not required for:

(a) Plan assets measured at fair value in accordance with IAS 19 Employee benefits
(b) Plan investments measured at fair value in accordance with IAS 26 Accounting and reporting by retirement benefit plans; and
(c) Assets for which the recoverable amount is fair value less disposal costs under IAS36.

1.4 MEASUREMENT

Fair value is a **market-based measurement**, not an entity-specific measurement. It focuses on assets and liabilities and on exit (selling) prices. It also takes into account market conditions at the measurement date. In other words, it looks at the amount for which the holder of an asset could sell it and the amount which the holder of a liability would have to pay to transfer it. It can also be used to value an entity's own equity instruments.

Because it is a market-based measurement, fair value is measured using the assumptions that market participants would use when pricing the asset, taking into account any relevant characteristics of the asset.
It is assumed that the transaction to sell the asset or transfer the liability takes place either:

(a) In the principal market for the asset or liability; or
(b) In the absence of a principle market, in the most advantageous market for the asset or liability.

The principal market is the market which is the most liquid (has the greatest volume and level of activity) for that asset or liability. In most cases the principal market and the most advantageous market will be the same.

IFRS 13 acknowledges that when market activity declines an entity must use a valuation technique to measure fair value. In this case the emphasis must be on whether a transaction price is based on an orderly transaction, rather than a forced sale.

Fair value is not adjusted for transaction costs. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

Fair value measurements are based on an asset or a liability's unit of account, which is specified by each IFRS where a fair value measurement is required. For most assets and liabilities, the unit of account is the individual asset or liability, but in some instances may be a group of assets or liabilities.

1.4.1 Illustration 1: Principal of most advantageous market

An asset is sold in two active markets, Market X and Market Y, at shs58m and shs57m respectively. Warid Co does business in both markets and can access the price in those markets for the asset at the measurement date as follows.

	Market X shs"m"	*Market Y shs"m"*
Price	58	57
Transaction costs	(4)	(3)
Transport costs (to transport the asset to that market)	(4)	(2)
	50	52

Remember that fair value is not adjusted for transaction costs. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

If Market X is the principal market for the asset (i.e. the market with the greatest volume and level of activity for the asset), the fair value of the asset would be shs54m, measured as the price that would be received in that market (shs58m) less transport costs (shs4m) and ignoring transaction costs.

If neither Market X nor Market Y is the principal market for the asset, Warid Co must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and transport costs (i.e. the net amount that would be received in the respective markets).

The maximum net amount (after deducting both transaction and transport costs) is obtainable in Market Y (shs52m, as opposed to shs50m). But this is not the fair value of the asset. The fair value of the asset is obtained by deducting transport costs but not transaction costs from the price received for the asset in Market Y: shs57m less shs2m = shs55m.

1.4.2 Non-financial assets

For non-financial assets the fair value measurement looks at the use to which the asset can be put. It takes into account the ability of a market participant to generate economic benefits by using the asset in its highest and best use.

1.5 VALUATION TECHNIQUES

IFRS 13 states that valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The standard establishes a three-level hierarchy for the inputs that valuation techniques used to measure fair value:

Level 1	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.
Level 2	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, e.g. quoted prices for similar assets in active markets or for identical or similar assets in non-active markets or use of quoted interest rates for valuation purposes.
Level 3	Unobservable inputs for the asset or liability, i.e. using the entity's own assumptions about market exit value.

1.6 VALUATION APPROACHES

The IFRS identifies three valuation approaches:

(a) **Income approach**. Valuation techniques that convert future amounts (e.g. cash flows or income and expenses) to a single current (i.e. discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

(b) **Market approach**. A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

(c) **Cost approach**. A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

Entities may use more than one valuation technique to measure fair value in a given situation. A change of valuation technique is considered to be a change of accounting estimate in accordance with IAS 8, and must be disclosed in the financial statements.

	Asset or liability	Input
Level 1	Equity 'shares in a listed company	Unadjusted quoted prices in an active market.
Level 2	Licensing arrangement arising from a business combination.	Royalty rate in the contract with the unrelated party at inception of the arrangement.
	Cash generating unit	Valuation multiple (e.g. a multiple of earnings or revenue or a similar performance measure) derived from observable market data, e.g. from prices in observed transactions involving comparable businesses.
	Finished goods inventory at a retail outlet	Price to customers adjusted for differences between the condition and location of the inventory item and the comparable (i.e. similar) inventory items.
	Building. held and used	Price per square metre for the derived from observable market data e.g. prices, in observed transactions involving comparable buildings in similar locations.
Level 3	Cash generating unit	Financial forecast (e.g. of cash flows or profit or loss) developed using the entity's own data.
	Three-year option on exchange-traded shares	Historical volatility, i.e. the volatility for the shares derived from the shares' historical prices.
		Adjustment to a mid-market consensus (non-binding) price for the swap developed using data not directly observable or otherwise corroborated by observable market data.

1.7 MEASURING LIABILITIES

Fair value measurement of a liability assumes that that liability is transferred at the measurement date to a market participant, who is then obliged to fulfill the obligation. The obligation is not settled or otherwise extinguished on the measurement date.

1.8 ENTITY'S OWN CREDIT RISK

The fair value of a liability reflects the effect of non-performance risk, which includes but is not limited to the entity's own credit risk. This may be different for different types of liabilities.

Example: Entity's own credit risk

Black Co and Blue Co both enter into a legal obligation to pay shs20 million cash to Green Go in seven years.
Black Co has a top credit rating and can borrow at 4%. Blue Co's credit rating is lower and it can borrow at 8%.
Black Co will receive approximately shs15.2 million in exchange for its promise. This is the present value of shs20 million in seven years at 4%. Blue Co will receive approximately shs11.660 million in exchange for its promise. This is the present value of shs20 million in seven years at 8%.

6

1.9 IFRS 13 AND BUSINESS COMBINATIONS

Fair value generally applies on a business combination.

1.10 DISCLOSURE

An entity must disclose information that helps users of its financial statements assess both of the following:

(a) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis, the valuation techniques and inputs used to develop those measurements.

(b) For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period. Disclosure requirements will include:
   i. Reconciliation from opening to closing balances
   ii. Quantitative information regarding the inputs used
   iii. Valuation processes used by the entity
   iv. Sensitivity to changes in inputs

1.11 Advantages and disadvantages of fair value Vs historical cost

Fair value

Advantages
- Relevant to users' decisions
- Consistency between companies
- Predicts future cash flows

Disadvantages
- Subjective (not reliable)
- Hard to calculate if no active market
- Time and cost
- Lack of practical experience/familiarity
- Less useful for ratio analysis (bias)
- Misleading in a volatile market

Historical cost

Advantages
- Reliable
- Less open to manipulation
- Quick and easy to ascertain
- Matching (cost and revenue)
- Practical experience & familiarity

Disadvantages
- Less relevant to users' decisions
- Need for additional measure of recoverable amounts (impairment test)
- Does not predict future cash flows
- Misleading in a volatile market

PRACTICE QUESTIONS

QUESTION 19.1

The International Accounting Standards Board has recently completed a joint project with the Financial Accounting Standards Board (FASB) on fair value measurement by issuing IFRS 13 Fair value measurement. IFRS 13 defines fair value, establishes a framework for measuring fair value and requires significant disclosures relating to fair value measurement. The IASB wanted to enhance the guidance available for assessing fair value in order that users could better gauge the valuation techniques and inputs used to measure fair value. There are no new requirements as to when fair value accounting is required, but the IFRS gives guidance regarding fair value measurements in existing standards. Fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used. However, the guidance in IFRS 13 does not apply to transactions dealt with by certain specific standards.

Required

(i) Discuss the main principles of fair value measurement as set out in IFRS 13.
(ii) Describe the three-level hierarchy for fair value measurements used in IFRS 13.

QUESTION 19.2 WIDE VISION GROUP Ltd

Wide Vision Group (WVG) a public limited company, is reviewing the fair valuation of certain assets and liabilities in light of the introduction of IFRS 13. It carries an asset that is traded in different markets and is uncertain as to which valuation to use. The asset has to be valued at fair value under International Financial Reporting Standards. WVG currently only buys and sells the asset in the Afro-Asian market. The data relating to the asset are set out below.

Year to 30 November 2015	Asian market	European market	Afro-Asian Market
Volume of market - units	4 million	2 million	1 million
Price	Shs19	Shs16	Shs22
Costs of entering the market	Shs2	Shs2	Shs3
Transaction costs	Shs1	Shs2	Shs2

Additionally, WVG had acquired an entity on 30 November 2015 and is required to fair value a decommissioning liability. The entity has to decommission a mine at the end of its useful life, which is in three years' time. WVG has determined that it will use a valuation technique to measure the fair value of the liability. If WVG were allowed to transfer the liability to another market participant, then the following data would be used.

Input	*Amount*
Labour and material cost	shs2 million
Overhead	30% of labour and material cost
Third party mark-up – industry average	20%
Annual inflation rate	5%
Risk adjustment – uncertainty relating to cash flows	6%
Risk-free rate of government bonds	4%
Entity's non-performance risk	2%

WVG needs advice on how to fair value the liability.

Required

Discuss, with relevant computations, how WVG should fair value the above asset and liability under IFRS 13.

QUESTION 19.3 KABOGA Ltd

IFRS 13: Fair Value Measurement framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurements) and the lowest priority to unobservable inputs (level 3 measurements). The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques used need to maximize the use of observable inputs and minimize the use of unobservable inputs. The following is a description of financial instruments and their levels in the fair value hierarchy of Kaboga Ltd:

1. Debt securities issued by banks with a fair value of Shs 6.5 billion for which there is currently no active market. An observable, recent transaction took place in this particular instrument. This was sufficiently close to the reporting date that no adjustments were deemed necessary to determine the fair value.
2. Other debt securities with a fair value of Shs 5.5 billion for which there is currently no active market. An observable recent transaction took place in this particular instrument. Because of events between the date of the transaction and the reporting date, adjustments are necessary to determine the fair value. The adjustments are considered not to be significant.
3. Loans and advances with a fair value of Shs 4.321985 billion for which there is currently no active market. An observable recent transaction took place in this particular instrument. Because of events between the date of the transaction and the reporting date, adjustments are necessary to determine the fair value. The adjustments are considered to be significant.
4. Equities with a fair value of Shs 7.890567 billion for which there is currently no active market. An observable transaction took place on the reporting date in a similar instrument. Although the instrument is similar, it is not the same. Therefore, adjustments are necessary to determine the fair value. The adjustments are considered not to be significant.
5. Government debt securities whose fair value is Shs 9.868659 billion for which there is currently no active market. An observable transaction took place on the reporting date in a similar instrument. Although the instrument is similar, it is not the same. Therefore, adjustments are necessary to determine the fair value. The adjustments are considered to be significant.
6. Other financial instruments whose fair value is Shs 2.745678 billion traded in an active market for which one or more market participants provide a binding price quotation on the reporting date.
7. Quoted investments whose fair value is Shs 5.7896 billion for which there is currently no active market. The entity uses a valuation model that is accepted in the market/ industry. A significant input to the model is a credit spread based on historical default statistics and the credit rating assigned by an agency to the instrument.
8. A debt security with a fair value of Shs 9.6785 billion for which there is currently no active market. The entity uses a valuation model which is accepted in the market/ industry based on a price/earnings ratio for similar entities. No statistical technique is used to corroborate.
9. Structured loan notes with a fair value of Shs 11.906789 billion for which no active market exists. The company recently entered into an off-setting transaction with a third party.
10. There are government debt securities for which a model is applied to determine fair value of Shs 3.960644 billion. For one input variable, the company interpolates between two observable variables to determine the variable to include in the model for this particular instrument.

Required:

(a) Prepare a schedule classifying the above transactions under each level of input as per IFRS 13, giving considerations upon which classification has been made. (Show in Columns 1: Instrument Characteristic, Column 2: Considerations and Column 3: Conclusion / level)

(b) Prepare Kaboga Ltd's illustrative financial statements showing the hierarchical classification of financial assets and liabilities measured at fair value.

Provisions, Contingent Liabilities & Assets

20.0
IAS 37 *"PROVISIONS, CONTIGENT LIABILITIES AND CONTIGENT ASSETS"*

UNIT 20 OVERVIEW:

- Key definitions under IAS 37
- Objective of IAS 37
- Accounting for provisions
- Accounting for contingent liabilities
- Accounting for contingent assets

1.1 PROVISIONS

Under IAS 37 a provision should be recognized when:

- *An entity has a present obligation, legal or constructive*
- *It is probable that a transfer of resources embodying economic benefits will be required to settle it.*
- *A reliable estimate can be made of its amount.*

1.2 OBJECTIVE

IAS 37 Provisions, contingent liabilities and contingent assets aims to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

1.3 PROVISIONS

Before IAS 37, there was no accounting standard dealing with provisions. Companies wanting to show their results in the most favourable light used to make large one off provisions in years where a high level of underlying profits was generated. These provisions, often known as big bath provisions, were then available to shield expenditure in future years when perhaps the underlying profits were not as good. The key aim of IAS 37 is to ensure that provisions are made only where there are valid grounds for them.

1.3.1 IAS 37 views a provision as a liability.

- **A provision** is a liability of uncertain timing or amount.

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

- The IAS distinguishes provisions from other liabilities such as trade creditors and accruals. This is on the basis that for a provision there is uncertainty about the timing or amount of the future expenditure. Whist uncertainty is clearly present in the case of certain accruals the uncertainty is generally much less than for provisions.

1.3.2 Recognition

IAS 37 states that a provision should be recognised as a liability in the financial statements when;

- An entity has a present obligation(legal or constructive) as a result of past event
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
- A reliable estimate can be made of the amount obligation

1.3.3 Meaning of obligation

It is fairly clear what a legal obligation is, however, you may not know what a constructive obligation is.

IAS 37 defines a constructive obligation as;

An obligation that derives from an entity action where;

- By an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities; and.
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

For instance, an oil company may have an established practice of always making good any environmental damage caused by drilling, even though it is not legally obliged to do so. In this way, it has created a valid expectation that it will do this and it will have to recognize the constructive obligation and make a corresponding provision each time it drills a new well.

1.3.4 Probable transfer of resources

For the purpose of the IAS 37, a transfer of resources embodying economic benefits is regarded as probable If the event is more likely than not to occur. This appears to indicate a probability of more than 50%.However, standard makes it clear that where there is a number of similar obligations the probability should be based on considering the population as a whole, rather than one single item.

Example: transfer of resources

If a company has entered into a warranty obligation then the probability of transfer of resources embodying economic benefits may well be extremely small in respect of one specific item, however, when considering the population as a whole the probability of some transfer of resources is quite likely to be much higher. If there is a greater than 50% probability of some transfer of economic benefits then a provision should be made for the expected amount.

1.3.5 Measurement of provisions

The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.
The estimates will be determined by the judgment of the entity management supplemented by the experience of similar transactions.

Allowance is made for uncertainty. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities, i.e. expected value. Where the provision involves a single item, such as the outcome of a legal case provision is made in full for the most likely outcome.

Activity 20.1

Parker Co sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defect that becomes apparent within the first six months of purchase. The company's past experience and future expectations indicate the following pattern of likely repairs.

% of goods sold	Defects	Cost of repairs if all items suffered from these defects
75	None	-
20	Minor	Shs. 10 million
5	Major	Shs. 40 million

What is the provision required?

ANSWER

Here, the cost is found by using 'expected values' that is to say;

Cost = (75% x nil) + (20% x shs. 10m) + (5% x shs. 40m)
= nil + shs. 2m) + shs. 2m
= **shs. 4m**

Where the effect of time value of money is material the amount of a provision should be the present value of the expenditure required to settle the obligation. An appropriate discount rate should be used.
The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money. The discount rate(s) should not reflect risks for which future cash flows estimates have been adjusted.

Note: You will be given any relevant discount rates in the exam.

Activity 20.2

A company knows that when it ceases a certain operation in 5 years' time it will have to pay environmental cleanup costs of shs 5million. The provision to be made now will be the present value of shs5 million in 5 years' time. The relevant discount rate in this case is 10%.

	Shs
Therefore a provision will be made for;	
shs5m x 0.62092	3,104,600
The discount rate for 5 years at 10%.	
The following year the provision will be;	
shs5mx0.68301	3,415,050
The discount rate for 4 years at 10%	**310,540**

The increase in the second year of shs310,450 will be charged to profit or loss. It is referred to as the unwinding of the discount. This is accounted for as a finance cost. The original provision of shs3,104,600

.

1.3.6 Future events

Future events which are reasonably expected to occur (e.g. new legislation, changes in technology) may affect the amount required to settle the entity's obligation and should be taken into account.

1.3.7 Expected disposal of assets

Gains from the expected disposal of assets should not be taken into account in measuring a provision.

1.3.8 Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party. If so, the reimbursement should be recognized only when it is virtually certain that reimbursement will be received if the entity settles the obligation.

- The reimbursement should be treated as a separate asset, and the amount recognized should not be greater than the provision itself.
- The provision and the amount recognized for reimbursement may be netted off in profit or loss.

1.3.9 Changes in provisions

Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of resources will be required to settle the obligation, the provision should be reversed.

1.3.10 Use of provisions

Provisions should be used only for expenditures for which the provision was originally recognized .Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

1.3.11 Future operating losses

Provisions should not be recognized for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard.

1.3.12 Onerous contracts

If an entity has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. An example might be vacant leasehold property. The entity holding the lease is under an obligation to maintain the property but is receiving no income or benefit from it.

An onerous contract is a contract entered into with another party under which the unavoidable costs of fulfilling the terms of the contract exceed any revenues expected to be received from the goods or services supplied or purchased directly or indirectly under the contract and where the entity would have to compensate the other party if it did not fulfill the terms of the contact.

1.3.13 Examples of possible provisions

(a) **Warranties**. These are argued to be genuine provisions as on past experience it is probable, i.e. more likely than not, that some claims will emerge. The provision must be estimated, however, on the basis of the class as a whole and not on individual claims. There is a clear legal obligation in this case.

(b) **Major repairs**. In the past it has been quite popular for companies to provide for expenditure on a major overhaul to be accrued gradually over the intervening years between overhauls. Under IAS 37 this is no longer possible as IAS37 would argue that this is a mere intention to carry out repairs, not an obligation. The entity can always sell the asset in the meantime. The only solution is to treat major assets such as aircraft, ships, furnaces etc. as a series of smaller assets where each part is depreciated over shorter lives. Thus any major overhaul may be argued may be argued to be replacement and therefore capital rather than revenue expenditure.

(c) **Self-insurance**. A number of companies have created a provision for self-insurance based on the expected cost of making good fire damage etc. instead of paying premiums to an insurance company. Under IAS 37 this provision is no longer justifiable as the entity has no obligation until a fire or accident occurs. No obligation exists until that time.

(d) **Environmental contamination**. If the company has an environmental policy such that other parties would expect the company to clean up any contamination or if the company has broken current environmental legislation then a provision for environmental damage must be made.

(e) **Decommissioning** or abandonment costs. When an oil company initially purchases an oilfield it is put under a legal obligation to decommission the site at the end of its life. Prior to IAS 37 most oil companies set up the provision gradually over the life of the field so that no one year would be unduly burdened with the cost.

IAS 37, however, insists that a legal obligation exists on the initial expenditure on the field and therefore a liability exists immediately. This would appear to result in a large charge to profit and loss in the first year of operation of the field. However, the IAS takes the view that the cost of purchasing the field in the first place is not only the cost of the field itself but also the costs of putting it right again. Thus all the costs of decommissioning may be capitalized.

(f) **Restructuring**. This is considered in detail below.

1.3.14 Provisions for restructuring

One of the main purposes of IAS 37 was to target abuses of provisions for restructuring. Accordingly; IAS 37 lays down strict criteria to determine when such a provision can be made.

IAS 37 defines a restructuring as;
A programme that is planned and is controlled by management and materially changes one of two things.

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

The IAS gives the following examples of events that may fall under the definition of restructuring.

- The sale or termination of a line of business
- The closure of business locations in a country or region or the relocation of business activities from one country region to another
- Changes in management structure, for example, the elimination of a layer of management
- Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations

The question is whether or not an entity has an obligation-legal or constructive-at the end of the reporting period. For this to be the case;

- An entity must have a detailed formal plan for the restructuring
- It must have raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

A mere management decision is not normally sufficient. Management decisions may sometimes trigger recognition, but only if earlier events such as negotiations with employee representatives and other interested parties have been concluded subject only to management approval.
Where the restructuring involves the sale of an operation then IAS 37 states that no obligation arises until the entity has entered into a binding sale agreement. This is because until this has occurred the entity will be able to change its mind and withdraw from the sale even if its intentions have been announced publicly.

Costs to be included within a restricting provision
The IAS states that a restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

- Necessarily entailed by the restructuring; and
- Not associated with the ongoing activities of the entity

The following costs should specifically not be included within a restructuring provision.

- Retraining or relocating continuing staff
- Marketing
- Investment in new systems and distribution networks

1.4 Disclosure

Disclosures for provisions fall into two parts.
Disclosure of details of the change in carrying value of provision from the beginning to the end of the year
Disclosure of the background to the making of the provision and the uncertainties affecting its outcome.

Activity 20.3

In which of the following circumstances might a provision be recognized?

(a) On 13 December 2014 the board of an entity decided to close down a division. The accounting date of the company is 31 December. Before 31 December 2014 the decision was not communicated to any of those affected and no other steps were taken to implement the decision.
(b) The board agree a detailed closure plan on 20 December 2014 and details were given to customers and employees
(c) A company is obliged to incur cleanup costs for environmental damage (that has already been caused).
(d) A company intends to carry out future expenditure to operate in a particular way in the future.

ANSWER

(a) No provision would be recognized as the decision has not been communicated.
(b) A provision would be made in the 2014 financial statements.
(c) A provision for such costs is appropriate.
(d) No present obligation exists and under IAS37 no provision would be appropriate. This is because the entity could avoid the future expenditure by its future actions, maybe by changing its method of operation.

1.5 CONTINGENT LIABILITIES AND CONTINGENT ASSETS

An entity should not recognize a contingent asset or liability, but they should be disclosed.

1.5.1 IAS 37 defines a contingent liability as

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

- A present obligation that arises from past events but is not recognized because;
  -It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  -The amount of the obligation cannot be measured with sufficient reliability

As a rule of thumb, probable means more than 50% likely. If an obligation is probable, it is not a contingent liability-instead a provision is needed.

1.5.2 Treatment of contingent liabilities

Contingent liabilities should not be recognized in financial statements but they should be disclosed. The required disclosures are:

- A brief description of the nature of the contingent liability
- An estimate of its financial effect
- A n indication of the uncertainties that exist
- The possibility of any reimbursement

1.5.3 Contingent assets

IAS 37 defines a contingent asset as;

- A possible asset that arises from past events and whose existence will be confirmed by the occurrence of non-occurrence of one or more uncertain future events not wholly within control of the entity

- A contingent asset must not be recognized. Only when the realization of the related economic benefits is virtually certain should recognition take place. At that point, the asset is no longer a contingent asset.

Activity 20.4

A company is engaged in a legal dispute. The outcome is not yet known. A number of possibilities arise;

- It expects to have to pay about shs250 million. A provision is recognized.
- Possible damages are shs250 million but it is not expected to have to pay them. A contingent liability is disclosed.
- The company expects to have to pay damages but is unable to estimate the amount. A contingent liability is disclosed.
- The company expects to receive damages of shs250 million and this is virtually certain. An asset is recognized.
- The company expects to probably receive damages of shs250 million and this is virtually certain. An asset is recognized.
- The company expects to probably receive damages of shs250 million. A contingent asset is disclosed.
- The company thinks it may receive damages, but it is not probable. No disclosure.

1.5.4 Disclosure

- **Disclosure; contingent liabilities**

A brief description must be provided of all material contingent liabilities unless they are likely to be remote. In addition, provide

- An estimate of their financial effect
- Details of any uncertainties
- The possibility of any reimbursement

- **Disclosure; contingent assets**

Contingent assets must only be disclosed in the notes if they are probable. In that case a brief description of the contingent asset should be provided along with an estimate of its likely financial effect.

- **Let out**

IAS 37 permits reporting entities to avoid disclosure requirements relating to provisions, contingent liabilities and contingent assets if they would be expected to seriously prejudice the position of the entity in dispute with other parties. However, this should only be employed in extremely rare cases. Details of the general nature of the provision/contingencies must be provided, together with an explanation of why it has not been disclosed.

1.5.5 Summary

- The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingencies and that sufficient information is disclosed.
- The IAS seeks to ensure that provisions are only recognized when a measurable obligation exists and how to measure the obligation.
- The standard attempts to estimate the profit attempts to eliminate the profit smoothing which has gone on before it was issued.

PRACTICE QUESTIONS

QUESTION 20.1

An entity sells goods with a warranty covering customers for the cost of repairs of any defects that are discovered within the first two months after purchase. Past experience suggests that 88% of the goods sold will have no defects, 7% will have minor defects and 5% will have major defects. If minor defects were detected in all products sold, the cost of repairs would be shs24,000; if major defects were detected in all products sold, the cost would be shs200,000.

Required:
(i) What amount of provision should be made?
(ii) Give the accounting entries to be made to recognise this provision.

QUESTION 20.2

An entity has to rectify a serious fault in an item of plant that it has constructed for a customer. The individual most likely outcome is that the repair will succeed at the first attempt at a cost of shs400,000, but there is a chance that a further attempt will be necessary, increasing the total cost to shs500,000.

Required:
(i) What amount of provision should be made?
(ii) Give the accounting entries to be made to recognise this provision

QUESTION 20.3

(a) Define the following in relation to IAS 37 Provisions, Contingent liabilities and Contingent assets; giving the accounting treatment as given in the standard

(i) Warranty Provisions

(ii) Guarantees

(iii) Onerous contracts

(b) A company has ten years left to run on the lease of a property that is currently unoccupied. The present value of the future rentals at the reporting date is shs50 million. Subletting possibilities are limited but the directors feel that likely future subletting rentals could have a present value of shs10 million.

Required:
What will be the accounting treatment of the above transaction?

QUESTION 20.4 VIVO Ltd

(a) Vivo Limited is a company that carries out many different activities. It is proud of its reputation as a 'caring' organisation and has adopted various ethical policies towards its employees and the wider community in which it operates. As part of its annual financial statements, the company publishes details of its environmental policies, which include setting performance targets for activities such as recycling, controlling emissions of noxious substances and limiting use of nonrenewable resources.

The company has an overseas operation that is involved in mining precious metals. These activities cause significant damage to the environment, including deforestation. The company incurred capital costs of shs100 million in respect of the mine and it is expected that the mine will be abandoned in eight years' time. The mine is situated in a country where there is no environmental legislation obliging companies to rectify environmental damage and it is very unlikely that any such legislation will be enacted within the next eight years. It has been estimated that the cost of cleaning the site and replanting the trees will be shs25 million if the replanting were successful at the first attempt, but it will probably be necessary to make a further attempt, which will increase the cost by a further shs5 million. The company's cost of capital is 10%.

Required:
Discuss whether a provision for the cost of cleaning the site be made and prepare extracts of the financial statements.

(b) On 14 June 2017 a decision was made by the board of Vivo Limited to close down a division. The decision was not communicated at that time to any of those affected and no other steps were taken to implement the decision by the year end of 30 June 2017. The division was closed on 20 July 2017.

Required:
Describe the accounting treatment of the above event in the financial statements of Vivo Limited for the year ended 30 June 2017

(c) During the year to 30 June 2017, a customer started legal proceedings against Vivo Limited, claiming that one of the food products that it manufactures had caused several members of his family to become seriously ill. The company's lawyers have advised that this action will probably not succeed.

Required:
Describe the accounting treatment of the above event in the financial statements of Vivo Limited for the year ended 30 June 2017

QUESTION 20.5

IAS 37: Provisions, Contingent Liabilities and Contingent Assets aims to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users understand their nature, timing, and amount.

Required:
For each of the following scenarios, explain how the transaction should be treated, giving reasons and identifying the relevant disclosures that should be made in the financial statements in accordance with IAS 37:

(a) XYZ Ltd gives warranties at the time of sale to customers of its products. Under the terms of the sale contracts, XYZ Ltd undertakes to refund the customers for the costs of repairs of any manufacturing defect which becomes apparent within the first six months of purchase. For the period ended 31 march, 2016 XYZ Ltd sold equipment for Shs 100 million and by the end of the period there was a 40% probability of defects.

(b) XYZ Ltd will pay environmental clean-up cost of Shs 500 million when it ceases one of its lines of operation in five years from now. The relevant discount rate factors after 5 and 4 years at 10% are 0.62092 and 0.68301 respectively. Calculate the provision to be made in the accounts in the current period and the following year.

(c) XYZ Ltd owns land that was donated by one of its shareholders upon which the company erected some structures. Recently, one member of the community neighbouring the said land filed a case in court against XYZ Ltd claiming that the said land was actually his and that the company was trespassing. He paid court for damages amounting to Shs 150 million. By the end of the reporting period under consideration, the chief finance officer did not make any provision for the above case contending that he was not sure of the likely outcome of the court case.

QUESTION 20.6

The accountant of Kyengera Enterprises Ltd created a provision of Shs 4.8 million as at the end of the financial period of 2015 on the basis that the company's plant would need quarterly repairs of Shs 1.2 million in the financial period of 2016 as per the recommendation of the supplier for the machine.

Required:
Comment on the accountant's decision to create the provision.

(a) IAS 37: Provisions, Contingent Liabilities and Contingent Assets aims to ensure appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets.

Required:
(i) Explain circumstances under which contingent assets and contingent liabilities are not recognised in the financial statements.

(iii) KDCA has issued a new directive that all buildings within its jurisdiction should be fitted with protective lightening conductors by 31 December, 2016. Eve Ltd plans to install the conductors on its buildings and estimated costs are Shs 56,780,000. Due to cash flow constraints it was agreed the installation takes place in June, 2017.

Required:
Explain whether Eve Ltd should provide for the conductor installation costs in the year to 31 March, 2016 and 31 March, 2017.

QUESTION 20.7

During 2017 Smack Co gives a guarantee of certain borrowings of Pony Co, whose financial condition at that time is sound. During 2018, the financial condition of Pony Co deteriorates and at 30 June 2018 Pony Co files for protection from its creditors.

Required
Describe the accounting treatment required;
- ***(a) At 31 December 2017?***
- ***(b) At 31 December 2018?***

QUESTION 20.8

Warren Co gives warranties at the time of sale to purchasers of its products. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within a period of three years the date of the sale. ***Should a provision be recognized?***

QUESTION 20.9

After a wedding in 2017 ten people died, possibly as a result of food poisoning as a result of food poisoning from products sold by Callow C. Legal proceedings are started seeking damages from Callow but it disputes liability. Up to the date of approval of the financial statements for the year to 31 December 2017, Callows lawyers advise that it is probable that it will not be found liable .However, when Callow prepares the financial statements for the year to 31 December 2018 its lawyers advise that, owing to developments in the case, it is probable that it will be found liable.

Required
What is the required accounting treatment;
- ***(a) At 31 December 2017?***
- ***(b) At 31 December 2018?***

Presentation of Financial Statements for External Users (IAS 1)

21.0
IAS 1 "*PRESENTATION OF FINANCIAL STATEMENTS*"

UNIT 21 OVERVIEW:
- IAS 1 (REVISED) Presentation of financial statement.
- Statement of financial Position.
- The current and non-current distinction.
- Statement of profit or loss and other comprehensive income.
- Statement of profit or loss.
- Revision of Basic Accounts.
- Changes in equity.
- Notes to financial statements.

1.1 INTRODUCTION

This chapter presents a discussion about the overall content and format of company financial statements. These are governed by IAS 1 (revised) Presentation of financial statements.

1.1.1 IAS 1 (REVISED) PRESENTATION OF FINANCIAL STATEMENTS

An amendment to IAS 1 was published in June 2011. This amendment changed the name of the full statement from 'statement of comprehensive income' to 'statement of profit or loss and other comprehensive income'. The statement down to 'profit (loss) for the year', which had previously been referred to as the 'income statement', then became the 'statement of profit or loss'. We have used the revised terminology in this text, but you will still probably meet 'income statement' and 'statement of comprehensive income in other publications or articles.

1.2 PROFIT OR LOSS FOR THE YEAR

The statement of profit or loss and other comprehensive income is the most significant indicator of a company's financial performance. So it is important to ensure that it is not misleading. IAS 1 stipulates that all items of income and expense recognized in a period shall be included in profit or loss unless a standard or an interpretation requires otherwise. Circumstances where items may be excluded from profit or loss for the current year include the correction of errors and the effect of changes in accounting policies. These are covered in IAS 8.

1.3 HOW ITEMS ARE DISCLOSED

IAS 1 specifies disclosures of certain items in certain ways.

- Some items must appear on the face of the statement of financial position or statement of profit or loss and other comprehensive income.
- Other items can appear in a note to the financial statements instead.
- Recommended formats are given which entities may or may not follow, depending on their circumstances.

Obviously, disclosures specified by other standards must also be made, and we will mention the necessary disclosures when we cover each statement in turn. Disclosures in both IA S 1 and other standards must be made either on the face of the statement or in notes unless otherwise stated, i.e. disclosures cannot be made in an accompanying commentary or report.

1.4 IDENTIFICATION OF FINANCIAL STATEMENTS

As a result of the above point, it is most important that entities distinguish the financial statements very clearly from any other information published with them. This is because all IASs/IFRSs apply only to the financial statements (i.e. the main statements and related notes), so readers of the annual report must be able to differentiate between the parts of the report which are prepared under IFRSs, and other parts which are not.

The entity should identify each financial statement and the notes very clearly. IAS 1 also requires disclosure of the following information in a prominent position. If necessary it should be repeated wherever it is felt to be of use to the reader in his understanding of the information presented.

- Name of the reporting entity (or other means of identification)
- Whether the accounts cover the single entity only or a group of entities
- The date of the end of the reporting period or the period covered by the financial statements (as appropriate)
- The presentation currency
- The level of rounding used in presenting amounts in the financial statements

Judgement must be used to determine the best method of presenting this information. In particular, the standard suggests that the approach to this will be very different when the financial statements are communicated electronically.

The level of rounding is important, as presenting figures in thousands or millions of units make the figures more understandable. The level of rounding must be disclosed, however, and it should not obscure necessary details or make the information less relevant.

1.5 REPORTING PERIOD

It is normal for entities to present financial statements annually and IAS 1 states that they should be prepared at least as often as this. If (unusually) the end of an entity's reporting period is changed, for whatever reason, the period for which the statements are presented will be less or more than one year. In such cases the entity should also disclose.

(a) The reason(s) why a period other than one year is used; and
(b) The fact that the comparative figures given are not in fact comparable.

For practical purposes, some entities prefer to use a period which approximates to a year, e.g. 52 weeks, and the IAS allows this approach as it will produce statements not materially different from those produced on an annual basis.

1.6 TIMELINESS

If the publication of financial statements is delayed too long after the reporting period, their usefulness will be severely diminished. An entity with consistently complex operations cannot use this as a reason for its failure to report on a timely basis. Local legislation and market regulation imposes specific deadlines on certain entities.

IAS 1 looks at the statement of financial position and statement of profit or loss and other comprehensive income. We will not give all the detailed disclosures as some are outside the scope of your syllabus. Instead we will look at a 'proforma' set of accounts based on the standard.

1.7 STATEMENT OF FINANCIAL POSITION

IAS 1 discusses the distinction between current and non-current items in some detail, as we shall see in the next section. First of all we can look at the suggested format of the statement of financial position. (The format presented below has been adjusted to suit a single company as per the syllabus prescribed by ICPAU for paper 8 "*Financial Reporting*"

1.7.1 Statement of financial position example

The example given by IAS 1 is as follows.

XYZ (U) LTD – STATEMENT OF FINANCIAL POSITION AT 30 JUNE

	2018	2017
ASSETS	**UGX'000**	**UGX'000**
NON-CURRENT ASSETS		
Property, plant and equipment	XX	XX
Goodwill	XX	XX
Other intangible assets	XX	XX
Investment Property	XX	XX
Investment in equity instruments	XX	XX
	XX	XX
CURRENT ASSETS		
Inventories	XX	XX
Trade receivables	XX	XX
Other current assets	XX	XX
Cash and cash equivalents	XX	XX
	XX	XX
Total assets	XX	XX
EQUITY AND LIABILITIES		
EQUITY		
Share Capital	XX	XX
Retained earnings	XX	XX
Revaluation reserve	XX	XX
Other components of equity	XX	XX
Total Equity	XX	XX
NON-CURRENT LIABILITIES		
Long-term borrowings	XX	XX
Deferred tax	XX	XX
Long-term provisions	XX	XX
Total non-current liabilities	XX	XX
CURRENT LIABILITIES		
Trade and other payables	XX	XX
short-term borrowings	XX	XX
Current portion of long-term borrowings	XX	XX
Current tax payable	XX	XX

Short-term provisions	XX	XX
Total current liabilities	XX	XX
Total liabilities	XX	XX
Total equity and liabilities	XX	XX

IAS 1 (revised) specifies various items which must appear on the face of the statement of financial position as a minimum disclosure.

(a) Property, plant and equipment *(Chapter 12)*
(b) Investment property *(Chapter 15)*
(c) Intangible assets *(Chapter 21)*
(d) Financial assets *(outside the scope of the syllabus of paper 8)*
(e) Investments accounted for using the equity method *(outside the scope of the syllabus of paper 8)*
(f) Biological assets *(Chapter 22)*
(g) Inventories *(chapter 9)*
(h) Trade and other receivables
(i) Cash and cash equivalents *(Chapter 7)*
(j) Assets classified as held for sale under IFRS 5 *(outside the scope of the syllabus of paper 8)*
(k) Trade and other payables
(l) Provisions *(Chapter 20)*
(m) Financial liabilities *(outside the scope of the syllabus)*
(n) Current tax liabilities and assets as in IAS 12 *(Chapter 11)*
(o) Deferred tax liabilities and assets *(Chapter 11)*
(p) Liabilities included in disposal groups under IFRS 5 *(outside the scope of the syllabus of paper 8)*
(q) Non-controlling interests *(Chapter 24)*
(r) Issued capital and reserves

We will look at these items in the chapters marked.

Any other line items, headings or sub-totals should be shown on the face of the statement of financial position when it is necessary for an understanding of the entity's financial position.

The example shown above is for illustration only (although we will follow the format in this study text). The IAS, however, does not prescribe the order or format in which the items listed should be presented. It simply states that they must be presented separately because they are so different in nature or function from each other.

Whether additional items are presented separately depends on judgments based on the assessment of the following factors.

(a) Nature and liquidity of assets and their materiality. Thus goodwill and assets arising from development expenditure will be presented separately, as will monetary/non-monetary assets and current/non-current assets.
(b) Function within the entity. Operating and financial assets, inventories, receivables and cash and cash equivalents are therefore shown separately.
(c) Amounts, nature and timing of liabilities. Interest-bearing and non-interest bearing liabilities and provisions will be shown separately, classified as current or non-current as appropriate.

The standard also requires separate presentation where different measurement bases are used for assets and liabilities which differ in nature or function. According to IAS 16, for example, it is permitted to carry certain items of property, plant and equipment at cost or at a revalued amount.

1.7.2 Information presented either on the face of the statement of financial position or by note

Further sub-classification of the line items listed above should be disclosed either on the face of the statement of financial position or in the notes. The classification will depend upon the nature of the entity's operations. As well as each item being sub-classified by its nature, any amounts payable to or receivables from any group company or other related party should also be disclosed separately.

The sub-classification details will in part depend on the requirements of IFRSs. The size, nature and function of the amounts involved will also be important and the factors listed above should be considered. Disclosures will vary from item to item and IAS 1 gives the following examples.

(a) Property, plant and equipment are classified by class as described in IAS 16, property, plant and equipment.
(b) Receivables are analyzed between amounts receivable from trade customers, other members of the group, receivables from related parties, prepayments and other amounts.
(c) Inventories are sub-classified, in accordance with IAS 2 inventories, into classifications such as merchandise, production supplies, materials, work in progress and finished goods.
(d) Provisions are analyzed showing separately provisions for employee benefit costs and any other items classified in a manner appropriate to the entity's operations.
(e) Equity capital and reserves are analysed showing separately the various classes of paid in capital, share premium and reserves.

The standard then lists some specific disclosures which must be made, either on the face of the statement of financial position or in the related notes.

(a) Share capital disclosures (for each class of share capital)
   (i) Number of shares authorised
   (ii) Number of shares issued and fully paid, and issued but not fully paid
   (iii) Par value per share, or that the shares have no par value
   (iv) Reconciliation of the number of shares outstanding at the beginning and at the end of the year
   (v) Rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital.
   (vi) Shares in the entity held by the entity itself or by related group companies.
   (vii) Shares reserved for issuance under options and sales contracts, including the terms and amounts.

(b) Description of the nature and purpose of each reserve within owners' equity.

Some types of entity have no share capital, e.g. partnerships. Such entities should disclose information which is equivalent to that listed above. This means disclosing the movement during the period in each category of equity interest and any rights, preferences or restrictions attached to each category of equity interest.

1.7.3 The current/non-current distinction

An entity must present current and non-current assets as separate classifications on the face of the statement of financial position. A presentation based on liquidity should only be used where it provides more relevant and reliable information, in which case all assets and liabilities must be presented broadly in order of liquidity.

In either case, the entity should disclose any portion of an asset or liability which is expected to be recovered or settled after more than twelve months. For example, for an amount receivable which is due in installments over 18 months, the portion due after more than twelve months must be disclosed.

The IAS emphasizes how helpful information on the operating cycle is to users of financial statements. Where there is a clearly defined operating cycle within which the entity supplies goods or services, then information disclosing those net assets that are continuously circulating as working capital is useful.

This distinguishes them from those net assets used in the long-term operations of the entity. Assets that are expected to be realized and liabilities that are due for settlement within the operating cycle are therefore highlighted.

The liquidity and solvency of an entity is also indicated by information about the maturity dates of assets and liabilities. IFRS 7 Financial instruments: disclosures requires disclosure of maturity dates of both financial assets and financial liabilities. (Financial assets include trade and other receivables; financial liabilities include trade and other payables)

1.7.4 Current assets

An asset should be classified as a current asset when it:
- Is expected to be realized in, or is held for sale or consumption in, the normal course of the entity's operating cycle; or
- Is held primarily for trading purposes or for the short-term and expected to be realized within twelve months of the end of the reporting period; or
- Is cash or a cash equivalent asset which is not restricted in its use

All other assets should be classified as non-current assets.

Non-current assets include tangible, intangible, operating and financial assets of a long-term nature. Other terms with the same meaning can be used (e.g. 'fixed', 'long-term').

- **Operating Cycle**

The term 'operating cycle' has been used several times above and the standard defines it as follows.

The operating cycle of any entity is the time between the acquisition of assets for processing and their realization in cash or cash equivalents.

Current assets therefore include inventories and trade receivables that are sold, consumed and realized as part of the normal operating cycle. This is the case even where they are not expected to be realized within twelve months. Current assets will also include marketable securities if they are expected to be realized within twelve months after the reporting period. If expected to be realized later, they should be included in non-current assets.

1.7.5 Current liabilities

A liability should be classified as a current liability when it;-
- Is expected to be settled in the normal course of the entity's operating cycle; or
- Is held primarily for the purpose of trading; or
- Is due to be settled within twelve months after the end of the reporting period; or when
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the end of the reporting period.

All other liabilities should be classified as non-current liabilities.

The categorization of current liabilities is very similar to that of current assets. Thus, some current liabilities are part of the working capital used in the normal operating cycle of the business (i.e. trade payables and accruals for employee and other operating costs). Such items will be classed as current liabilities even where they are due to be settled more than twelve months after the end of the reporting period.

There are also current liabilities which are not settled as part of the normal operating cycle, but which are due to be settled within twelve months of the end of the reporting period. These include bank overdrafts, income taxes, other non-trade payables and the current portion of interest-bearing liabilities. Any interest-bearing liabilities that are used to finance working capital on a long-term basis, and that are not due for settlement within twelve months, should be classed as non-current liabilities.

A non-current financial liability due to be settled within twelve months of the end of the reporting period should be classified as a current liability, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the end of the reporting period and before the financial statements are authorised for issue.

End of the reporting Period	Agreement to refinance on long-term Basis	Date financial statements authorised for issue	settlement date <12 months after end of the reporting period therefore current liability

A non-current financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the end of the reporting period even if the lender has agreed after the end of the reporting period, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach.

Condition of loan agreement breached. Non-current liability	End of the reporting Period	Lender agrees not to enforce payment resulting from breach	Date financial statements are authorised for issue. Loan shown as current Liability

However, if the lender has agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the end of the reporting period within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as non-current.

1.8 STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

1.8.1 Format

IAS 1 (revised) allows income and expense items to be presented either:

(a) In a single statement of profit or loss and other comprehensive income; or

(b) In two statements: a separate statement of profit or loss and statement of other comprehensive income.

In the examinations, if a statement of profit or loss and other comprehensive income is referred to, this will always relate to the single statement format. If statements of profit or loss are referred to, this relates to the statement from revenue to profit for the year. Exams may refer to other comprehensive income which relates to the other comprehensive income section of the statement. In practice, the item of other comprehensive income you are most likely to meet is a revaluation gain. Where we have used statement of profit or loss in this text, this can be taken to refer to the profit or loss section of the full statement or separate statement of profit or loss.

XYZ (U) LTD – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 2018.

	2018	**2017**
	UGX'000	**UGX'000**
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross income	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administration expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Profit before tax	126,567	97,900
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	86,150	65,900
Loss for the year from discontinued operations	-	(30,500)
Profit for the year	86,150	35,400
OTHER COMPREHENSIVE INCOME:		
Items that will be reclassified to profit or loss		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Income tax relating to items not reclassified	5,834	(7,667)
	(17,900)	23,700
Items that may reclassified subsequently to profit or loss		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassifies	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,400)	28,700
Total comprehensive income	71,750	64,100
Earnings per share (in currency unit)	0.46	0.30

1.8.2 Issues to take note

- Some items shown in the above illustration are not within the CPA (U) Paper 8 "Financial Reporting" syllabus. This is the full statement as issued by the IASB.

- The amendment to IAS 1 now splits items of other comprehensive income into those which can be reclassified to profit or loss and those which cannot be reclassified. In practice, none of the items which can be reclassified are examinable at paper 8 "*Financial Reporting*", so this is not an issue that you will encounter in your exam.

- Companies are given the option of presenting this information in two statements as follows:

XYZ (U) LTD – STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 2018

	2018	2017
	UGX'000	**UGX'000**
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross income	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administration expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Profit before tax	126,567	97,900
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	86,150	65,900
Loss for the year from discontinued operations	-	(30,500)
Profit for the year	86,150	35,400

XYZ (U) LTD STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 2018 (TWO STATEMENT FORMAT)

	2018	2017
	UGX'000	**UGX'000**
Profit for the year	86,150	35,400
OTHER COMPREHENSIVE INCOME:		
Items that will be reclassified to profit or loss		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Income tax relating to items not reclassified	5,834	(7,667)
	(17,900)	23,700
Items that may reclassified subsequently to profit or loss		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassifies	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,400)	28,700
Total comprehensive income	71,750	64,100

1.9 STATEMENT OF PROFIT OR LOSS

1.9.1 Examples of separate statements of profit or loss

XYZ (U) LTD STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 2018

Illustrating the classification of expenses by function

	2018	2017
	Shs '000	Shs '000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X

Illustrating the classification of expenses by nature

	2018	2017
	Shs '000	Shs '000
Revenue	X	X
Other operating income	X	X
Changes in inventories of finished goods and work in progress	(X)	(X)
Work performed by the entity and capitalized	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation and amortisation expense	(X)	(X)
Impairment of property, plant and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X

Note: The usual method of presentation is expenses by function and this is the format likely to appear in your exam.

1.9.2 Information presented in the statement of profit or loss

The standard lists the following as the minimum to be disclosed on the face of the statement of profit or loss.

(a) Revenue
(b) Finance costs
(c) Share of profits and losses of associates and joint ventures accounted for using the equity method
(d) Pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to discounted operations.
(e) Tax expense
(f) Profit or loss

The following items must be disclosed as allocations of profit or loss for the period.

(a) It is permitted or required by an IFRS, or
(b) Gains, losses and related expenses arising from the same or similar transactions and events are immaterial, in which case they can be aggregated.

1.9.3 Information presented either in the statement or in the notes

An analysis of expenses must be shown either in the profit or loss section (as above, which is encouraged by the standard) or by note, using a classification based on either the nature of the expenses or their function. This sub-classification of expenses indicates a range of components of financial performance; these may differ in terms of stability, potential for gain or loss and predictability.

1.9.4 Nature of expense method

Expenses are not reallocated amongst various functions within the entity, but are aggregated in the statement of profit or loss according to their nature (e.g. purchase of materials, depreciation, wages and salaries, transport costs). This is by far the easiest method, especially for smaller entities.

1.9.5 Function of expense / cost of sales method

You are likely to be more familiar with this method. Expenses are classified according to their function as part of cost of sales, distribution or administration activities. This method often gives more relevant information for users, but the allocation of expenses by function requires the use of Judgement and can be arbitrary. Consequently, perhaps, when this method is used, entities should disclose additional information on the nature of expenses, including staff costs, and depreciation and amortization expense.

Which of the above methods is chosen by an entity will depend on historical and industry factors, and also the nature of the organisation. Under each method, there should be given an indication of costs which are likely to vary (directly or indirectly) with the level of sales or production. The choice of method should fairly reflect the main elements of the entity's performance. This is the method you should expect to see in your exam.

1.9.6 Dividends

IAS 1 also requires disclosure of the amount of dividends paid during the period covered by the financial statements. This is shown either in the statement of changes in equity or in the notes.

4.10.7 Further points.

(a) All requirements previously set out in other standards for the presentation of particular line items in the statement of financial position and statement of profit or loss and other comprehensive income are now dealt with in IAS 1. These line items are: biological assets, liabilities and assets for current tax and deferred tax: and pre-tax gain or loss recognized on the disposal of assets or settlement of liabilities attributable to discontinued operations.

(b) An entity must disclose, in the summary of significant accounting policies and/or other notes, the judgments made by management in applying the accounting policies that have the most significant effect on the amounts of items recognized in the financial statements.

(c) An entity must disclose in the notes information regarding key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

1.10 STATEMENT OF CHANGES IN EQUITY

IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.

1.10.1 Format

Presented below is the format of the statement of changes in equity as per IAS 1.

XYZ (U) LTD STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 30 JUNE 2018

	Share capital	**Retained earnings**	**Investment in equity instruments**	**Revaluation surplus**	**Total**
	Shs'000'	Shs'000'	Shs'000'	Shs'000'	Shs'000'
Balance as at 1 July 2016	600,000	118,100	1,600	-	719,700
Changes in accounting policy	-	400	-	-	400
Restated balance	600,000	118,500	1,600	-	720,100
Changes in equity					
Dividends	-	(10,000)	-	-	(10,000)
Total comprehensive income for the year	-	53,200	16,000	1,600	70,800
Balance as at 30 June 2017	600,000	161,700	17,600	1,600	780,900
Changes in equity for 2018					
Issue of share capital	50,000	-	-	-	50,000
Dividends	-	(15,000)	-	-	(15,000)
Total comprehensive income for the year	-	96,600	(14,400)	800	83,000
Transfer to retained earnings	-	200	-	(200)	-
Balance as at 30 June 2018	650,000	243,500	3,200	2,200	898,900

Note that there has been a change of accounting policy necessitating a retrospective restatement, the adjustment is disclosed for each period. So, rather than just showing an adjustment to the balance b/f on 1.July 2017, the balances for 2017 are restated.

1.11 NOTES TO THE FINANCIAL STATEMENTS

Some items need to be disclosed by way of note. The notes to the financial statements will amplify the information given in the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. We have already noted above the information which the IAS allows to be shown by note rather than in the statements. To some extent, then, the contents of the notes will be determined by the level of detail shown on the face of the statements.

1.11.1 Structure

The notes to the financial statements should perform the following functions.

(a) Provide information about the basis on which the financial statements were prepared and which specific accounting policies were chosen and applied to significant transactions/events
(b) Disclose any information, not shown elsewhere in the financial statements, which is required by IFRSs
(c) Show any additional information that is relevant to understanding which is not shown elsewhere in the financial statements

The way the notes are presented is important. They should be given in a systematic manner and cross referenced back to the related figure(s) in the statement of financial position, statement of comprehensive income or statement of cash flows.

Notes to the financial statements will amplify the information shown therein by giving the following.
(a) More detailed analysis or breakdowns of figures in the statements
(b) Narrative information explaining figures in the statements
(c) Additional information, e.g. contingent liabilities and commitments

IAS 1 suggests a certain order for notes to the financial statements. This will assist users when comparing the statements of different entities.
(a) Statement of compliance with IFRSs
(b) Statement of the measurement basis (bases) and accounting policies applied
(c) Supporting information for items presented in each financial statement in the same order as each line item and each financial statement is presented
(d) Other disclosures, e.g.
   (i) Contingent liabilities, commitments and other financial disclosures
   (ii) Non-financial disclosures

The order of specific items may have to be varied occasionally, but a systematic structure is still required.

1.11.2 Presentation of accounting policies

The accounting policies section should describe the following.
(a) The measurement basis (or bases) used in preparing the financial statements
(b) The other accounting policies used, as required for a proper understanding of the financial statements

This information may be shown in the notes or sometimes as a separate component of the financial statements. The information on measurement bases used is obviously fundamental to an understanding of the financial statements. Where more than one basis is used, it should be stated to which assets or liabilities each basis has been applied.

1.11.3 Other disclosures

An entity must disclose in the notes;

(a) The amount of dividends proposed or declared before the financial statements were authorized for issue but not recognized as a distribution to owners during the period, and the amount per share.
(b) The amount of any cumulative preference dividends not recognized.
(c) IAS 1 ends by listing some specific disclosures which will always be required if they are not shown elsewhere in the financial statements.
(d) The domicile and legal form of the entity, its country of incorporation and the address of the registered office (or, if different, principal place of business).
(e) A description of the nature of the entity's operations and its principal activities.
(f) The name of the parent entity and the ultimate parent entity of the group.

PRACTICE QUESTIONS

QUESTION 21.1 KIKAMBA ENTERPRISES LTD

The following balances were extracted from the books of Kikamba Enterprises Ltd as at 30 April 2018:

	Shs 000	Shs 000
Land (at valuation)	4,160,000	
Plant & Equipment (at cost)	2,697,600	
Software (at cost)	320,000	
Investment (Valuation at 1 May 2017)	384,000	
Depreciation as at 1 May 2017:		
Plant & machinery		777,600
Software		192,000
Extraordinary item	1,024,000	
Sales		7,558,400
Purchases	4,091,200	
Opening inventory	622,400	
Trade receivables	736,000	
Administration expenses	300,800	
Distribution costs	96,000	
Loan interest paid	76,800	
Bank balance		11,200
Trade payables		486,400
Preference dividend	32,000	
10% preference shares		640,000
Ordinary shares of Shs 250 each		1,920,000
12% Debentures (issued 1 July 2017)		1,280,000
Deferred tax		96,000
Revaluation Reserve		1,440,000
Retained Earnings		139,200
	14,540,800	14,540,800

Additional information:

1. Inventory on 30 April 2018 was valued at Shs 872 million.
2. Plant and equipment are depreciated at 20% per annum on reducing balance basis. Software is depreciated by the sum of the digits method over a 5 year life.
3. The extra-ordinary item relates to a fraud suffered by Kikamba at the hands of its former employees in February 2017. It is unlikely that any of the funds will be recovered.
4. The investment represents Kikamba's shareholding in Safe Ways Ltd. The changes in the value of investment are taken to the revaluation reserve which at 1 May 2017 contained a surplus of Shs 160 million from previous revaluations of the investment. The stock market price of Safe Ways Ltd's ordinary shares was Shs 2,500 per share on 1 May 2017. This has since fallen to Shs 2,250.
5. The directors had declared a final ordinary dividend of Shs 30 per share on 20 April 2018.

Required

In compliance with IAS1, prepare the financial statements of Kikamba Ltd for the period ended 30 April 2018.

QUESTION 21.2 RECENT RIOTERS LTD

The following trial balance was extracted from the books of Recent Rioters Limited as at 30 June 2018:

	Debit Shs '000'	Credit Shs '000'
Share capital (19,500 shares of Shs 1,000 per share)		19,500
Share premium		5,000
Freehold land and building (at cost)	20,600	
6% debentures secured on land and building		10,000
Debenture interest to 31 December 2017	300	
Motor Vehicles (cost Shs 8 million)	3,200	
Directors fees	5,200	
Purchases and sales	150,200	196,420
Inventory 1 July 2017	13,600	
Revenue reserve 1 July 2017		8,060
Revaluation reserve		10,000
General reserve		6,000
Short-term investments	16,000	
General expenses	16,435	
Salaries and wages	17,800	
Electricity	650	
Bank balance	15,390	
Interim dividends paid	975	
Motor vehicle expenses	860	
Rates and insurance	830	
Discounts allowed and received	1,680	1,140
Bad debts	460	
Provision for bad debts		320
Receivables and payables	18,460	16,200
Deferred tax	-	10,000
	282,640	**282,640**

The following information is also provided:

(i) Inventory on 30 June 2018 was valued at Shs 16.3 million.
(ii) A provision for debenture interest accrued must be made. Rate and insurance prepaid at 30 June 2018 was Shs 120,000.
(iii) The bad debts provision is to be adjusted to Shs 240,000. Provision is to be made for depreciation of motor vehicles at the rate of 20% per annum on cost.
(iv) Motor vehicle expenses outstanding at 30 June 2018 amounted to ShS 70,000.
(v) No entry has been made in the books for goods amounting to Shs 90,000 in transit as on 30 June.
(vi) Provision is to be made for a final dividend of 10% on the paid up capital on 1 July 2017.
(vii) It is company's policy to transfer 10% of the profit for the year to the general reserve.
(viii) The company has a tax holiday up the year 2025.

Required

In compliance with IAS 1, prepare the full set of financial statements of Recent Rioters Ltd for the period ended 30 June 2018.

Financial Analysis and Interpretation

22.0 RATIO ANALYSIS

UNIT 22 OVERVIEW:

- General Introduction.
- Profitability Ratios.
- Debt and Gearing Ratios
- Liquidity Ratios.
- Efficiency Ratios.
- Shareholders' Investment ratios

1.1 RATIO ANALYSIS

Ratio analysis the systematic production of ratios from both internal and external financial reports so as to enable comparisons between consecutive period performances and assessing whether the ratio indicates a weakness or strength in the company affairs.

With reference to the calculated ratios, users of financial statements shall access whether a company is doing well or badly. The users are also able to determine whether the company is financially strong or vulnerable.

1.2 Categories of Ratios

A number of ratios can be calculated. However, basic ratios can be grouped into 5 major categories. These categories include;

(a) ***Profitability and return***

(b) ***Long-term solvency and stability***

(c) ***Short-term solvency and liquidity***

(d) ***Efficiency (turnover ratios)***

(e) ***Share holders' investment ratios***

1.3 Important considerations:

- Each individual business must be considered separately, and a ratio that is meaningful for a manufacturing company may be completely meaningless for a financial institution. The key to obtaining meaningful information from ratio analysis is **comparison**. This may involve comparing ratios over time within the same business to establish whether things are improving or declining, and comparing ratios between similar businesses to see whether the company you are analyzing is better or worse than average within its specific business sector.

- Ratio analysis on its own is not sufficient for interpreting company accounts, and there are other items of information which should be looked at for example;
  - *The content of any accompanying commentary on the accounts and other statements*
  - *The age and nature of the company's assets*
  - *Current and future developments in the company markets, at home and overseas, recent acquisitions or disposals of a subsidiary by the company*
  - *Unusual items separately disclosed in the final statements*

- *Any other noticeable features of the report and accounts, such as events after the end of a reporting period, contingent liabilities, a qualified auditors' report, the company's taxation position and so on.*

1.4 General interpretation of ratios

- **What does a company's calculated ratio tell us?**

- There are three comparisons usually made;
  - *Compare the change from one year to the next*
  - *Compare the calculated ratio with those of other companies (preferably in the same industry). This might call for additional information.*
  - *Compare the ratio with those prevailing in the market. Again this might call for additional information.*

FEATURED CASE QUESTION

The following case question shall be used throughout this unit.

Presented below are the financial statements of Harvest Co. You are required to use the accounts to answer Activity 5.1 to 5.7

HARVEST LTD STATEMENT OF PROFIT AND LOSS FOR THE YEAR ENDED 31 DECEMBER 2017

	Notes	2017	2016
		UGX "000"	UGX"000"
Revenue	1	3,095,576	1,909,051
Operating profit	1	359,501	244,229
Interest	2	17,371	19,127
Profit before Taxation		342,130	225,102
Income tax expense		74,200	31,272
Profit for the year		**267,930**	**198,830**

HARVEST LTD STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2017

		2017	2016
Assets		**UGX"000"**	**UGX"000"**
Non-current assets			
Property plant and equipment		802,180	656,071
Current assets			
Inventory		64,422	86,550
Receivable	3	1,002,701	853,441
Cash at bank and in hand		1,327	68,363
		1,068,450	1,008,354
		1,870,630	**1,664,425**

Equity and liabilities			
Equity			
Ordinary shares 10c each	**5**	210,000	210,000
Share premium account		48,178	48,178
Retained earnings		651,721	410,591
		909,899	668,769
Non-current liabilities			
10% loan stock	**4**	100,000	100,000
Current liabilities		860,731	895,656
Total equity and liabilities		**1,870,630**	**1,664,425**

NOTES TO THE ACCOUNTS

	2015 UGX	2014 UGX
1. Sales revenue and profit		
Sales revenue	3,095,576	1,909,051
Cost of sales	2,402,609	1,441,950
Gross profit	692,967	467,101
Administration expenses	333,466	222,872
Operating profit	359,501	244,229
Depreciation charged	151,107	120,147
2. Interest		
Payable on bank overdrafts and other loans	8,115	11,909
Payable on loan stock	10,000	10,000
	18,115	21,909
Receivable on short term deposits	744	2,782
Net payable	17,371	19,127
3. Receivables		
Amounts falling due within one year		
Trade receivables	905,679	807,712
Prepayments and accrued income	97,022	45,729
	1,002,701	853,441
4. Current liabilities		
Tax payables	627,018	545,340
Accruals and deferred income	81,279	280,464
Corporate taxes	108,000	37,200
Other taxes	44,434	32,652
	860,731	895,656
5. Called-up share capital		
Authorised ordinary shares 10c each	1,000,000	1,000,000
Issued and fully paid ordinary shares of 10c each	210,000	210,000
6. Dividends paid	20,000	-

1.5 PROFITABILITY AND RETURN ON CAPITAL

- **Return on capital employed (ROCE)** may be used by shareholders or the Board to access the performance of management.

- **Profit before taxation (PBT)** is generally thought to be a better figure to use than profit after, because there might be unusual variations in the tax charge from year to year which would not affect the underlying profitability of the company's operations.

- Another profit figure that should be calculated is PBIT, **profit before interest and tax**. This is the amount of profit which the company earned before having to pay interest to the providers of loan capital, such as loan notes and medium-term bank loans, which will be shown in the statement of financial position as non-current liabilities.

- **Profit before income tax is therefore**;
  - *The profit on ordinary activities before taxation: plus,*
  - *Interest charges on loan capital*

1.5.1 Return of Capital employed (ROCE)

- It is impossible to assess profits or profit growth properly without relating them to the amount of funds (capital) that were employed in making profits. The most important profitability ratio is therefore return on capital employed (ROCE), which states the profit as a percentage of the amount of capital employed

$$ROCE = \frac{Profit\ before\ interest\ and\ taxation}{Total\ assets\ less\ current\ liabilities} \times 100\%$$

- Capital employed = Shareholders' equity plus non-current liabilities
  (or total assets less current liabilities)
- The underlying principle is that we must compare like with like, and so if capital means share capital and reserves plus non-current liabilities and debt capital, profit must mean the profit earned by all this capital together.

- This is PBIT, since interest is the return for loan capital.

Activity 22.1:

i. Compute the Return on Capital Employed (ROCE) of Harvest Co.
ii. Interpret the results obtained in (i) Above

1.5.2 Analysing Profitability and return in more detail

- <u>**The Secondary Ratios**</u>

  - ❑ Often ROCE is sub-analysed to find out more about why the ROCE is high or low, or better or worse than last year. There are two factors that contribute towards a return on capital employed, both related to sales revenue. i.e.;
    a) *Profit margin*
    b) *Asset turnover*

(a) Asset turnover

Asset turnover is the measure of how well the assets of a business are being used to generate sales. This is measured as below;

$$Asset\ turnover\ = \frac{Sales}{Capital\ employed}$$

(b) Profit Margin

This is the ration of profit before Interest and taxation and sales for the period. i.e.;

$$Profit\ margin\ = \frac{PBIT}{Sales}$$

The profit margin and asset turnover (secondary ratios) together explain the ROCE (primary ration). The relationship between the three ratios can be expressed mathematically as follows;

$$Profit\ margin \quad \times \quad Asset\ turnover \quad = \quad ROCE$$

$$\frac{PBIT}{Sales} \quad \times \quad \frac{Sales}{Capital\ employed} \quad = \quad \frac{PBIT}{Capital\ employed}$$

Activity 22.2 Compute the profit margin and asset turnover of Harvest Co .

Use the results obtained in (i) above to further interprete the ROCE computed in Activity 12.1.

1.5.3 A warning about comments on profit margin and asset turnover

- It might be tempting to think that a high profit margin is good, and a low asset turnover means sluggish trading. In broad terms, this is so. But there is a trade-off between profit margin and asset turnover, and you cannot look at one without allowing the other.
- A high profit margin means a high profit per shilling of sales, but if this means sales prices are high, there is a strong possibility that sales revenue will be depressed, and so asset turn over lower.
- A high asset turnover means that the company is generating a lot of sales, but to do this it might have to keep its prices down and so accept a low profit margin per shilling of sales.

1.5.4 Return on Equity (ROE)

Return on equity gives a more restricted view of capital than ROCE, but it is based on the same principles.

$$ROE\ = \frac{Profit\ after\ tax\ and\ preference\ dividend}{Equity\ shareholders'funds} \times 100\%$$

Activity 22.3

i. Compute the Return on Equity (ROE) of Harvest Co.
ii. Interpret the results obtained in (i) Above

1.5.5 Gross profit margin, net profit and profit analysis

- Depending on the format of the statement of profit and loss, you may be able to calculate the gross profit margin as well as the net profit margin. Looking at the two together can be informative.

Activity 22.4

Presented below is a summarized statement of profit and loss of WBS Co for two consecutive years

	2017	2018
	Shs	Shs
Revenue	70,000	100,000
Cost of sales	42,000	55,000
Gross profit	28000	45,000
Expenses	21,000	35,000
Profit of the year	7,000	10,000

***Required**: Compute and comment on WBS Co's gross and net profit margins for the 2 years.*

1.5.6 Historical Vs Current Cost

The interpretation of financial statements above is mainly based on historical cost accounts. It is worth considering how the analysis would change if we were dealing with financial statements based on some form of current value accounting. There are some issues that arise which include;

- *Non-current asset values would probably be stated at fair value. This may be higher than depreciated historical costs. Therefore, capital employed would be higher. This would lead to a reduction in ROCE.*
- *Higher asset values would lead to a higher depreciation charge, which would reduce net profit.*
- *If opening inventory were shown at current value, this would increase cost of sales and reduce net profit.*

- Therefore the ROCE based on historical cost accounts is probably over stated in real terms

1.6 LONG-TERM SOLVENCY (DEBT AND GEARING RATIOS)

Banks and other lenders will be interested in a company's gearing level. Debt ratios are concerned with how much the company owes in relation to its size, whether it is getting into heavier debt or improving its situation, and whether its debt burden seems heavy or light. When a company is heavily in debt, banks and other potential lenders may be unwilling to advance further funds. When a company is earning only a modest profit before interest and tax, and has a heavy debt burden, there will be very little profit left over for shareholders after the interest charges have been paid. And so if interest rates were to go up (on bank overdraft and so on) or the company was to borrow even more, it might soon be incurring interest charges in excess of PBIT. This might eventually lead to the liquidation of the company. These are two big reasons why companies should keep their debt burden under control.

There are 4 ratios that are particularly worth looking at;

a) ***The debt ratio,***
b) ***Gearing ratio***
c) ***Interest cover and***

1.6.1 The debt ratio

There is no absolute guide to the maximum safe debt ratio, but as a very general guide, you might regard 50% as a safe limit to debt. In practice, many companies operate successfully with a higher debt ratio than this, but 50% is nonetheless a helpful benchmark. In addition, if the debt ratios over 50% and getting worse, the company's debt position will be worth looking at more carefully

Activity 22.4

i. Compute the debt ratio of Harvest Co.
ii. Use the results obtained in (i) to comment on the company's debt position.

1.6.2 Gearing ratio

Gearing or leverage is concerned with a company's long time capital structure. We can think of a company as consisting of non-current assets and net current assets (*i.e. working capital, which is current assets minus current liabilities*). These assets must be financed by long-term capital of the company, which is one of two things.

(a) ***Issued share capital which can be divided into:***

- *Ordinary shares plus other equity (e.g. reserves)*
- *Non-redeemable preference shares (unusual)*

(b) ***Long term debt including redeemable preference shares.***

Preference share capital is normally classified as a non-current liability in accordance with IAS 32, and preference dividends (paid or accrued) are included in financial costs in profit and loss. The capital gearing ratio is a measure of the proportion of a company's capital that is debt. It is measured as follows;

$$Gearing = \frac{Interest\ bearing\ debt}{Shareholders'\ equity + interest\ bearing\ debt} \times 100\%$$

As with the debt ratio, there is no absolute limit to what a gearing ratio ought to be. A company with a gearing ratio of more than 50% is said to be high-geared (whereas low gearing means ratio of less than 50%). Many companies are high geared, but if a high geared company is becoming increasingly high geared, it is likely to have difficulty in the future when it wants to borrow even more, unless it can also boost its shareholders' capital, either with retained profits or by a new share issue.

1.6.3 Leverage ratio

Leverage is an alternative term for gearing; the words have the same meaning. The words have the same meaning. Note that leverage (or gearing) can be looked at conversely, by calculating the proportion of the total assets financed by equity, and which may be called the equity to assets ratio. It is calculated as follows;

$$Equity\ to\ assets\ ratio = \frac{Shareholders'\ equity}{Shareholders'\ equity + interest\ bearing\ debt} \times 100\%$$

Alternatively,

$$Equity\ to\ assets\ ratio = \frac{Shareholders'equity}{Total\ assets - current\ liabilities} \times 100\%$$

Activity22.5

i. Compute the gearing and leverage ratios of Harvest Co.
ii. Use the results obtained in (i) to comment on the company's gearing and leverage position

- **Implication of high or low gearing**
  - Gearing is, amongst other things, an attempt to quantify the degree of risks involved in holding equity shares in a company, risk both in terms of the company's ability to remain in business and in terms of expected ordinary dividends from the company.
  - The problem with a highly geared company is that by definition there is a lot of debt. Debt carries a fixed rate generally of interest hence there is a given (and large) amount to be paid out from profits to holders of debt before arriving at a residue available for distribution to holders of equity .
  - The more highly geared the company, the greater the risk that little (if anything) will be available to distribute the way of dividend to the ordinary shareholders.
  - A highly geared company has a large amount of interest to pay annually (assuming that the debt is external borrowing rather than preference shares). If those borrowings are secured in any way, then the holders of the debt are perfectly entitled to force the company to realize assets to pay their interest if funds are not available from other sources.

1.6.4 Interest cover

The Interest cover ratio shows whether a company is earning enough profits before interest and tax to pay its interest costs comfortably, or whether its interest costs are high in relation to the size of its profits, so that a fall in PBIT would then have a significant effect on profits available for shareholders.

$$Interest\ cover = \frac{Profit\ before\ interest\ and\ tax}{Interest\ charges}$$

An interest cover of 2 times or less would be low, and should really exceed 3 times before the company's interest costs are to be considered within acceptable limits.

Activity 22.6

i. Compute the interest cover ratio of Harvest Co.
ii. Interpret the results obtained in (i) above.

1.7 LIQUIDITY RATIOS

Liquidity is the amount of cash a company can put its hands on quickly to settle its debts (and possibly to meet other unforeseen demands for cash payments too). Liquid funds consist of;

- *Cash*
- *Short-term investments for which there is a ready market*
- *Fixed term deposits with a bank or other financial institution, for example, a six month high-interest deposit with a bank*

- *Trade receivables (because they will pay what they owe within a reasonable short period of time)*
- *Bills of exchange receivable (because like ordinary trade receivable, these represent amounts of cash due to be received within a relatively short period of time)*

In summary, liquid assets are current asset items that will or could soon be converted into cash, and cash itself. The reason why a company needs liquid assets is so that it can meet its debts when they fall due. Payments are continually made for operating expenses and other costs, and so there is a cash cycle from trading activities of cash coming from sales and cash going out for expenses.

- There are 2 major types of liquidity ratios that can be calculated; i.e;
  a. ***Current ratio***
  b. ***Quick ratio***

1.7.1 Current Ratio

The standard test of liquidity is the current ratio. It can be obtained from the statement of financial position.

$$Current\ ratio = \frac{Current\ Assets}{Current\ Liabilities}$$

The idea behind this is that a company should have enough current assets that give a promise of 'cash to come' to meet its future commitments to pay off its current liabilities. A ratio of in excess of 1 is desirable, otherwise the company might be unable to pay debts on time.

1.7.2 Quick Ratio

Some companies are not able to convert all their current assets (especially inventories) quickly. In this case, the quick ratio is computed to give an indication of the entity's liquid position.

$$Quick\ ratio = \frac{Current\ Assets - Inventory}{Current\ Liabilities}$$

A gain a quick ratio in excess of 1 is desirable for companies with slow moving inventory.

Activity 22.7 Compute the following liquidity ratios for BIL and interprete your results

(i) Current Ratio
(ii) Quick Ratio

1.8 EFFICIENCY RATIOS

Three major ratios are calculated in regard to the entity's level of efficiency; i.e.;
(a) Accounts receivables collection period
(b) Inventory turnover period
(c) Accounts payables payment period

1.8.1 Accounts receivables collection period

This ratio measures the average length of time it takes the company's customers to pay what they owe. The ratio is calculated as follows;

$$\frac{Trade\ receivables}{Sales} \times 365\ days$$

Please note:

(i) Cash sales should be excluded since these are paid for immediately. The ratio uses only credit sales.

(ii) Sales are usually made on "normal credit terms" of payment within 30 days. A collection period significantly in excess of this might signal poor management of funds of the business.

1.8.2 Inventory turnover period

This ratio measures the average number of days that items of inventory are held for. The ratio is computed as follows;

$$\frac{Inventory}{Cost\ of\ Sales} \times 365\ days$$

- The inventory turnover period is another measure of how vigorously a business is trading. A lengthening inventory period from one year to the next indicates;
  - (i) A slowdown in trading
  - (ii) A build up in inventory levels, perhaps suggesting that the investment in inventories is becoming excessive.

1.8.3 Accounts payables payment period

This ratio helps in assessing a company's liquidity. An increase in the payment period is often a sign of lack of long-term finance or poor management of current assets, resulting in the use of extended credit from suppliers, increased bank overdraft and so on. The ratio is computed as follows;

$$\frac{Trade\ accounts\ payable}{Purchases} \times 365\ days$$

NOTE:

It is often rare to find the figure of purchases disclosed in published accounts and therefore, cost of sales serve as an approximation.

1.9 SHARE-HOLDERS' INVESTMENT RATIOS

These ratios help equity shareholders and other investors to assess the value and quality of an investment in the ordinary shares of a company. Shareholders' investment ratios include; *Earnings per Share, Dividend per share, Dividend cover, Price – Earnings ratio and Dividend yield.* The value of an investment in ordinary shares in a company listed on a stock exchange is its market value and so investment ratios must have regard not only to information in the company's published accounts, but also to the current price.

1.9.1 Earnings Per share

This ratio measures the return on each ordinary share in the year. EPS is the amount of net profit for the period that is attributed to each ordinary share which is outstanding during all or part of the period.

Hence;

$$EPS = \frac{Net\ profit\ or\ loss\ attributable\ to\ ordinary\ shareholders}{Number\ of\ ordinary\ shares\ outstanding\ dueirng\ the\ period}$$

1.9.2 Dividend cover

This is calculated as;

$$= \frac{Earnings\ per\ share}{Dividend\ per\ (ordinary) share}$$

1.9.3 P/E ratio

$$= \frac{Share\ price}{Earnings}$$

1.9.4 Dividend yield

$$\frac{Dividend\ on\ the\ share\ for\ the\ year}{Current\ market\ value\ of\ the\ share\ (ex\ div)} \times 100\%$$

PRACTICE QUESTIONS

QUESTION 22.1 KWAMBA LTD

The following information has been extracted from the recently published financial statements of Kwamba Ltd.

Extracts from the statement of profit or loss to 31 June:

	2018	2017
	Shs '000'	Shs '000'
Sales	302,200	170,500
Cost of sales	(98,460)	(80,000)
Profit before tax	203,740	90,500
This is after charging:		
Depreciation	60,000	40,000
Loan note interest	40,000	12,000
Interest on bank overdraft	35,000	13,000
Audit fees	50,000	20,000

Statement of financial position as at 30 June

	2018		2017	
	Shs '000'	Shs '000'	Shs '000'	Shs '000'
Assets:				
Non-current assets		895,000		716,000
Current assets:				
Inventory	4,000		7,000	
Receivables	40,000		20,000	
Cash	120,000		225,000	
		164,000		252,000
Total assets		*1,059,000*		*968,000*
Equity and liabilities:				
Equity:				
Ordinary share capital	700,000		700,000	
Retained earnings	129,000		91,000	
		829,000		791,000
Non-current liabilities:				
10% loan stock		70,000		50,000
Current liabilities:				
Bank overdraft	99,000		77,000	
Payables	11,000		10,000	
Taxation	50,000		40,000	
		160,000		127,000
Total equity and liabilities		*1,059,000*		*968,000*

The following ratios have been computed for Kwamba Ltd, based on its published financial statements for the previous reporting period, alongside the latest industry average ratios.

	Industry average	30 June, 2017
ROCE (%)	12	13.7
Profit/ sales (%)	3	5
Assets turnover (times)	0.20	0.4
Current ratio (times)	1.98	1.9
Quick ratio (times)	1.93	1.27
Gross profit margin (%)	3	8
Accounts receivable collection period (days)	43	52
Accounts payable payment period (days)	46	49
Inventory turnover (times)	32	35
Gearing (%)	6	10

Required:

(a) Compute comparable ratios for Kwamba Ltd for the reporting period ended 30 June, 2018. Clearly show all your workings. (10 marks)

(b) Write a report to the board of directors of Kwamba Ltd analysing the performance of Kwamba Ltd, comparing the results against the previous year and against the industry average. (10 marks)

QUESTION 22.2 MOVIT Uganda Ltd

Movit Uganda Ltd manufactures beauty products. The company's summarised financial statements for the year ended 31 March 2018, and 2017 comparatives, are provided as below:

Statement of profit or loss and other comprehensive income for the year ended 31 March:

	2018 Shs '000'	2017 Shs '000'
Revenue	830,000	720,000
Cost of sales	(715,000)	(625,000)
Gross profit	115,000	95,000
Administrative expenses	(45,000)	(27,000)
Distribution costs	(20,000)	(13,500)
Finance costs	(15,500)	(12,700)
Profit before taxation	34,500	41,800
Income tax expense	(10,350)	(12,540)
Profit for the year	24,150	29,260

Statement of financial position as at 30 June:

	2018		2017	
Assets:	Shs '000'	Shs '000'	Shs '000'	Shs '000'
Non-current assets:				
Property, plant and equipment	80,000		108,000	
Investments	12,000	92,000	18,200	126,200
Current assets:				
Inventory	35,000		28,000	
Trade receivables	34,000		32,000	
Bank and cash	16,000	85,000	21,600	81,600
Total assets		177,000		207,800

Equity and liabilities:		
Equity:		
Equity shares of Shs 1,000 each	50,000	50,000
Revaluation Reserve	6,000	26,000
Retained earnings	94,000	93,700
	150,000	169,700
Non-current liabilities:		
Bank loan	15,000	16,000
Current liabilities		
Trade payables	12,000	22,100
Total equity and liabilities	177,000	207,800

The following information is also available:
There were no additions to or disposals of non-current assets during the year, but the properties suffered impairment losses of Shs1 billion during the financial year.

Required:
Analyze and discuss the financial performance and position of Movit Uganda Ltd. ***(20 marks)***

QUESTION 22.3 KITONE (U) Ltd

Kitone (U) Ltd is a leading entertainment enterprise in Uganda with businesses ranging from print, electronic media, cinema and entertainment houses. The entity has a policy of growth through acquisitions. Currently, Kitone (U) Ltd would like to acquire Emu Discotheque situated in downtown Kampala, in a bid to diversify into a new market. As financial advisor to the chief executive officer (CEO) of Kitone (U) Ltd, you have been nominated to be part of a team to investigate the prospect of purchasing Emu Discotheque. The CEO wants you to prepare a report evaluating the recent performance of Emu Discotheque, the quality of its management, and its potential to enhance the overall performance of Kitone (U) Ltd. You have the following financial information which has been derived from the financial statements of Emu Discotheque for the three years ended 31 March:

Financial year ended 31 March	2018	2017	2016
Item			
Turnover (Shs million)	3,452	3,633	3,460
Cash and cash equivalents (Shs million)	50	114	50
Return on equity (%)	13	19	23
Sales revenue to total assets (times)	2.44	3.6	3.71
Cost of sales to sales revenue (%)	89	89	88
Operating expenses to sales revenue (%)	8	6	5
Net income to sales revenue (%)	1.80	2.60	3.20
Current/ working capital ratio (to 1)	1.01	1.58	1.51
Acid test ratio (to 1)	0.8	1.25	1.23
Inventory turnover (times)	0.6	0.5	0.4
Credit to customers (months)	2	1.5	1.5
Credit from suppliers (months)	2	1.2	1.2
Net assets per share (in cents)	1	1.01	0.96
Divided per share (in cents)	14	14	10
Earnings per share (in cents)	12.8	19.2	22.5

Required:
Prepare a report for the CEO which reviews the performance of Emu Discotheque and make recommendations as to how the overall performance of Emu Discotheque could be improved. (In the report, indicate any limitations in your analysis.) ***(Total 20 marks)***

Exploration for & Evaluation of Mineral Resources

23.0
IFRS 6" *EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES"*

UNIT 23 OVERVIEW:

- Scope of IFRS 6
- Key terms under IFRS 6
- Accounting for mineral resources
- Evaluation of mineral resources
- Disclosure requirements

1.1 KEY DEFINITIONS

- **Exploration for and evaluation of mineral resources** means the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

- **Exploration and evaluation expenditures** are expenditures incurred in connection with the exploration and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource is demonstrable.

1.2 ACCOUNTING POLICIES FOR EXPLORATION AND EVALUATION

IFRS 6 permits an entity to develop an accounting policy for recognition of exploration and evaluation expenditures as assets without specifically considering the requirements of paragraphs 11 and 12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Thus, an entity adopting IFRS 6 may continue to use the accounting policies applied immediately before adopting the IFRS. This includes continuing to use recognition and measurement practices that are part of those accounting policies.

1.2.1 Impairment

IFRS 6 effectively modifies the application of IAS 36 Impairment of Assets to exploration and evaluation assets recognised by an entity under its accounting policy. Specifically:

(I) Entities recognising exploration and evaluation assets are required to perform an impairment test on those assets when specific facts and circumstances outlined in the standard indicate an impairment test is required. The facts and circumstances outlined in IFRS 6 are non-exhaustive, and are applied instead of the 'indicators of impairment' in IAS 36

(II) Entities are permitted to determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of CGUs. This accounting policy may result in a different allocation than might otherwise arise on applying the requirements of IAS 36

(III) If an impairment test is required, any impairment loss is measured, presented and disclosed in accordance with IAS 36.

1.3 PRESENTATION AND DISCLOSURE

An entity treats exploration and evaluation assets as a separate class of assets and make the disclosures required by either IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets consistent with how the assets are classified.

IFRS 6 requires disclosure of information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources, including:

- its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets the amounts of assets, liabilities,

- income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

EXAM TYPE QUESTIONS

Activity 23.1

Atlas (U) Ltd is involved in the exploration of oil resources in Bukiki district. Atlas (U) Ltd started the exploration of the oil resources in July 2013.

Atlas (U) Ltd has incurred costs after the acquisition of the legal rights to explore Bukiki district, Kaloke oil well. The costs include topological costs Shs 50 million, geological costs Shs 30 million, geochemical and geophysical studies Shs 100 million, exploration drilling Shs 180 million, trenching costs Shs 120 million, sampling costs Shs 340 million, and evaluating the technical feasibility costs Shs 230 million, as well as development of minerals resources Shs 300 million.

Atlas (U) Ltd has purchased drilling machines and rigs and also leased excavation machines amounting to Shs 120 million and Shs 270 million respectively.

Atlas (U) Ltd acquired drilling rights estimated at Shs 300 million. However, after the first year of exploration, the drilling rights were valued to Shs 235 million.

Before the Atlas (U) Ltd obtained the legal rights to explore Bukiki district, Kaloke oil well, they incurred technical feasibility costs Shs 250 million, geological studies costs Shs 360 million, hire of machines Shs 150 million, and workers costs Shs 300 million.

The proprietors of Atlas (U) Ltd are in the process of preparing their first set of financial statements and have contracted you for advice on the treatment of the above costs.

Required:

In accordance with IFRS 6: Exploration for and Evaluation of Minerals Resources, advise the proprietors of Atlas (U) Ltd on the treatment of any five of the costs incurred by the company and the appropriate standards to apply.

Liquidation & Receivership

24.0 RECEIVERSHIP AND LIQUIDATION

UNIT 24 OVERVIEW:

- Key definitions.
- Appointment of Receiver.
- Accounts of a Receiver.
- Liquidation Accounts.
- The deficiency Account.

1.1 RECEIVERSHIP

This refers to the process by which a creditor(s) realize the amount due from a debtor by taking over the financial affairs of the debtor. This right originates from having a secured debt.

It is more common where there is a floating charge. In the case of a fixed charge, the creditor may realize only the specified asset.

1.2 LIQUIDATION

This refers to the process by which the life of the company is brought to an end (winding up). The assets are realized, creditors paid off and the balance distributed to shareholders in accordance with their rights and holding.

1.3 APPOINTMENT OF A RECEIVER

(a) Where the receivership arises out of a charge, the creditors shall appoint the receiver.

(b) The receiver might be appointed by court where;
- *The creditors fail to appoint one*
- *The creditors' rights arise from court judgment other than from contract.*

1.4 DUTIES OF A RECEIVER

(a) To obtain enough money from the company to pay off creditors (debenture holders).
(b) Where there are other creditors other than debenture holders, the receiver should balance between the interests of the secured debenture holders and other creditors.

(c) The receiver should;
   (i) Collect and take possession of the company's assets especially those included in the charge
   (ii) Take note of the right of set off.
   (iii) Where the deed authourises the receiver to carry on the business of the company, the receiver may / can borrow money for the purpose with or without a charge on a property covered by the debenture holder's charge.

1.4.1 Distribution of Property

(a) The receiver should distribute the property in the following order;

(i) Pay costs of collecting the assets
(ii) Pay costs and remuneration of the receiver
(iii) If the charge is a floating charge, preferential debts should be paid before settling the debenture holder's dues.
(iv) The receiver will then satisfy the amount due to the debenture holders and the surplus if any is handed back to the company.

NOTE:

Before accepting appointment, the receiver should:

(a) Ensure his appointment is legal and proper. Appointment validity considerations include;
- If the borrowing was intravires
- Was the charge registered properly and in time (within 14days from contract date)
- If the charge was created in the previous 6months, take care to ensure it is not a fraudulent preference.
- If the charge is floating charge created within the last 12 months, it might be valid as a preference transfer.

(b) If the charge is invalid the receiver is in fact a trespasser in the property of the company.
(c) The receiver may face problem
(d) s if the company has reserved the title over the goods.
(e) His remuneration is guaranteed and properly calculated.

1.5 ACCOUNTS OF A RECEIVER

The receiver should maintain the following financial records;

(i) A register of assets charged including the company's valuation of these assets.
(ii) Records of amounts realized and paid out.
(iii) A statement showing amounts received and paid.

1.5.1 Receiver's statement to the company and debenture holders

	Book value shs	Received shs		Payment shs
Total value of assets charged	XX	XX	Realisation costs	XX
Total amount received from trading activities		XX	Remuneration of the receiver	XX
Total paid on trading activities		(XX)	Preferential debts (if floating charge)	XX
			Payments to debenture holders	XX
			Balance back to the company	XX
		XX		XX

1.5.2 Provision with regard to past members

(i) Not liable to contribute in respect of debts acquired after he has ceased to be a member.
(ii) Not liable or ceased to be a member for one year and above.
(iii) In the case of a company limited by shares, liability is limited to amounts unpaid on the shares in respect of which he is liable as such a member.
(iv) In the case of a company limited by guarantee, liability is limited to amounts undertaken to be contributed by him in case the company is being wound-up.

1.5.3 Order of payment:

The amounts realized from the assets not specifically pledged, and amounts realized from any trading activity must be distributed by the liquidator in the following order:

(i) Expenses of winding up including the liquidator's remuneration.
(ii) Preferential creditors.
(iii) Creditors secured by a floating charge.
(iv) The surplus if any amongst the contributories according to their respective rights.

1.6 LIQUIDATION ACCOUNTS

The liquidator appointed by the company will produce the following statements:

(a) Statement of affairs as at the date of the winding up order.
(b) The deficiency account
(c) A statement to accompany the payment of dividends to the shareholders.
(d) The liquidator's final statement.

The liquidator is also expected to have the lists of the following as ranked;

RANK	PARTICULARS
A	Assets not specifically pledged
B	Assets specifically pledged
C	Preferential creditors
D	Debentures secured by floating charge
E	Unsecured creditors
F	Preferential shares (preference shareholders)

1.6.1 Asset Classification

In the statement of affairs, assets are no longer classified in accordance with accounting rules of current versus non-current; instead, they take on a legal classification, i.e.;

(a) Assets pledged with fully secured creditors
(b) Assets pledged with partially secured creditors
(c) Assets not pledged / free.

All assets are valued / measured at their **realizable value**.

1.6.2 Liabilities Classification

Liabilities are similarly given a legal classification although stated at their book values. The following classifications are made in the statement of affairs;

(a) Fully secured creditors
(b) Partly secured creditors
(c) Preferential creditors
(d) Unsecured creditors

(a) Fully secured Creditors

A secured creditor is one who holds some mortgage or charge on property belonging to the holder. Any surplus of the security over the debt is carried forward to cover any partly secured creditors having a charge on the specific property.

A creditor whose debt is secured by a guarantee given by a third party, or a mortgage charge on property belonging to a third party would not be treated as a secured creditor in the statement of affairs but would be included in the unsecured creditors. He would prove against the debtor for full payment of the debt without bringing in his security to make good of any loss suffered.

(b) Preferential Creditors

These are creditors payable in full in priority to other debts. These include creditors such as URA (for any taxes unpaid to date), employees (salaries and wages unpaid) and Landlord (for any rent unpaid).

Any surplus in excess of amounts carried as surplus after clearing secured creditors and those realized from assets not specifically pledged is carried forward to cover debentures secured by floating charge and unsecured creditors.

(c) Unsecured Creditors

These are creditors who hold no mortgage, charge or lien on property belonging to the debtors.

1.7 THE STATEMENT OF AFFAIRS

The statement of affairs is given on the next page.

IN THE MATTER OF THE COMPANIES ACT 2012, INSOLVENCY ACT 2011 & INSOLVENCY REGULATIONS 2013 & IN THE MATTER OF …………………. LIMITED
STATEMENT OF AFFAIRS AS ON …………………………………

		Estimated Realisable Value				
	Assets not specifically pledged (as per list A)					**shs**
	Balance at Bank					XX
	Cash at Hand					XX
	Marketable Securities					XX
	Bills receivable					XX
	Trade debtors					XX
	Loans & Advances receivables					XX
	Stock at hand					XX
	Work in progress					XX
	Investments					XX
	Furniture, fittings and other					XX
	Property not secured					XX
						XX
	Assets specifically pledged (as per list B)	(a)	(b)	(c)	(d)	
		Estimated realisable values	Due to secured creditors	Deficiency ranking as unsecured	Surplus carried to last column	
		shs	shs	shs	shs	

	Freehold property	XX	XX	XX	XX	XX
	Estimated total assets available for preferential					
	creditors, debenture holders secured by a floating					
	charge and unsecured creditors					**XX**
	Summary of Gross Assets					
	Gross realizable value of assets not specifically pledged					XX
	Other Assets					XX
						XX
Gross						
Liabilities						
XX	Secured creditors					(XX)
XX	Preferential creditors					(XX)
XX	Estimated assets available for debentures secured by floating charge and unsecured creditors					XX
XX	Debentures secured by floating charge					(XX)
	Estimated surplus as regards debentures secured by floating charge					XX
XX	Unsecured creditors					(XX)
	Estimated deficiency as regards creditors					XX
	Issued and called up capital					XX
	Estimated Deficiency as regards contributories					**XX**

1.8 THE DEFICIENCY ACCOUNT

The purpose of this account is to show how the deficiency disclosed by the statement of affairs has been caused.

The account begins with the excess of assets over liabilities, or excess of liabilities over assets one year prior to the date of the receiving order and shows how such surplus has been increased by;

(a) Net profit (before charging director's salary and interest on capital)
(b) Other sums received since that date

and decreased by;

(c) Net losses
(d) Personal drawings
(e) Depreciation of assets
(f) Other losses and expenses

The balance on the deficiency account should be the deficiency as shown by the statement of affairs.

Revision Questions

PRACTICE QUESTIONS

Question 24.1 World Business Services Ltd (WBS)

World Business Services (WBS) a public limited company received a compulsory order of winding up from Commercial Court on 31 March 2018. Records of the business as at that date showed the following.

	Debit Shs"000"	**Credit Shs"000"**
Land and buildings	600,000	
Share capital		320,000
Cash in hand	10,000	
Trade receivables	40,000	
Furniture and fittings	200,000	
NSSF and PAYE payable		60,000
Trade payables		200,000
Mortgage on land and buildings		420,000
Loan – Barclays Bank		100,000

Additional Information

1. The loan from Barclays bank is registered as a debenture and is secured by a floating charge.
2. Estimated liability for bills discounted was shs. 60 million estimated to rank shs. 60 million.
3. Other contingent liabilities were shs. 120 million, estimated to rank shs. 120 million.
4. On investigation, it was found that the assets are likely to be realized as follows;

	Shs "000"
Land and buildings	480,000
Furniture and fittings	200,000
Cash in hand	10,000

5. Of the trade receivables, shs. 4 million is considered doubtful and thus uncollectable.
6. The assets exceeded the liabilities by shs 50 million three years ago. The results of the last 3 years' trading reveal that WBS made a loss of shs300 million.
7. The liquidator's expenses are estimated at shs 2 million and remuneration will be paid at 1.5% of the assets realized and 1% on amounts available for payouts.

Required
Prepare a:
(a) Statement of affairs of WBS Limited as at 31 March 2018
(b) Liquidators' final statement of account.
(c) Deficiency Account

OTHER EXAM TYPE QUESTIONS:

Please attempt the following questions from your question Banks:

CPA(U) August 2016 Question 1: UKUMI LIMITED

CPA(U) May 2017 Question 5: KEEFE LIMITED