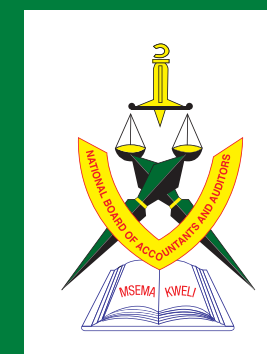


FINANCIAL REPORTING

STUDY TEXT

B2

Intermediate level



THE NATIONAL BOARD OF
ACCOUNTANTS AND AUDITORS
TANZANIA (NBAA)

B2 FINANCIAL REPORTING

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B2
FINANCIAL REPORTING

STUDY TEXT

NBAA



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FOREWORD.

The National Board of Accountants and Auditors is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 (CAP 286 R.E.2002). The Board has been charged with among other things, the responsibility to promote, develop and regulate the accountancy profession in the country.

In fulfilling its statutory obligations, NBAA prepares National Accountancy Examination Scheme for students aspiring to sit for Accounting Technician and Professional Examinations. Further, for effective implementation of the examination scheme and improve examination results, the Board provides Study Guides for all subjects to assist both examination candidates and trainers in the course of learning and teaching.

The Study Guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The Study Guides cover a wide range of topics in the NBAA syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a learner to pass the respective examination levels.

Furthermore, the Study Guides have been prepared to match with the Competency Based Syllabi to enable the learners to be exposed to practical understanding of issues rather than memorisation of concepts. In this case, the Study Guides are characterized by the following features:-

1. Focus on outcomes – The outcomes shown in every topic provides clear understanding on what to be learnt.
2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge and skills necessary for effectively performance in a work place. This is different from the traditional training where much concern has been expressed in theoretical perspectives.
3. Assessments as judgments of competence – The assessment questions embedded in the Study Guides are adequate measures of understanding of the subject matter.

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

NBAA believes that these standard Study Guides are about assisting candidates to acquire necessary skills and knowledge that will enable them to perform as professionals. The outcomes to be achieved are clearly stated so that learners may know exactly the skills and knowledge they are supposed to acquire in a particular topic.

NBAA wishes all the best to NBAA Examination candidates, trainers in their review classes, lecturers in the higher learning institutions and all other beneficiaries of these learning materials in making good use of the Study Guides towards promoting the accountancy profession in Tanzania.

CPA. Pius A. Maneno
EXECUTIVE DIRECTOR
JUNE, 2019

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Features of the book

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

Contents of each Study Guide

- ❑ **'Get Through Intro'**: explains **why** the particular Study Guide is important through real life examples.
- ❑ **'Learning Outcomes'**: on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

- ✓ **'Definition'**: explains the meaning of important terminologies discussed in the learning Outcome.
- ✓ **'Example'**: makes easy complex concepts.
- ✓ **'Tip'**: helps to understand how to deal with complicated portions.
- ✓ **'Important'**: highlights important concepts, formats, Acts, sections, standards, etc.
- ✓ **'Summary'**: highlights the key points of the Learning Outcomes.
- ✓ **'Diagram'**: facilitates memory retention.
- ✓ **'Test Yourself'**: contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

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

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination. 5 conventional questions of 20 marks each need to be solved.

The examination will consist of two sections.

- | | |
|-----------|---------------------------|
| Section A | One compulsory question |
| Section B | Four questions out of six |

STUDY GUIDE A1: THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) AND THE CONCEPTUAL FRAMEWORK

Get Through Intro

As with any profession, people who practice accountancy are expected to possess certain expertise. Under this assumption, society accepts advice from professional accountants in good faith and acts on this advice.

The main area, in which this faith is evident, is the reliance on financial statements prepared by professional accountants. Readers should be able to accept them without question and in turn base their decisions on them.

There has to be some mechanism to ensure that accounting work is performed according to set principles and standards. Furthermore, an assurance is needed that the assumed professional expertise does actually exist and is applied to the work in hand. This is achieved by means of a regulatory framework.

As an accountant, you can not underestimate the importance of the regulatory framework. Without it, you will not be able to do your job properly. In future, you will need to remain up-to-date on this area; otherwise you will have no idea about any changes that occur in the accountancy profession!

Learning Outcomes

- a) Explain broad branches of accounting.
- b) Describe how accounting has developed through time.
- c) Explain the importance of Regulatory Framework for accounting and reporting.
- d) Discuss the structure of the IFRSF/IASB.
- e) Explain the regulatory framework of accounting in Tanzania.
- f) Identify and present the financial effects of accounting for events and transactions under the IASB Conceptual Framework.
- g) Explain the general purpose financial statements according to IASB.
- h) Explain the accounting reporting concepts, framework and practices governing presentation of financial statements.
- i) Explain and present the qualitative characteristics of financial statement information and disclosures.
- j) Explain the meaning of true and fair or fairly presented in relation to financial reporting.
- k) Describe the accrual, cash, going concern and breakup basis concept in presentation of financial statements.
- l) Present and explain the differences between financial statements prepared using accruals and cash bases.
- m) Explain the objectives and limitations of financial statements using appropriate examples or using a given scenario.
- n) Identify, present and explain to professional accountants or general users the different bases of measurement or of capital and capital maintenance that may be used under accrual-based accounting.
- o) Describe the accounting concepts and theories governing presentation of financial statements.

2: International Accounting Standards Board (IASB) and Conceptual Framework

- p) Describe various types of financial statements according to the concepts used.
- q) Explain the role of a financial accountant in facing criticisms and challenges currently facing the accounting profession.
- r) Describe the role of IASB and NBAA in regulating accounting profession.
- s) Explain the need for recording transactions based on the commercial substance rather than their legal form.

1. Explain broad branches of accounting.
2. Describe how accounting has developed through time.

[Learning Outcomes a and b]

1.1 A Brief history of accounting

It is not surprising that evidence of record keeping for economic events has been found in the earliest civilizations. Many ancient civilisations such as the Mesopotamians were keeping records for various economic activities.

A dictionary meaning of the word is to give a satisfactory record of money. In the period of pre-industrial revolution, there were feudal societies that had wealthy landlords who owned vast properties and wealth. These properties were scattered at many places and they found it difficult to maintain control of activities being held on their properties. This need to control and look after the properties was addressed by appointing stewards at these distant locations who would look after the landlord's interests. As a result of this arrangement, there was a separation of ownership and control of resources. This is also true for modern day companies, wherein the management runs the business and acts as stewards for the owners of the business (i.e. shareholders).

Early references to the subject of accounting are found in the works of some ancient oriental writers.

The year 1494 witnessed the advent of the double entry book keeping system when a Franciscan monk and mathematics professor **Luca Pacioli**, published the first known text '**Summa de Arithmetica, Geometria, Proportione et Proportionalita**' to describe a comprehensive double-entry bookkeeping system. He authored several books and also contributed to the way companies ran and how transactions were recorded. In his short, fifty year life, he did so much for the business world that he never took credit for. It was Pacioli who was the first to describe the system of **debits and credits in journals and ledgers** that is still the basis of today's accounting systems. He is therefore even referred to by some as the father of accounting. This was the beginning of a systematic approach to double entry system.

Later, the industrial revolution spurred the need for more advanced cost accounting systems. Also to cater to mass production, there was felt a need for external capital providers (shareholders and bondholders) for which large corporations were set up. These corporations needed accountants to maintain the cost records and accounting records. The rising public status of accountants helped to transform accounting into a profession.

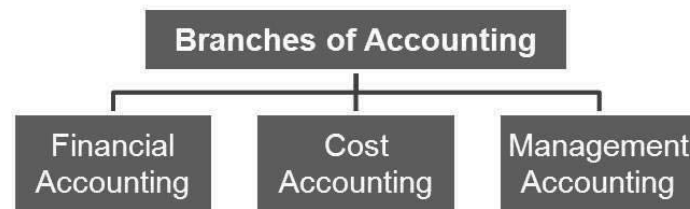
In Tanzania, it was a general opinion that there was a shortage of qualified accountants to manage and run businesses. In 1972, The National Board of Accountants and Auditors (NBAA) were set up to regulate and oversee the development of accounting in the country. NBAA was conferred all the statutory powers to regulate the accounting profession in Tanzania.

1.2 Branches of accounting

The changing business scenario over a period of time has given rise to specialized branches of accounting which could cater to the changing requirements. The broad branches of accounting are:

4: International Accounting Standards Board (IASB) and Conceptual Framework

Diagram 1: Branches of accounting



The above branches are explained in detail below:

1. Financial Accounting



Definition

Accounting is the **process of recording, analysing and reporting (in the form of statement of profit or loss and statement of financial position)**

Financial accounting is concerned only with the financial state of affairs and financial results of operations. It is mainly concerned with the preparation of financial statements which primarily includes statement of profit or loss and the statement of financial position. These financial statements are used by various stakeholders such as trade payables, investors and financial institutions.

The statement of profit or loss is a statement of the business's financial performance and reflects all the items of income and expenses incurred by a business during a certain period. In a statement of profit or loss, the items of income and expenditure incurred by a business are matched against each other to arrive at the **profit / loss** generated by the business during that period.

The statement of financial position (SOFP) is a statement reflecting everything that the entity **owns** (its assets e.g. property, equipment, cash) and everything it **owes** (its liabilities to the owners and third parties e.g. suppliers / vendors, equity) as at a certain point in time.

2. Cost Accounting



Definition

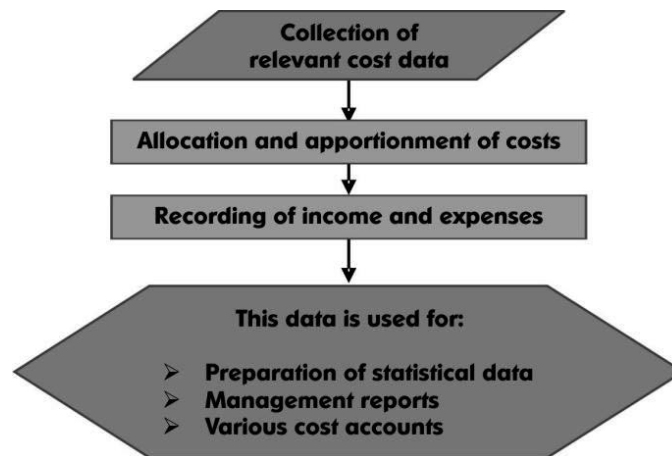
Cost accounting is "the establishment of budgets, standard costs (benchmark for comparison with actual) and actual costs of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds".

CIMA Official Terminology, 2005

Cost Accounting is the process of accounting for costs. It shows classification and analysis of cost on the basis of functions, process, products etc. It also deals with cost computation, cost saving, cost reduction etc. In cost accounting, cost per unit of output produced or services rendered is ascertained. It helps management in the control of cost of output or services rendered.

Cost accounting is the process of accounting or recording all attributable and allocable costs for a product or service, beginning with recording of income and expenditure relating to the product and ending with preparation of statistical data. Costing is essentially an activity of assigning the appropriate costs to a product and creating a data for future references as regards the cost relating to it.

Diagram 2: Cost accounting process



Its main objective is the creation of an underlying data for use in management accounting. This should include recording of:

- Cost of goods produced or services rendered
- Cost of combinations of activities grouped as a cost centre
- Accumulation of revenues
- Profitability at any level
- Optimum selling prices, ensuring all costs are covered
- Value of inventory
- Future costs
- Actual cost versus budgeted cost for budgetary control

Cost accounting systems can be found in all types of organisations, but are highly developed and extensively used in the manufacturing sector. This is because the industry is sensitive to costs, and the production costs need to be monitored and controlled effectively for the profit margins to be at the desired level. Cost accounting can be, and is generally, applied to all areas of the organisation. It is not department specific.

3. Management Accounting

It deals with the processing of data in financial accounting and cost accounting for managerial decision making. It also deals with the application of managerial economic concepts for decision making for the efficient running of the business, thus maximising profits.

In other words, it is accounting for the management. Management accounting is useful to the management to provided necessary information for decision making and creation of suitable policies within the organisation. The aim of management accounting is the efficient running of the business, and thus, maximising profits.

Where financial accounting focuses on external users, management accounting emphasises on the preparation and analysis of accounting information within the organisation.

The concept envisages the application of appropriate techniques and concepts, which would **aid management in the formulation of a strategy** for the achievement of objectives.

Data used for management accounting should serve its intended purpose. An appropriate concept or technique, even if borrowed from other branches of accounting or subjects such as mathematics or economics, can be used for management accounting purposes.



Test Yourself 1

Management accounting, as a concept, makes use of:

- A Both cost and financial accounting disciplines
- B Neither cost nor financial accounting disciplines
- C Cost accounting discipline only
- D Financial accounting discipline only

6: International Accounting Standards Board (IASB) and Conceptual Framework

3. Explain the importance of Regulatory Framework for accounting and reporting.
4. Discuss the structure of the IFRSF/IASB.
5. Explain the regulatory framework of accounting in Tanzania.

[Learning Outcomes c, d and e]

2.1 Need and importance of a Regulatory Framework

Firstly, let us understand what a regulatory framework is. It is a structure which helps an entity decide how to treat items that need to be included in the financial statements. It is based on

- Company law
- International Accounting Standards (if followed)
- The influence of other national standard-setting bodies
- Stock Exchange requirements
- Overseeing by the professional bodies such as ICAEW, ACCA or IFAC to ensure that the professional standards for accounting and auditing are followed in practice.

A regulatory framework is needed mainly for the following reasons.

1. To prevent material manipulations or errors in financial statements

Many important economic decisions are regularly made on the basis of financial statements. However, financial information is open to manipulation or errors.

In order to avoid manipulation of figures in the financial accounts, there needs to be a consistent way of deciding which elements are recognised and measured, and how information is presented in the financial statements.



Example

An entity may revalue only those assets that have increased in value, so as to show a better picture. IAS 16 allows an entity to revalue property, plant and equipment. However, it lays down a rule that an entire class of property, plant or equipment has to be revalued.

In absence of such guidance from the IAS the entity would have easily managed to manipulate the accounts. Thus in this case IAS 16 provides guidance that all the assets of that class should be revalued, irrespective of whether there is an increase or decrease in their value.

2. To ensure that items are treated in a consistent manner or an explanation is given as to why not

Accounting is not a subject where the results are always the same whoever does it. For example, in mathematics, 2 plus 2 must always equal 4; but in accounts, a figure for (say) profit or loss may vary, sometimes vastly, depending upon the subjective judgments of the person doing the calculations. It is important that explanations are given to help the user of financial statements make correct decisions.



Example

Disc Co does not provide for investment property revaluations of Tshs600 million, based on an independent revaluation report, and does not disclose this fact. Disc's profits are Tshs1,200 million. The user compares the financial statements with those of a similar company, Clip Co that provides for revaluations of investment properties. Under IAS 40, all revaluation gains and losses are included in the profit for the year. Klip's properties have increased substantially in value and therefore its profits have increased from Tshs1,200 million to Tshs1,800 million.

Disc's profits for the year are lower than Klip by Tshs600 million. The user concludes that Disc Co is less profitable, therefore decides to invest in Klip. This is an incorrect decision because the same accounting item has been treated differently by 2 companies. By having international accounting standards, items should be treated in a consistent manner, or, if there is a different treatment, an explanation should be given. So, under IAS, Disc would need to state in its accounting policies that it does not revalue its investment properties.

3. To help in global harmonisation

This is a corollary of the purpose mentioned in the previous paragraph. Unless accounting activities are regulated across the globe, different entities in different countries will apply their own rules, which are unlikely to be harmonious.

The process of global harmonisation leads to global accounting standards. Global standards will help global trade and global economic growth as all users will be able to use the same standards to analyse the financial statements of any company, whether in the UK, Poland, Singapore or Australia.

The process of global harmonisation of standards is not complete. There are countries like North America and India which use their own standards. However, now most of the national standard setters are harmonising their standards with the international standards

2.2 Structure of IFRS / IASB

The International Accounting Standards Committee (IASC)

The International Accounting Standards Board (IASB) was previously run as the IASC, which operated from 1973 until 2001. The **IASC was founded in June 1973** as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK and Ireland and the US. These countries formed the Board of IASC initially. The purpose of the Board was to **work towards the improvement and harmonisation of accounting standards and reporting**. In March 2001, as part of a restructuring, the IASC Foundation was set up in Delaware as a not-for-profit entity. The IASC in turn gave approval for the IASB to assume standard-setting responsibilities.

IASB Foundation became IFRS Foundation on 1 July 2010.

On 1 July 2010, the IASC Foundation has formally changed its name to the IFRS Foundation. The change represents the next step in a process to simplify the names in use across the organisation which was announced following the conclusion of the Constitutional Review in 2010. The International Financial Reporting Interpretations Committee and the Standards Advisory Council are also renamed as the IFRS Interpretations Committee and the IFRS Advisory Council, respectively. The name of the International Accounting Standards Board (IASB) remains unchanged.

The objectives of the IFRS Foundation, as stated in its constitution, are:

- 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 financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions.
- To **promote the use** and rigorous application of those standards.
- In fulfilling the objectives associated with (a) and (b), **to take account**, as appropriate, of the special needs of **small and medium-sized entities** and emerging economies.
- To bring about **convergence of national accounting standards** and IASs and IFRSs to high-quality solutions.

1. The structure of the IFRS Foundation

- (a) The monitoring board
- (b) The Foundation is governed by trustees.
- (c) There are 22 trustees, appointed as follows:

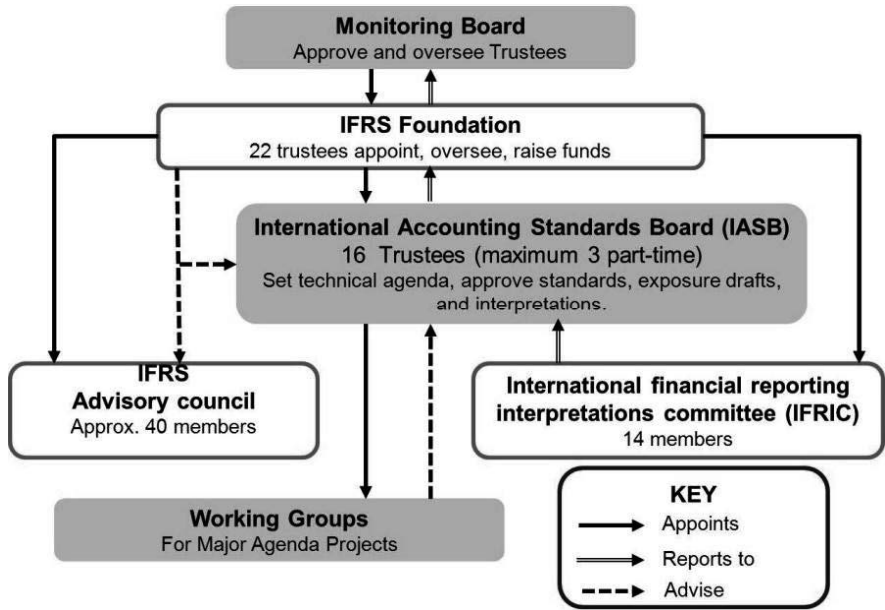
8: International Accounting Standards Board (IASB) and Conceptual Framework

- (i) 6 from North America;
- (ii) 6 from Europe;
- (iii) 6 from the Asia / Oceania region; and
- (iv) 4 from any area, subject to establishing overall geographical balance.

(d) The trustees should comprise individuals from different professional backgrounds such as auditor’s preparers, users and academicians.

(e) They should meet at least twice each year.

Diagram 3: The structure of the IFRS Foundation and its components



(Source: www.iasb.org)

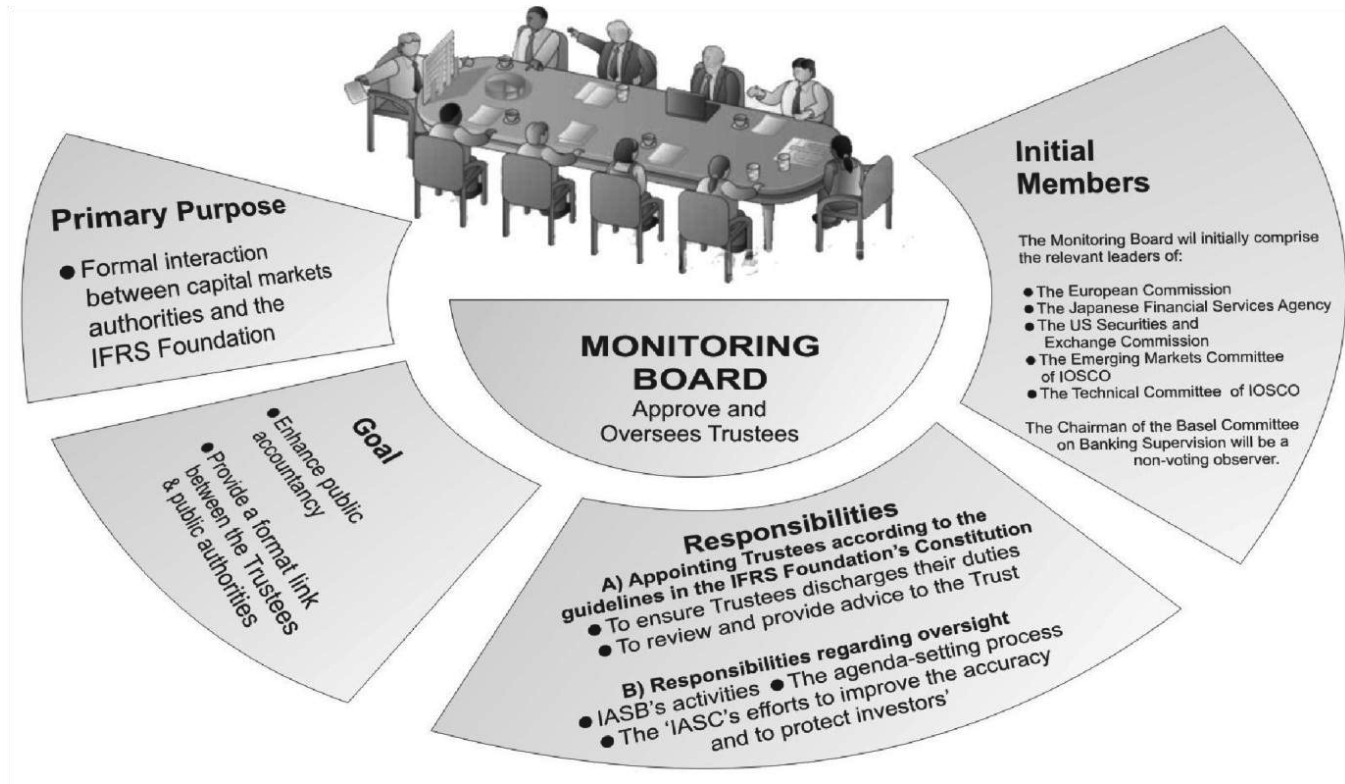
Monitoring Board

The primary purpose of the Monitoring Board is to serve as a mechanism for formal interaction between the IFRS Foundation and the capital market authorities that allow or require the use of IFRS in their jurisdictions to effectively discharge their mandates relating to investor protection, market integrity and capital formation.

This step has increased the public accountability of the IFRS Foundation while not impairing the standard setting process.

The following diagram provides details regarding the primary purpose, goals, responsibilities and members of the monitoring board:

Diagram 4: Monitoring Board



Name of body	Structure	Role
1. The monitoring board	Given in detail in diagram 2 above	Given in detail in diagram 2 above
<p>2. The International Accounting Standards Board (IASB)</p> <p>It was previously run as the IASC, which operated from 1973 until 2001. The purpose of the Board was to work towards the improvement and harmonisation of accounting standards and reporting.</p> <p>In March 2001, as part of restructuring, the new IASB took over from the IASC, the responsibility for setting International Accounting Standards.</p>	<p>(a) The IASB comprises sixteen individual members; thirteen full-time and three part-time.</p> <p>(b) Members have professional competence and practical experience.</p> <p>(c) Trustees appoint one of the full-time members to be the Chairman of the IASB, who is also the Chief Executive of the IFRS Foundation.</p> <p>(d) Each member of the IASB has one vote.</p> <p>A quorum is formed by at least 60% of the members of the IASB.</p>	<p>To achieve the following objectives:</p> <p>(a) To develop high quality, understandable and enforceable global accounting standards.</p> <p>(b) To promote the use and rigorous application of those standards.</p> <p>(c) Take account of special needs of small and medium sized entities and emerging economies.</p> <p>(d) To bring about convergence of national accounting standards and IASs and IFRSs to high-quality solutions.</p> <p>The IASB has complete responsibility for all IASB technical matters, including preparing and issuing IFRS, IAS, and Exposure Drafts.</p>

10: International Accounting Standards Board (IASB) and Conceptual Framework

<p>3. The IFRS Advisory Council</p> <p>It is a formal body which gives advice to the IASB and individuals relating to the various accounting standards</p>	<p>(a) It comprises forty or more members, and a chairman, all appointed by the trustees.</p> <p>(b) The members are expected to be from diverse professional and geographical backgrounds.</p>	<p>(a) To provide a forum where the IASB consults individuals and the representatives of the organisations.</p> <p>(b) To support the IASB in the promotion and adoption of IFRSs throughout the world.</p>
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2.3 Regulatory framework of accounting in Tanzania

Subject to the provisions of Companies Act 2002 Act, every company's is required to prepare its balance sheet, profit and loss account and cash flow statement in accordance with the requirements specified in regulations prescribed by the Minister, or the National Board of Accountants and Auditors or such other body as the Minister may decide.

Tanzania migrated to IFRSs, IPSASs and ISAs with effect from 1st July, 2004 and therefore, every entity in the country, whether small or large, was required to prepare its financial statements in accordance with the IFRSs or IPSASs as the case may be.

Following the issuance of the IFRSs for SMEs by the International Accounting Standards Board (IASB) on 9 July, 2009, some entities in Tanzania are permitted to use the IFRSs for SMEs issued by IASB.

The National Board of Accountants and Auditors Tanzania issued a technical pronouncement on 15 October 2009 to clarify on the scope of the applicability of those standards in the country. The scope of applicability of IFRSs/IASs is as follows:

Sr.No	Type of Standard	Category of entities
1.	Full IFRS	<p>Publicly accountable entities or entities that represent public interest such as entities that take deposits or loans from the public; offer shares to the public; have essential public responsibility or privilege essential public service or entities that hold assets in a fiduciary capacity for a broad group of outsiders.</p> <p>Example of entities that should use full IFRSs include but not limited to:</p> <ol style="list-style-type: none"> 1. Listed Companies, 2. Banks and Financial Institutions, 3. Insurance Companies, 4. Pension Funds 5. Utility Companies, 6. Government Agencies, 7. Mutual Funds, 8. SACCOs, 9. Cooperative Societies, 10. Securities brokers/dealers, 11. All Entities which receive subvention from the Government, except those which are required to use IPSASs. 12. All entities including Government Business Entities (GBEs) with 100 or more employees***, 13. All entities including GBEs with capital investment in non- current assets of above TShs.800,000,000***
2.	IPSAS's	<p>Public sector entities including ministries, regional governments, government departments, agencies and local government provided that they are no Government Business Entities (GBEs).Entities using Accrual based IPSASs are encouraged to use full IFRSs</p>
3.	IFRS for SME's	<ol style="list-style-type: none"> 1. Entities that are not publicly accountable or representing public interest, 2. Entities including GBEs with less than 100 employees provided that they are not in categories 1 and 2 above, 3. Entities including GBEs with capital investment in non-current assets of less than TShs.800,000,000 provided that they are not in categories 1 and 2 above.

The International Accounting Standards Board (IASB) and Conceptual Framework: 11

NB: Entities in categories 2 and 3 are free to use full IFRSs provided that they fully comply with it.

*****A Government Business Entity (GBE) is defined as an entity that has ALL of the following characteristics:**

- (a) Is an entity with the power to contract in its own name,
- (b) Has been assigned the financial and operational authority to carry on a business,
- (c) Sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery,
- (d) Is not reliant on continuing government funding to be a going concern (other than purchases of output at arm's length), and
- (e) Is controlled by a public sector entity.

Below is the list of current standards of IASB

Standard Number	Title
IAS 1	Presentation of financial statements
IAS 2	Inventories
IAS 7	Statement of cash flows
IAS 8	Accounting policies, changes in accounting estimates and errors
IAS 10	Events after the reporting period
IAS 11	Construction contracts
IAS 12	Income taxes
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effects of changes in foreign exchange rates
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 26	Accounting for reporting by Retirement Benefit Plans
IAS 27	Separate financial statements (revised 2011)
IAS 28	Investments in associates and joint ventures
IAS 29	Financial reporting in hyperinflationary economies
IAS 30	Disclosure in the financial statements of banks and similar financial institutions
IAS 32	Financial instruments – disclosure and presentation
IAS 33	Earnings per share
IAS 34	Interim financial reporting
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 39	Financial instruments - recognition and measurement
IAS 40	Investment Property
IAS 41	Agriculture
IFRS 1	First time adoption of IFRS
IFRS 2	Share-based payment
IFRS 3	Business combinations
IFRS 4	Insurance contracts
IFRS 5	Non-current assets held for sale and discontinued operations
IFRS 6	Exploration for and evaluation of mineral resources
IFRS 7	Financial instruments: disclosures
IFRS 8	Operating segments
IFRS 9	Financial instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint arrangements
IFRS 12	Disclosure of interests in other entities
IFRS 13	Fair Value Measurement

12: International Accounting Standards Board (IASB) and Conceptual Framework

6. Identify and present the financial effects of accounting for events and transactions under the IASB Conceptual Framework.
7. Explain the general purpose financial statements according to IASB.
8. Explain the accounting reporting concepts, framework and practices governing presentation of financial statements.

[Learning Outcomes f, g and h]

3.1 Conceptual framework and general purpose financial statements

The IFRS Framework gives a set of concepts in certain basic areas about the why, what and how of the accounting process and the financial statements e.g. whether an item should be recognised as an asset or not. In this Study Guide, we take an overview of these concepts, so as to understand what the overall framework is.

General purpose financial statements are also referred to as 'financial statements'.

It is to be noted that the Framework is concerned with **general purpose financial statements**. It does not cover special statements such as prospectus. General purpose financial statements are those intended to serve users who are not in a position to require financial reports tailored to their particular information needs.

The Framework **is not itself an International Accounting Standard**; it does not define standards for any particular measurement or disclosure issue.

This IASB's Conceptual Framework deals with:

- (i) the objective of financial statements;
- (ii) the qualitative characteristics that determine the usefulness of information in financial statements;
- (iii) the definition, recognition and measurement of the elements from which financial statements are constructed; and
- (iv) concepts of capital and capital maintenance.

The framework is concerned with financial statements, including consolidated financial statements. These are presented at least annually, and are directed towards the needs of a wide range of users. The concepts and practices suggested by the Framework are discussed throughout this Study Guide. We will be discussing objective of financial statements, qualitative characteristics and recognition / measurement of elements in this Learning Outcome, followed by a discussion on concepts of capital and capital maintenance in the subsequent Learning Outcome.

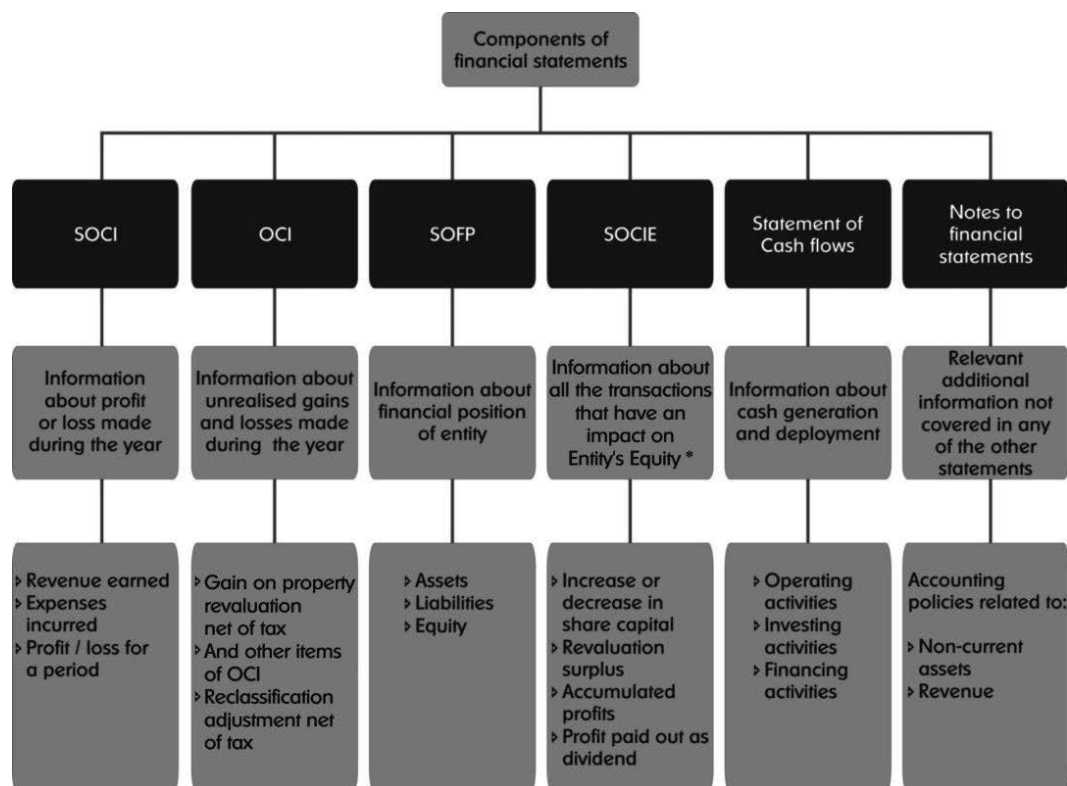
3.2 Objectives of financial statements

This is a fundamental concept. Before we do anything, we need to be clear about why we are doing it, i.e. why we are preparing financial statements. This concept tells us as to why we perform accounting.

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

3.3 Components of financial statements

Diagram 5: Components of financial statements



Note: Amendment to IAS 1 on 16th June 2011 has introduced change in the title of the statement of comprehensive income. The revised title is 'Statement of profit or loss and other comprehensive income'.

* Changes in entity's economic resources and claims not resulting from financial performance.

1. Definition of asset



Definition

An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The Conceptual Framework for Financial Reporting, Para 4.4

Breaking down this definition

A resource controlled by the entity	The important word is 'control'. If the resource is not controlled by the entity, it cannot be considered an asset in financial accounting terms. For example, a building is a resource which is 'controlled', as the entity has the option of using the building in whichever way it wants to. However, staff of the entity cannot be considered an asset, as they can leave the company at any time, therefore are not 'controlled' by the entity
As a result of past events	Something must have happened in the past, to ensure that the asset has the right to be controlled by the entity. So, the building discussed above, was purchased by the company this act, in the past, means that the right to use the building passed to the company.
From which future economic benefits are expected to flow	The whole point of an asset is that it should help generate revenue for the entity. Thus the building could be used to produce goods for sale, or to provide services for customers. Hence the building meets this part of the definition. Conversely, a receivable who has now become insolvent, should be removed as an asset as there are no longer expected to produce future benefits (the money owed will not be received).

14: International Accounting Standards Board (IASB) and Conceptual Framework

An asset may be classified as 'current' or 'non-current'. Examples of assets include buildings, property, plant and machinery, inventories, etc.

2. Definition of liabilities



Definition

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 Conceptual Framework for Financial Reporting, Para 4.4

The same logic shown above in the case of assets can be applied here for liabilities. Similarly, a liability may be classified as 'current' or 'non-current'. Examples of liabilities include trade payable, provisions, outstanding expenses, etc.

3. Definition of equity



Definition

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

The Conceptual Framework for Financial Reporting, Para 4.4

Effectively this is the remaining amount after deducting all liabilities from assets, which is owed to the equity holders of the entity. Examples of equity include ordinary shares, capital reserves, revenue reserves etc.

4. Definition of income



Definition

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

The Conceptual Framework for Financial Reporting, Para 4.25

Breaking down this definition

Increase in economic benefits	The entity should see an increase in economic benefits e.g. cash through sales etc.
Inflows or enhancements of assets or decreases of liabilities	This shows a SOFP approach. All inflows are measured in terms of increasing assets or decreasing liabilities.
Result in increases in equity, other than those relating to contributions from equity	The resultant effect should be to see that equity increases. So if a dividend is received, it means cash (asset) increases and correspondingly profit for the period increases (dividend income), thereby increasing equity. The definition specifically removes any contributions for shares from shareholders from being counted as income.

Examples of income include sales revenue, dividends received, consultancy receipts etc.

The concept of income for the purpose of IFRSs is much wider than its usual meaning. The concept also includes within its scope gains and incomes such as unrealised gains, revaluation gains etc.

5. Definition of expenses



Definition

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The Conceptual Framework for Financial Reporting, Para 4.25

The same logic shown above in income can be used here for expenses. Examples of expenses include operating expenses, administrative expenses, selling expenses etc.



Important

An entity shall classify an asset as current when:

- (a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
- (b) it holds the asset primarily for the purpose of trading;
- (c) it expects to realise the asset within twelve months after the reporting period; or
- (d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current. A similar logic applies to classification of liabilities into current and non-current.

3.4 Recognition

According to the Conceptual Framework, recognition is the process of incorporating in the statement of financial position and the statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

- ⑩ It is **probable** that any **future economic benefit** associated with the item will flow to or from the entity.
- ⑩ The cost or value of the element can be **measured reliably**.

It should be noted that the first criteria is that the element meets the definition of an element of financial statement.



Test Yourself 2

Do the following classify as an asset or liability within the definitions given by the Framework? Give reasons.

- (a) Mitchell Ltd has purchased machinery for Tshs100 million. It also purchased a patent for Tshs10 million. The patent will give the company exclusive use of a particular manufacturing process which will save TShs9 million a year for the next four years.
- (b) Adams Car Sales intends to purchase four imported cars, in the coming international car show to be held in London.
- (c) Poolwhirl Co provides a warranty with every refrigerator sold.

- 9. Explain and present the qualitative characteristics of financial statement information and disclosures.
- 10. Explain the meaning of true and fair or fairly presented in relation to financial reporting.

[Learning Outcomes i and j]

16: International Accounting Standards Board (IASB) and Conceptual Framework

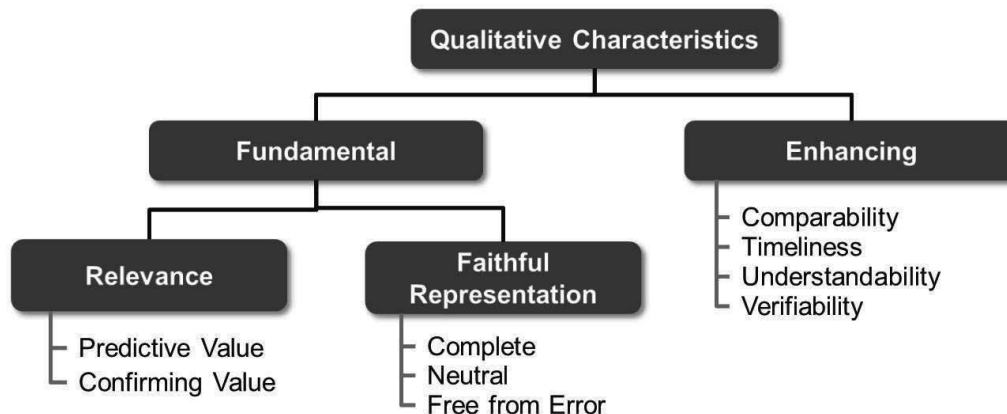
4.1 Qualitative characteristics

In order to fulfil their purpose, the statements must possess certain qualities. These essential qualities, without which the statements would lose their value, are listed in the diagram given below.

In accordance with the Conceptual Framework for the preparation and presentation of financial statements, the qualitative characteristics are divided into two main groups:

1. Fundamental qualitative characteristics
2. Enhancing qualitative characteristics

Diagram 6: Characteristics of financial statements



1. Fundamental qualitative characteristics

(a) Relevance



Definition

Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.

The Conceptual Framework for Financial Reporting, Para QC6

The relevance of the information is related to the decision-making needs of users. How does the information help in making decisions? A person evaluates past, present and future events and then arrives at a decision. He can also confirm or correct his past evaluations. Financial information is capable of making a difference in decisions if it has **confirmative value, predictive value or both**. The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value.

- Financial information has predictive value if it can be used as an input for processes employed by users to predict future outcomes.
- Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.



Example

The financial statements give information about an intangible asset in the form of a licence valid for a period of five more years in the future. The user is able to confirm the past event as well as predict future events. He can confirm from the financial statements that the licence does indeed belong to the company, and can also predict with a fair amount of certainty that after five years, the licence will expire and the entity may be open to more competition.

(b) Faithful representation (True and fair view)

People say that the financial statements ‘talk’ to us. Each statement and each figure in the financial statements communicates or ‘represents’ something to us. Representation is information that the item purports to give or is expected to give. Therefore, the statement of financial position represents the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria. The statement of profit or loss represents the transactions and other events that result in revenue or expenses of the entity which meet the recognition criteria.

Similarly, the **cash flow statement** represents the flows of cash and cash equivalents during the period.

Faithful

The word ‘faithful’ or its alternative, ‘true and fair’, indicates truthfulness and fairness in the representations. In the financial statements each element therein (asset, liability, equity, income and expense) represents something to us. If all representations regarding these elements are reliable and fair, we call them faithful representations.

The question is when do we treat a representation as being faithful or true and fair?

Financial information that faithfully represents economic phenomena has three characteristics:

- (i) **Complete:** a complete depiction would include all the information necessary for the user to understand the phenomenon being depicted along with all necessary description and explanations.



Example

In the case of a group of assets, a complete depiction would include, at a minimum:

- ⑩ description of nature of assets
- ⑩ numerical depiction of all the assets in the group
- ⑩ special classification, if any (assets held for sale)

- (ii) **Neutral:** a neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.

It should be noted that neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users’ decisions.

- (iii) **Free from errors:** this means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects.

Faithful representation, however, is achieved if no errors or omissions affect the description of economic phenomena and the process applied to produce reported information has been selected and applied without errors.



Example

Delta Ltd estimated an allowance for bad and doubtful debts to be 5% of the value of the closing receivables. The allowance for bad and doubtful debts is an estimate. A representation of this estimate can be faithful if the amount is described clearly and accurately as being an estimate, along with the nature and limitations of the estimating process. Also, it is necessary that no errors are made in selecting and applying an appropriate process for developing the estimate.

18: International Accounting Standards Board (IASB) and Conceptual Framework

Therefore, in order to achieve the above characteristics (which are important criteria to determine whether financial information is faithfully represented), one needs to ensure:

- compliance with the definitions and recognition criteria set out in the Framework for assets, liabilities, income and expense
- application of IFRSs, with additional disclosures when necessary

The Conceptual Framework generally gives definitions of the elements and detailed guidance on their recognition. IFRSs give guidance on the specialised areas.

In fact, if an entity's financial statements comply with all the requirements of IFRSs, IAS 1 requires that it shall make an explicit and unreserved declaration to that effect. This is probably designed not only to ensure good quality financial statements but also to reassure users.



Example

Let us take an asset (e.g. a plant erected) and check whether it satisfies the recognition and measurement criteria given by the Framework (discussed later in this Study Guide) and IAS. If it does so, we can assume that the asset is faithfully represented in the financial statements.

2. Enhancing qualitative characteristics

(a) Comparability

Comparability is one of the enhancing qualitative characteristics in accordance with the Conceptual Framework for Financial Reporting 2010. Comparability helps the users to identify and understand similarities in, and differences among items. A comparison requires at least two items for comparison.

Comparability in financial statements is of two kinds

- Within the entity over time:** the user should be able to compare the amounts of different periods and identify trends, if any, in the financial position and performance.
- Between different entities:** the user should find it possible to evaluate the relative financial position, changes in financial position and performance of the entity.

In order to make the financial statements comparable in this manner, certain requirements have to be fulfilled.

- There should be **consistency in the measurement and display** of the financial effects of like transactions and events.
- **Users** should be **informed of the accounting policies, changes in those policies and effects of the changes**. Compliance with IFRSs helps in ensuring comparability. (This is an important issue and is discussed separately in the next sections of this Study Guide.)
- **Corresponding information** for the previous period should be **disclosed**.



Example

An entity consistently had a gross profit margin of around 20%. During 20X6, it fell to 18%. A user compared the ratio with industry averages and found that the industry average had also gone down from 17% to 16%.

Both these facts could be established because there was comparability among the financial statements of the entity over the period of time and among the statements of different entities for the same period.

Also, the existence of industry data enables one to see the performance of the entity in the context of the industry average.

The data shows that the reduction in the gross profit margin for the company is more than the reduction in the industry averages. However, still the percentage of its margin is higher than the industry average.

(b) Understandability

Financial statements are intended to provide certain information to users. These users are likely to use the information to make economic decisions and must therefore be able to understand the contents of the statements.

The objective of understandability is achieved with the help of the following **essential components**:

- Those preparing the statements **present / disclose full information that is essential** for the **understanding** of the statements, and present it in an understandable manner.

 **Example**

The schedule or note number (in the notes to accounts, of the financial statements of an entity) where the method and rates of depreciation are disclosed should be given next to the figure for depreciation. If the note is placed away from the depreciation schedule and the user finds it difficult to locate it, understandability is impaired.

- Users have a **reasonable knowledge** of business and economic activities and accounting principles, and show willingness to study the information.

 **Example**

The financial statements disclose an amount of depreciation. The user is expected to know what depreciation means and why it is charged. It is not practicable to explain these things in the financial statements.

(c) Verifiability

Information has the quality of verifiability when different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. If **users are to take decisions** based on the financial statements, the information in the statements has to be verifiable; otherwise **it would not be of any help even if it is relevant**.

(d) Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. For the users of general purpose financial statements, the information is useful for decision making only if it is timely.

 **Test Yourself 3**

Sollato Co-operates in the field of mining. There was an estimate total of 1,000,000 MT of the mineral dynasia, out of which it had extracted 600,000 MT to date. During the current year, the local government had declared a limit on production, since new research had confirmed grave health hazards associated with dynasia.

The government gave the companies one year to stop extracting dynasia. Sollato managed to extract only 200,000 MT in that year. It did not report in the financial statements the fact that the government had stopped production.

Required:

Has Sollato violated any principles? If so, which ones?

20: International Accounting Standards Board (IASB) and Conceptual Framework

11. Describe the accrual, cash, going concern and breakup basis concept in presentation of financial statements.
12. Present and explain the differences between financial statements prepared using accruals and cash bases.
13. Explain the objectives and limitations of financial statements using appropriate examples or using a given scenario.

[Learning Outcomes k, l and m]

5.1 Basis of accounting

1. Accrual basis

According to IAS 1 Preparation and Presentation of Financial Statements, an entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

It means that when the financial statements are prepared, the transactions and events are recognised as and when they are earned or incurred (and not as and when money is received or paid) and recorded in the financial statements of the periods to which they relate.

IAS 1 further specifies that under accrual basis, the elements of financial statements i.e. assets, liabilities, equity, income and expenses are recognised when they satisfy the definition and recognition criteria for those elements in the framework. These are already discussed earlier in this Study Guide.

Accrual basis accounting matches revenues to the time period in which they are earned and matches expenses to the time period in which they are incurred. While it is more complex than cash basis accounting, it provides much more information about the business.

2. Going concern basis

Under going concern, it is assumed that the entity will continue to operate for the foreseeable future and it has neither the intention nor the necessity of liquidation or of curtailing the scale of the operations materially. While preparing the financial statements, management should make an assessment of the company's going concern status. If the management assesses that the going concern status of the company will not be maintained during the foreseeable future, then the financial statements would be prepared on a different basis (named as the break up basis).



Example

Tom purchased a machine to manufacture toys. The measurement of the machine is made on the basis that it can be utilized throughout its useful life. If this assumption is not followed, the machine would have to be valued at its net realisable value.

The accrual basis and going concern are referred to by the Conceptual Framework as 'underlying assumptions'.

3. Cash basis

The cash basis of accounting is not permitted by IFRSs / IASs. Only the cash flow statements are prepared using the measurement base of cash.

Smaller companies that haven't formally incorporated and most sole proprietors use cash-basis accounting because the system is easier for them to use on their own, meaning they don't have to hire a large accounting staff.

Under cash basis of accounting, expenses are recorded when expenses are actually paid and revenue is recorded when cash is actually received. The primary focus is on the amount of cash in the bank, and the secondary focus is on making sure all bills are paid. Little effort is made to match revenues to the time period in which they are earned, or to match expenses to the time period in which they are incurred.

The cash basis may be used, however, for small unincorporated entities, for example clubs and societies.



Example

Tom buys 100 tables for Tshs50,000 each in the month of April 20X2. The purchase is made for cash. During April 30, tables are sold for cash at Tshs70,000 each.

Using accrual based accounting, the results for January would be as follows:

	Tshs	Tshs
Revenue (30 × Tshs70,000)		2,100,000
Cost of sales		
Purchases (100 × Tshs50,000)	5,000,000	
Closing inventory (70 × Tshs50,000)	(3,500,000)	1,500,000
Profit		600,000

Using cash accounting, the results for January would be as follows:

	Tshs
Revenue (30 × Tshs70,000)	2,100,000
Cost of sales (100 × Tshs50,000)	(5,000,000)
Loss	(2,900,000)

You will notice from above that the cash basis of accounting shows an overall loss of Tshs2.9 million. Under accrual basis, the costs are matched with the revenue earned and the value of the closing inventories is carried forward as an asset under accrual based accounting.

4. Break-up basis

A generally acceptable alternative authoritative basis other than the going basis is the “break-up basis” or the “liquidation basis”. In certain situations when going concern assumption is no longer valid, financial statements may have to be re-drafted on a break-up basis.

Under the break-up or the liquidation basis, all assets are stated at the lower of carrying value and their estimated realizable amounts and provision is made for any further estimated liabilities. All assets and liabilities are classified as current.

Break-up basis of accounting is adopted when a company has either the necessity or the intention to:

enter into a scheme of arrangement with its payables; or be placed into administrative receivership or liquidation.



Test Yourself 4

Jacques runs a small dress-designing business in Singapore. He operates his business from a small shop. The cost of the shop is Tshs60 million. He also has to repay a bank loan of Tshs10 million. Jacques has an opportunity to move to Paris and work for a top designer, and so decides to close down his business in Singapore. A customer has offered him Tshs35 million for the shop. The bank has agreed to accept Tshs9.5 million in full settlement of the loan.

Required:

State, with reasons, how the shop and the loan need to be recognised in the financial statements.

22: International Accounting Standards Board (IASB) and Conceptual Framework

5.2 Difference between financial statements prepared using cash basis and those prepared using accrual basis

In accordance with the IASB's Conceptual Framework, accrual basis of accounting is one of the underlying assumptions for preparing financial statements. In other words, IASB's Framework clearly prohibits cash basis of accounting.

Accrual basis of accounting helps to record the event more accurately, as events are recorded when they happen, and not when they are paid for. Thus, assets or liabilities arising out of the event are recognised in the financial statements. This way, the users of the financial statements will have a better understanding of the business's financial position and performance in the past as well as in future.

Cash basis of accounting has the effect of delaying reporting until the cash flows in or out of the business. Therefore, the users of financial statements may not have a complete understanding of the financial statements as events may not be reported in the period to which they relate. Furthermore, when the event will be reported under cash basis, the information would have become too stale to be used for decision making purposes or irrelevant for other information needs of the user.



Example

Star Ltd made sales worth Tshs2 million in the month of July 20X2 on credit basis. Half of the price is paid upfront by the customer (i.e. Tshs1 million) and the rest is promised to be paid in October. Let us understand the reporting of this transaction under accrual basis and cash basis:

Accrual basis

Under this basis, sales revenue of Tshs2 million will be recorded and Tshs1 million will be reported as receivable from the customer.

Cash basis

Under this basis, sales revenue of Tshs1 million will be recorded as only Tshs1 million was received from the customer in cash. No receivables will arise, as under cash basis, the accounting entry is recorded only when cash flow occurs. The remaining sales of Tshs1 million will be recorded in October when the customer pays.

In the above example, it can be seen that the accrual basis of accounting helps to reflect on past events, the entity's current financial standing and also the expected future events.

On the other hand, under cash basis, information was incomplete in the month of July; the user will have incomplete information of the actual amount of sales and the possible inflow of cash in future. Furthermore, when the receipt of Tshs1 million is recorded in the financial statements, this information would be irrelevant as it relates to the month of July. This will distort the results pertaining to October; i.e. wrongly inflating the revenue of October by Tshs1 million, as this amount actually relates to July's sales.

5.3 Objectives and limitation of financial statements

Objectives of financial statements

The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

Limitations of financial statements

The following are the limitations:

1. Even though financial statements tend to give an appearance of finality, the historical costs of assets reflected in them may not represent either their realisable or replacement value.

Thus, if future predictions are based on the existing figures, they are also likely to suffer from the defect of being unrealistic.



Example

An entity is setting aside the amount of depreciation, and investing it into sinking fund investments. (A sinking fund is an arrangement where an entity invests specified amount of money in securities each period. This amount is calculated in such a manner that the amount with interest earned will be equal to the cost of the asset to be replaced).

When it is the time to replace the asset, the entity may find that the amount is not sufficient to replace the asset. The original calculations may not remain relevant for a long time. It may be necessary to review the position regularly.

2. There are many non-monetary factors that affect the future of the business as much as the assets and liabilities in the statement of financial position.



Example

The reputation, credit rating, efficiency and integrity of management, and the efficiency and loyalty of employees, are important factors that determine the future performance of an entity. However, these are not reflected in the financial statements.

If one or two members of key management leave a company, it may make a big difference to the entity's future, and relying only on past financial statements may not be sufficient for estimating the future.

3. Individual primary users have different, and possibly conflicting, information needs and desires. The financial statements may not cater to the needs of all the stakeholders. Sometimes the financial statements may not provide all the information needed by the various stakeholders and they have to obtain information from other sources.

14. Identify, present and explain to professional accountants or general users the different bases of measurement or of capital and capital maintenance that may be used under accrual-based accounting.
15. Describe the accounting concepts and theories governing presentation of financial statements.
16. Describe various types of financial statements according to the concepts used.

[Learning outcomes n, o and p]

6.1 Measurement Bases

The IASB's Conceptual Framework also tells us about the manner of determining the value of the different elements i.e. measurements of the elements. There are the following **measurement bases**:

1. Historical cost
2. Current cost
3. Realisable (settlement) value
4. Present value

1. Historical cost

According to the Framework, under historical cost accounting, assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.

Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Simply put this means that - **Historical cost accounting (HCA)** is where **accountants record transactions at historical cost** that is, the actual amounts of money, or money's worth, **received or paid** to complete the transaction.

24: International Accounting Standards Board (IASB) and Conceptual Framework

Assets are recorded at

- The amount of cash or cash equivalents paid. For example assets purchased on cash basis will be recorded at the amount of cash paid for purchase of the asset.
- The fair value of the consideration given to acquire the assets, at the time of their acquisition.



Example

Affluent Co took over a branch of Dazzle Co by giving 3,000 ordinary shares of Brilliant Inc. The market value of the shares as on the date of sale is Tshs2,738 per share and the market value of the shares as at the end of the reporting period is Tshs2,950.

No. of shares

Market value on the date of sale

Affluent Company will reflect the machine at Tshs8,214,000 (3,000 x Tshs2,738)

Liabilities are recorded at

- The amount of proceeds received in exchange for the obligation or
- In some circumstances, the amounts of cash (or cash equivalents) expected to be paid to satisfy the liability in the normal course of business.



Example

If the amount of tax payable for an accounting period works out to be Tshs24 million, then a provision for tax payable will be recorded at Tshs24 million.

This is the amount of cash that will be required to satisfy the liability in the normal course of business.

2. Current cost

This base is also referred to as the fair value. According to the Framework, under fair value accounting, assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

3. Realisable (Settlement) value

According to the **Conceptual Framework for Financial Reporting**, under **Realisable (settlement) value** accounting, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.

Liabilities are carried at their settlement values; that is the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.



Test Yourself 5

Sure Co owns a building which was bought for Tshs230 million. The current estimated selling price of the building is Tshs400 million and the estimated selling expenses would be at 0.5%.

Required:

What would the net realisable value of the building be?

4. Present Value

According to the Conceptual Framework for Financial Reporting, under **present value accounting**, assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.

Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.



Test Yourself 6

Tom has taken an interest-free loan of Tshs12 million from his friend William. He will repay this loan by paying Tshs2 million every year for the next 6 years. He uses a discount rate of 8% for recording his transactions at net present value in his accounts.

Required:

What is the net present value?

The IASB's Conceptual Framework does not prescribe the application of any particular basis. Under IFRSs reporting the historical and the present cost are the most common basis. The other basis may be applied wherever appropriate. For example the inventory is valued at cost or net realisable value whichever is lower in accordance with the prudence principle.

6.2 Financial reporting Concepts

Concept of capital

The IASB's Conceptual Framework identifies two concepts of capital:

1. Financial concept

Under the financial concept, capital is the same as the net assets or the equity of an entity. This concept is **adopted by most entities**.

The financial concept of capital is suitable if the users of the financial statements are primarily concerned with the maintenance of the nominal invested capital.



Example

An entity has invested Tshs1 million of its own resources in a business. This amount is its capital (the financial concept).

2. Physical concept

The capital maintenance concept stems from the going concern concept. Since an entity is assumed to be a going concern, the capital that it introduces in the business is expected to be maintained.

That leads us to the determination of profits. Only if an entity can maintain the capital that was present at the beginning of the period and earn something over and above that is a profit earned.

The measurement of profit will depend upon the concept of capital followed. If the financial concept is followed, then profit is earned only if the financial or money amount of the net assets at the end of the period exceeds that at the beginning of the period. However, any contributions from or distributions to the owners need to be adjusted.

26: International Accounting Standards Board (IASB) and Conceptual Framework



Example

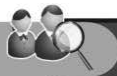
Suppose the capital was Tshs1 million at the beginning of the period, and Tshs1.4 million at the end of the period, and there was a distribution of profits of Tshs0.2 million. The profit is calculated as:

Profit = Capital at the end of the period – capital at the beginning of the period + distribution to shareholders (or drawings) – capital introduced

= Tshs1.4 million – Tshs1.0 million + Tshs0.2 million – Nil
= Tshs0.6 million

6.3 Various types of financial statements based on the capital concepts

Similarly, if the physical concept is followed, then profit is earned only if the physical productive or operating capacity of the entity at the end of the period exceeds that at the beginning of the period. Any contributions from or distributions to the owners are to be adjusted for.



Example

The capital of Yash Inc was 100,000 MT of physical capacity in the beginning of the period, and 120,000 MT at the end of the period. The cost of the capacity in the beginning of the period was Tshs2,000 per MT, while the current cost at the end of the period is Tshs2,100 per MT.

Opening capacity equivalent in Tshs terms was $100,000 \times \text{Tshs}2,000 = \text{Tshs}200$ million.

The same capacity at the end of the period at Tshs 210 (current cost at the end of the period) is equivalent to $100,000 \times \text{Tshs}2,100 = \text{Tshs}210$ million.

That part of the increase in opening capacity due solely to current cost changes is $\text{Tshs } 22\text{m} - \text{Tshs } 21\text{m} = \text{Tshs } 1\text{m}$.

At current cost of Tshs 210 per MT, the value of capital at the end of the period is $\text{Tshs } 120,000 \times 210 = \text{Tshs } 25.2\text{m}$.

This also includes price increase related to the opening capacity.

Difference between closing and opening physical capital in Tshs terms is:

	Tshs million
Physical capital at the end	25.2
Less: physical capital at the beginning	20.0
	5.2

Out of this, the effect of current cost change on the opening capacity is Tshs 1m.

Therefore, the profit during the period, using current cost at the end of the period, is $\text{Tshs } 5.2 \text{ million} - \text{Tshs } 1 \text{ million} = \text{Tshs } 4.2 \text{ million}$.



Test Yourself 7

Suppose the capital was Tshs1m at the beginning of the period, and Tshs1.4m at the end of the period, and there was a distribution of profits of Tshs0.2m.

Required:

What is the profit?

Similarly, if the physical concept is followed, then profit is earned only if the physical productive or operating capacity of the entity at the end of the period exceeds that at the beginning of the period. Any contributions from or distributions to the owners are to be adjusted for.



Test Yourself 8

The capital of Yash Inc was 100,000 MT of physical capacity in the beginning of the period when the current cost was Tshs 200 per MT and the total value of capacity was $100,000 \times 200 =$ Tshs 20m. It was 120,000 MT at the end of the period when current cost was Tshs 210 per MT. The value of capital at the end is Tshs $120,000 \times 210 =$ Tshs 25.2m.

Required:

What is the profit for the period under physical capital maintenance?

17. Explain the role of a financial accountant in facing criticisms and challenges currently facing the accounting profession.

18. Describe the role of IASB and NBAA in regulating accounting profession.

[Learning Outcomes q and r]

7.1 Areas where accountants play a role

In any organisation, accountants have a major role in the following fields:

1. Accounting (Financial reporting)

The purpose of accounting is to provide information to internal and external decision-makers. This information is provided in the form of reports. The financial information which is reported by the accountant is used by not just prospective investors but also by other stakeholders such as employees, customers and regulatory authorities. The reports which are prepared are called general purpose reports, examples of which are quarterly financial statements and annual financial statements.

In view of the number of users of the financial information and the purposes served, the accountant plays a very important role.

2. Management accounting

The financial information which is provided by accounting to **internal** decision-makers is known as management accounting. The users of this information use it to plan and control the operations of the entity. Internal users refer to management. Management uses not just the financial statements which are prepared for external decision-makers but also internal reports and summaries prepared specifically for it. The management reports are **special-purpose reports** to meet the needs of a specific user group (e.g. client profitability reports, monthly MIS statements, preparation of annual budgets, budget variance statements). Management accountants keep track of the money spent and made by the companies for which they work.

3. Auditing

An accountant may provide auditing services to an organisation. An **audit** may involve the evaluation of an organisation's system or process or product or the evaluation of financial information or reports. Audits are performed so as to evaluate and express an opinion. An external audit seeks to provide reasonable assurance that the financial statements are free from material error and give a true and fair view. In financial audits, the auditor expresses the opinion that the financial statements are true and fair when they are free of material misstatements (this includes both quantitative and qualitative factors).

28: International Accounting Standards Board (IASB) and Conceptual Framework

4. Taxation

Accountants act as tax advisers in many areas. Some of these areas of practice include corporate tax, international tax and transfer pricing, etc. The major role played by the accountant is to suggest schemes by which tax can be minimised

5. Consultation

Accountants provide various consultancy services such as:

- corporate restructuring
- business strategy
- business process re-engineering
- operational review
- financial risk management
- business process design and re-engineering and preparation of process manuals

6. Public sector accounting

Accountants may also work as public sector accountants. Public sector accountants undertake accounting, auditing, tax and consulting work for government and public sector companies.

7.2 Challenges facing the accounting profession

The pace and magnitude of changes in the accounting profession are dramatic. The accountants are an important part of the society as they serve as a link between the management and shareholders. In the light of recent scandals in various multinationals such as Enron, Worldcom, etc. there has been a loss of investor confidence in the accounting firms and their opinions on the financial statements. Some countries are facing problems of getting the right talent to implement the International Financial Reporting Standards issued by the IASB. Further the compliance with IFRSs itself is a challenge due to the lack of expertise and a vast literature to be understood for compliance. This is further aggravated when the accountant has to take care of the local regulations and laws.

7.3 The accountant plays a major role in the following matters:

(a) Protection of the public interest

The accountant is required to ensure that the codes of professional and ethics are complied. Such compliance should lead to the highest levels of integrity and objectivity. The role of the **accountant to consider in certain situations the public interest** before the interest of his client or employer is also important in the protection of society against some forms of financial risk.

Accountants can be encouraged to act in the public interest by the following means:

- (i) Compliance with accounting standards so as to protect public interest.
- (ii) Professional bodies clearly defining regulations so as to guide accountants to act in the public interest.
- (iii) Professional bodies such as the NBAA, IFAC and ICAEW can inform the public about the actions expected from the members of the accounting bodies so as to act in the public interest.
- (iv) Professional bodies can have a strict process so as to identify breaches of the public interest.
- (v) Breaches due to unprofessional behaviour must be subjected to suitable disciplinary action.
- (vi) Accountancy firms can develop and implement codes of business conduct or professional codes of ethics. Such codes specify what is right and wrong and thereby guide accountants to act in an ethical manner and in the interests of the public.

(b) Ensuring corporate governance

The accountancy profession has played a major role in the development of corporate governance codes and indeed practically in the improvement of corporate governance. The boardrooms of companies almost invariably contain professional accountants.

(c) Detection of fraud

Accountants as auditors (especially the internal auditors) have a responsibility to help fight corruption. This is because they are, after all, the eyes and ears of management; they understand the operations of the business, and are bound by standards of performance and conduct. In addition, their work is often used by independent auditors and other outside parties.

Therefore, they are in a position to influence management and the board on risks. By ensuring that they are proactive and undertaking preventive, detective and combative measures, internal auditors have an important role to play in the anticorruption effort.

(d) Meeting the concerns of environment and society

Accountants play a vital role in the provision of better quality information for better financial markets and bring knowledge, skills and experience to the table that can support improvements in social and environmental reporting, assurance reporting and the improvement of business practices and processes in these areas. Accountants are ethical and may support ethical business practices.

Challenges faced by the accounting profession in meeting the above roles include:

➤ **Disclosure requirements to be adhered to**

Due to the adoption of IFRSs / IASs, the accountant has to follow many regulations and standards due to which he is forced to spend less time helping their clients to solve real problems. For example, the IFRSs literature requires more than 2,000 disclosures to be made by the entity. This involves a lot of effort and also time to comply with the requirements.

➤ **Compliance with several regulations**

With passage of time, the regulatory environment has become complex and the accountant is expected to ensure that all laws, by-laws and regulations are adhered to.

➤ **Adherence to public interest**

The accounting profession needs to work in the public interest (i.e. work for the welfare of the public at large). In this connection, adherence to accounting, auditing and ethical standards would be required for a professional accountant to act in the public interest.

➤ **Ethical issues**

An accountant frequently encounters ethical issues and must remain continually vigilant to reduce the chances of outside forces manipulating financial records, which could lead to both ethical and criminal violations. While reporting such ethical issues, the accountant might face a major challenge from the management and the other parties involved.

7.4 Overcoming the challenges

1. Professional behaviour

An accountant should maintain professional behaviour at all times. In this regard, a professional accountant should:

- (a) adhere to all the applicable laws and regulations; and
- (b) avoid any acts which will discredit the profession.

30: International Accounting Standards Board (IASB) and Conceptual Framework

2. Following the IFAC Code of Ethics

In order to face the criticism and challenges posed by the accounting profession, the accountants are expected to abide by the ethical code of conduct which is set up by the International Federation of Accountants' Ethics Committee (IFAC).

3. Compliance with IFRSs/IASs or any other standards

In order to face the criticism and challenges posed by the accounting profession, the accountants are expected to follow all the IFRSs / IASs notified by NBAA or any other standards framed by NBAA from time to time.

4. Public interest

Ensuring that public interest is considered while performing the accounting function.



Test Yourself 9

Jack Jones is a qualified accountant employed in the treasury department of Frock Limited. Jack has seen documentation transferring large sums to and from the company bank account around the year end and believes that the managing director and financial director are window dressing the financial statements and may possibly be fraudulently taking money out of the company fearing that it might collapse. Jack believes that the auditors are not going to take any action since they may have been misled. The company employs 200 people and has many small customers who have paid in advance for products and services.

Required:

- (a) Is there a public interest here?
- (b) Should Jack make his views known to someone within the company?
- (c) What can Jack do if he wishes to protect the public interest?

7.5 Role of IASB and NBAA in regulating the accounting profession

The accounting profession needs to be regulated to ensure that there is credibility in the profession and also to ensure that financial reporting is done in a true and fair manner. Regulation of professions is needed to provide the public with protection and assurance in situations where the issues are too complex for the public to be reasonably expected to look after their own interests.

Accounting is a self-regulating profession. One of the main ways it regulates itself is by having bodies that set standards and practices that must be followed by its member accountants in preparing accounts and financial statements.

The accounting profession in Tanzania is regulated through several regulations such as the provisions of the Companies Act 2006, the regulations set up by the stock exchange rules, bye-laws framed by the Government, compliance with financial reporting standards framed by NBAA and IASB, etc.

In Tanzania, the accounting profession is regulated by the National Board of Accountants and Auditors, Tanzania (NBAA). NBAA is the professional body in Tanzania representing the interests of the accounting profession. The NBAA is an examining body for professional accountancy qualifications. The major role of NBAA is to issue Financial Reporting Standards (FRS) and to converge with IFRSs in order to provide guidance to the members for compliance. The NBAA has framed a code of ethics to be adhered to by the members to ensure public interest at large.

The NBAA has the following responsibilities towards its members

- Frame the minimum entry requirements and education for its members
- Set out criteria to engage in public practice
- Decide on the eligibility requirements to perform certain reserved activities under the statutory powers conferred by the government
- Set up professional conduct requirements
- Deal with professional misconduct

The accounting bodies (for example, NBAA) will randomly audit or examine the work of their member accountants to ensure that these procedures and rules are being followed. They will also investigate any claims or complaints they receive of an organisation's accounts and financial statements not accurately reflecting its financial position. If an accountant is found guilty of deliberately and intentionally preparing inaccurate statements and reports, he risks being removed from the profession (and may also have criminal charges brought against himself).

The International Accounting Standards Board (IASB) is an independent, privately-funded accounting standard setter based in London. The Board members come from nine countries and have a variety of functional backgrounds. The IASB is committed to developing standards in the public interest - a single set of high quality, understandable and enforceable global accounting standards that should be followed to ensure that information reported in financial statements is both transparent and comparable.

19. Explain the need for recording transactions based on the commercial substance rather than their legal form. [Learning Outcome s]

The importance of the commercial substance rather than the legal form of transactions becomes clear if we consider the objectives of preparing 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 payables in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

The financial statements should not only provide relevant information, but must also represent the phenomenon that they purport to represent. To be a perfectly faithful representation, financial statements should be neutral, complete and free from errors.

In accordance with Para QC 26 of the Conceptual Framework, 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. Faithful representation of any transaction is only possible if it is accounted for according to its **substance and economic reality**, and not according to its **legal form**.



Definition

Substance over form is the principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form.

The substance of transactions is sometimes different from their legal form.



Example

Fair Co sells a machine worth Tshs40 million to Perfect Co and Perfect Co agrees to pay an annual installment of Tshs7.5 million for the next three years. At the end of three years, Perfect Co has agreed to return the machine to Fair Co.

In this case:

The **legal form** of the transaction suggests that this is a **sale transaction** as the title of ownership has passed from Fair Co to Perfect Co.

However, a proper assessment of this transaction reveals the **substance** of the transaction, which is:

Fair Co has **retained with itself the future economic benefits embodied in the asset, which it will enjoy after completion of three years.**

32: International Accounting Standards Board (IASB) and Conceptual Framework

Hence, **this is just a financial arrangement, and cannot be recognised as sales revenue.**

When the substance of a transaction differs from its legal form, then the accounting treatment for the legal form of the transaction and the substance of the transaction vary.

If the legal form of this transaction were to be recorded

Fair Co would treat this transaction as a disposal of non-current assets and make the following journal entry

		Tshs'000	Tshs'000
Dr	Bank	7,500	
Dr	Receivable from Perfect Co	15,000	
Dr	Loss on sale of machine	17,500	
	Cr Machine		40,000

Being amount received on sale of machine. (It is assumed that this is a new machine, on which there is no accumulated depreciation).

Perfect Co would recognise the machine as a non-current asset in its statement of financial position.

		Tshs'000	Tshs'000
Dr	Machine	22,500	
	Cr Bank		7,500
	Cr Payable to Fair Co		15,000

Being machine procured from Fair Co

If the substance of this transaction were to be recorded then:

Fair Co would treat the annual instalment it receives as **lease rent received** in its statement of profit or loss and pass the following journal entry each year:

		Tshs'000	Tshs'000
Dr	Bank	7,500	
	Cr Lease rent received		7,500

Being lease rent received

The machine would be recognised as a non-current asset in its statement of financial position.

Perfect Co would reflect the instalments paid as **rent paid** in its statement of profit or loss and make the following journal entry each year:

		Tshs'000	Tshs'000
Dr	Lease rent paid	7,500	
	Cr Bank		7,500

Being lease rent paid

The machine would not be recognised as a non-current asset in its statement of financial position.

The above discussion clarifies how the accounting treatment for the legal form of the transaction and its substance vary.

According to Conceptual Framework, while assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality, and not merely its legal form.



Test Yourself 10

“Accounting for the substance of a transaction is always different from accounting for the legal form of the same transaction.”

Required:

Comment on the above statement.

Answers to Test Yourself

Answer to TY 1

The correct option is **A**.

Management accounting is tailor made for management purposes. As such, it makes use of both cost and financial accounting records to extract appropriate and complete information. It can be anything about which management needs information and therefore information needs to be extracted from all the relevant areas.

Answer to TY 2

The analysis of the given transactions is given below:

- (a) Machinery purchased is an asset as there is a past event (purchase), control (by Mitchell) and future economic benefit (use of the machine to create income).

The patent purchased is an (intangible) asset - there is a past event, control and future economic benefit through cost savings.

So, both are assets and will be recognised in the financial statements.

- (b) This cannot be classified as an asset.

Adams Car Sales only has an intention to purchase – this intention is only in the mind, not in hand. In order to recognise an item as an asset, a past event, control and future economic benefits are required.

The intention to purchase a car cannot become an asset as there is no past event, no control and no future economic benefits.

- (c) This is a liability: the business has taken on a present obligation as a result of a past event (the sales), there is a probability of future outflow of economic resources (replacing the fridge) and a reliable estimate can be made of the obligation (cost of replacing the fridge).

This liability would be recognised when the warranty is issued rather than when a claim is made.

Answer to TY 3

The government order was relevant but was not notified to the shareholders.

The value of the mine, i.e. a wasting asset in the statement of financial position, should have been tested for impairment and written down if required. Since this is not done, the assets values shown in the financial statements are not correct and hence do not meet the characteristic of:

- **Relevance** as the value of the mine is not predictive i.e. users are not aware that the value of mine reduced;
- **Faithful representation** as the value of the mine is not complete, neutral or free from error.

Answer to TY 4

- Jacques's business is not a going concern.
- Jacques has to sell the shop (no matter how low the realisable value is) and pay off the liability.
- When the entity is not a going concern the assets are recognised at disposable value and liabilities at settlement value.
- **Disposable value:** is the realisable value of an asset under a forced sale. Jacques is forced to sell the shop at Tshs35 million hence the disposable value is Tshs35 million.
- **Settlement value:** is the value of a liability for immediate settlement. Jacques can settle the liability immediately by paying Tshs9.5 million hence its settlement value is Tshs9.5 million.

34: International Accounting Standards Board (IASB) and Conceptual Framework

Below is a comparative statement of financial position for Jacques under the two conditions

Going concern		Not a going concern	
Tshs'000		Tshs'000	
Shop Premises	60,000	Shop premises	35,000
Total	60,000	Total	35,000
Bank loan	10,000	Bank loan	9,500
Capital (balancing amount)	50,000	Capital (Balancing amount)	25,500
Total	60,000	Total	35,000

Capital decreased because of a decrease in the asset value. It increased partially by Tshs0.5 million because of a decrease in the bank loan.

Answer to TY 5

	Tshs'000
Current estimated selling price of the building	400,000
Estimated selling expenses are (0.5% x Tshs400,000)	(2,000)
Net realisable value of the building	398,000

Answer to TY 6

The net present value of the future net cash outflows is Tshs9,246,000 (calculations shown in the table below). Hence, the loan will be recorded at this amount in the accounts of Tom.

	Future net cash outflows	NPV per Tshs at 8%	NPV of future net cash outflows
	Tsh000	Tsh000	Tsh000
Year 1	2,000	0.926	1,852
Year 2	2,000	0.857	1,714
Year 3	2,000	0.794	1,588
Year 4	2,000	0.735	1,470
Year 5	2,000	0.681	1,362
Year 6	2,000	0.630	1,260
		Total	9,246

Answer to TY 7

The profit is calculated as:

Profit = Capital at the end of the period – capital at the beginning of the period + distribution to shareholders (or drawings) – capital introduced

$$= \text{Tshs}1.4 + \text{Tshs}0.2 - \text{Tshs}1.0 = \text{Tshs}0.6\text{m}$$

Answer to TY 8

The value of closing capacity also includes price increase related to the opening capacity.

Opening capacity equivalent in Tshs terms was $100,000 \times 200 = \text{Tshs}20\text{m}$.

The same capacity at the end of the period at Tshs210 (current cost at the end of the period) is equivalent to $100,000 \times 210 = \text{Tshs}21\text{m}$.

That part of the increase in value due solely to current cost changes is $\text{Tshs}21\text{m} - \text{Tshs}20\text{m} = \text{Tshs}1\text{m}$.

The total difference between closing and opening physical capital in Tshs terms is:

	Tshs
Physical capital at the end	25.2m
Less: physical capital at the beginning	20.0m
	5.2m

Out of this, the effect of current cost change on the opening capacity, as discussed earlier, is Tshs1m. Therefore, the real profit during the period, using current cost at the end of the period, is Tshs5.2m – Tshs1= Tshs4.2m.

Answer to TY 9

- (a) Since there is a potential loss to members of the public or external stakeholders then there may be a public interest and an accountant may regard this as overriding obligations of confidentiality.
- (b) Jack should either confront the directors themselves or may approach a non-executive director. He should avoid being associated with fraud and may resign.
- (c) If he wishes to he can inform regulators or crime authorities and whilst he has some legal protection he may find this comes at a cost when he tries to get future work that is his moral decision.

Answer to TY 10

The statement is incorrect.

In most cases, the legal form and the substance of a transaction are one and the same. In these situations, the accounting treatment for both the legal form and substance will remain the same.

It is only when the legal form differs from the substance of the transaction that the accounting treatment differs. Faithful representation of any transaction is only possible if it is accounted for according to its **substance and economic reality**, and not according to its **legal form**.

Quick Quiz

1. Who governs the IFRS Foundation?
2. Who appoints the members of the IASB, IFRS Interpretation Committee and IFRS Advisory Council?
3. Who authorises the publication of Exposure Drafts and the final IFRSs?
4. Is it mandatory for IASB to consult IFRS Advisory Council?
5. What is the objective of financial statements?
6. With which kind of financial statements does the Framework deal?
7. What are the enhancing qualitative characteristics of the financial statements?
8. What decides whether an item of expenditure gets recognised as an expense or an asset?
9. Why are accounting standards on their own not a complete regulatory framework?

36: International Accounting Standards Board (IASB) and Conceptual Framework

Answers to Quick Quiz

1. The IFRS Foundation is governed by its trustees.
2. The trustees of the IFRS Foundation appoint the members of IASB, IFRS Interpretation Committee and IFRS Advisory Council.
3. The IASB authorises the publication of Exposure Drafts and final IFRSs.
4. Yes, it is mandatory to consult IFRS Advisory Council on major projects.
5. The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity.
6. The Framework deals with general purpose financial statements.
7. The qualitative characteristics are given below:
 - (a) Understandability
 - (b) Timeliness
 - (c) Verifiability
 - (d) Comparability
8. The probability of whether the **economic benefits** that flow to the entity will spill over to the subsequent **accounting period/s**, or **remain restricted to the current accounting period**, will determine whether an item of expenditure is to be recognised as an asset or an expense.
9. Accounting standards may not cover all the possible situations. Further, education and training of persons who are involved in the process of preparing and auditing financial statements is also important.

Self-Examination Questions

Question 1

Do the following classify as an asset or liability within the definitions given by the Framework? Give reasons.

- (a) Mitchell Ltd has purchased machinery for Tshs100 million. It also purchased a patent for Tshs10 million. The patent will give the company exclusive use of a particular manufacturing process which will save Tshs9 million a year for the next four years.
- (b) Adams Car Sales intends to purchase four imported cars, in the coming international car show to be held in London.
- (c) Poolwhirl Co provides a warranty with every refrigerator sold.

Question 2

Robot Co, a dealer in toys, has an inventory of 'computer games of tennis' amounting to Tshs30 million. He fears that, as now the Grand Slam tournaments for the year are over, he will be able to sell these games for Tshs15 million only.

Required

What will be the 'historical cost' and the 'fair value' of the inventory?

Question 3

Explain why a regulatory framework is needed? What is the regulatory framework based on?

Question 4

State the advantages and the disadvantages of historical cost accounting.

Question 5

The net assets of Stardust Inc. at the beginning and the end of the year were Tshs22.50 million and Tshs24.35 million respectively. Tshs3.40 million was introduced into the business by the owners during the year.

Required:

What is the amount of profit or loss made during the year under the financial capital maintenance model? Give reasons for your answer.

Answers to Self-Examination Questions

Answer to SEQ 1

The analysis of the given transactions is given below:

- (a) Machinery purchased is an asset as there is a past event (purchase), control (by Mitchell) and future economic benefit (use of the machine to create income).

The patent purchased is an (intangible) asset - there is a past event, control and future economic benefit through cost savings.

So, both are assets and will be recognised in the financial statements.

- (b) This cannot be classified as an asset.

Adams Car Sales only has an intention to purchase – this intention is only in the mind, not in hand. In order to recognise an item as an asset, a past event, control and future economic benefits are required.

The intention to purchase a car cannot become an asset as there is no past event, no control and no future economic benefits.

- (c) This is a liability: the business has taken on a present obligation as a result of a past event (the sales), there is a probability of future outflow of economic resources (replacing the fridge) and a reliable estimate can be made of the obligation (cost of replacing the fridge).

This liability would be recognised when the warranty is issued rather than when a claim is made.

Answer to SEQ 2

Historical cost accounting (HCA) is the situation in which **accountant's record transactions at historical cost** that is, the actual amounts of money, or money's worth, received or paid to complete the transaction.

Hence, the **historical cost** of the inventory will be **Tshs30 million**.

Fair value is defined as a **rational** and **unbiased** estimate of the potential market price of goods, services, assets, or liabilities taking into account various relevant factors.

Hence, the **fair value** of the inventory will be **Tshs15 million**.

Answer to SEQ 3

Regulatory framework is a structure which helps an entity decides how to treat items that need to be included in the financial statements.

38: International Accounting Standards Board (IASB) and Conceptual Framework

A regulatory framework is needed mainly for the following reasons:

- to prevent material manipulations or errors
- to ensure that the financial communication is in a standardised manner
- to help in global harmonisation

The regulatory framework is based on:

- company law
- international Accounting Standards (if followed)
- the influence of other national standard-setting bodies
- stock Exchange requirements
- overseeing by the professional bodies such as ACCA or IFAC to ensure that the professional standards for accounting and auditing are followed in practice.

Answer to SEQ 4

The advantages of historical cost accounting are:

- It leads to **absolute certainty** by providing **definite values**.
- It tells us **exactly what has been paid** and **what has been received** and it **fits in perfectly with the statement of cash flow**.

The disadvantages of historical cost accounting are:

- The values recorded may be of **old transactions**. As **changing prices** in the economy, are **not reflected** these values could be **outdated**.
- Any profit or loss on account of sale / disposal of asset is accounted for only in the year of sale / disposal.
- Depreciation of non-current assets could be more than / less than the amount required to replace the non-current asset.
- It does not consider the additional costs required to sell an asset or to settle a liability.
- Present values of future cash flows / current purchasing power is not reflected.

Answer to SEQ 5

In this case, the profit / (loss) for the year will be calculated as follows:

	Tshs'000
Net assets at the end of the year	24,350
Less: Capital introduced in the business	3,400
Revised balance of net assets at the end of the year	20,950
Less: Net assets at the beginning of the year	22,500
Loss made during the year	(1,550)

As per the financial capital maintenance model capital is synonymous with the net assets or equity of the entity. Stardust Inc. has made a loss because

- It has not been able to maintain its opening capital of Tshs22.5 million.
- The financial amount of the net assets at the **beginning** of the period **exceeds** the financial amount of net assets at the **end** of the period, after excluding contributions from owners during the period.

ELEMENTS OF FINANCIAL STATEMENTS

B1

STUDY GUIDE B1: PROPERTY, PLANT AND EQUIPMENT

Get Through Intro

An important component of any statement of financial position is non-current assets. If this figure is incorrectly stated, it can affect a number of areas. For example, companies are often given loans which are secured on the basis of the non-current assets they have. This means that if the loans are not repaid, the bank has the right to take the non-current assets in return, to sell and obtain the cash to settle the loans. So, if the non-current asset value is incorrectly calculated, the company may not be able to pay off its loans.

As an accountant, you will be expected to understand the value at which non-current assets should be held in the statement of financial position and to make all the necessary adjustments to account for depreciation, revaluations and disposals. This in turn will enable you to make decisions such as how much money your company can borrow; whether there are any problems with your non-current assets and whether your capitalisation policy makes sense.

Learning Outcomes

- a) Explain the initial recognition of a non-current asset (including a self-constructed asset).
- b) Account for borrowing costs in accordance with international accounting standards.
- c) Understand and illustrate the subsequent measurement of tangible non-current assets, including their revaluation and disposal.
- d) Account for depreciation and disclosures in financial statements.
- e) Apply the provisions of international accounting standards to government grants and government assistance.
- f) Describe the criteria for non-current assets to be classified as held for sale, either individually or as a disposal group.
- g) Illustrate the accounting for non-current assets and disposal groups that are held for sale.
- h) Apply the requirements of international accounting standards to investment properties.

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1. Explain the initial recognition of a non-current asset (including a self-constructed asset).

[Learning Outcome a]

1.1 Meaning of the term 'tangible non-current assets'

Before we proceed further, it may be useful to quickly revise the meaning of the terms 'tangible' and 'noncurrent assets.'

The dictionary meaning of the word tangible is "physical, concrete, and touchable".

A non-current asset is **defined only in negative terms** in the sense that it is an **asset which is not classified as current**.



Definition

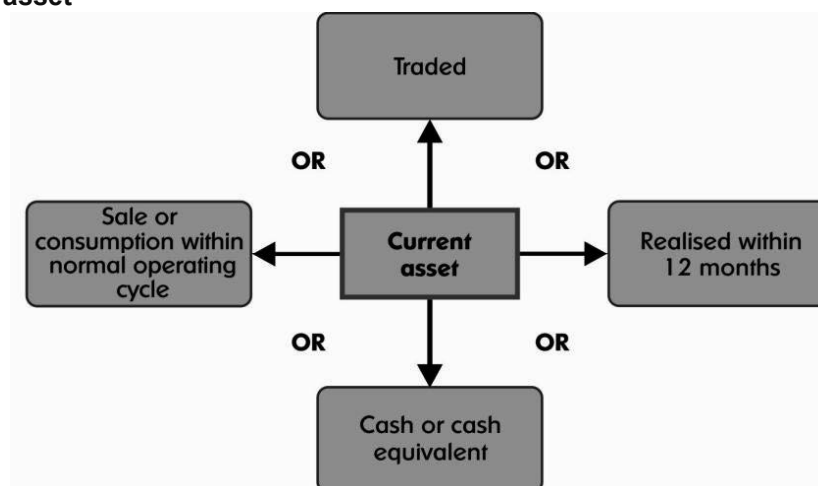
An **asset should be classified as current** when it satisfies any of the following criteria:

- (a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is expected to be realised within twelve months after the statement of financial position date; or
- (d) it is cash or a cash equivalent (as defined in IAS 7 Statement of Cash Flow), unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the statement of financial position date.

All other assets should be classified as non-current.

IAS 1 Para 66

Diagram 1: Current asset



1.2 Types and examples of tangible non-current assets are as follows:

Details	Covered by
(i) Property, plant and equipment: e.g. building, machinery and computers used for own business. Traditionally, these assets are called non-current assets	IAS 16 Property, Plant and Equipment
(ii) Property constructed on behalf of third parties	IAS 11 Construction Contracts
(iii) Property, plant and equipment classified as held for sale	IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

IAS 16 Property, Plant and Equipment

When another Standard requires or permits a different accounting treatment, that Standard should be followed to the extent of the specified issues. For the remaining issues not covered by another standard, IAS 16 should be followed.



Example

A property is obtained on a lease. IAS 17 'Leases', stipulates that the recognition of an item of leased property should be evaluated on the basis of transfer of risks and rewards. However certain issues which are not covered by IAS 17 (e.g. depreciation in this example) are governed by IAS 16.

IAS 16 **does not apply** to certain assets which are:

- (a) property, plant and equipment classified as held for sale in accordance with IFRS 5 **Non-current Assets Held for Sale and Discontinued Operations**;
- (b) biological assets related to agricultural activity (see IAS 41 Agriculture);
- (c) the recognition and measurement of exploration and evaluation assets (see IFRS 6 **Exploration for and Evaluation of Mineral Resources**); or
- (d) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

However, IAS 16 applies to property, plant and equipment used to develop or maintain the assets described in (b) - (d).

1.3 Initial measurement

The question of measurement arises only when we decide to recognise an asset. Hence, it is necessary to determine first whether and when the asset is to be recognised.

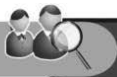
1.4 Recognition

Para 7 of IAS 16 gives the following criteria:

"The cost of an item of property, plant and equipment should 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 measured reliably."

Items of property, plant or equipment acquired for **safety or environmental** reasons may not increase the future economic benefits of any items. However, it may **be necessary to incur this expenditure in order to obtain economic benefits from other items**. Such items **qualify for recognition** as property, plant and equipment.



Example

Remedie Ltd, a chemical manufacturer, is required under local regulations to install new waste treatment and disposal equipment. It incurs expenditure of Tshs250 million on the equipment. This should be accounted for as property, plant and equipment. Although the new equipment is unlikely to yield future economic benefits, the old equipment cannot be used without the new equipment under the new legislation. Therefore the new equipment should be included in non-current assets.

Related issues

- (a) **Spare parts** and servicing equipment are usually **treated as inventory and recognised in profit or loss** as and when consumed.
- (b) **Major spare parts** and standby equipment are **treated as property, plant and equipment when they are expected to be used over more than one period**. They are included in non-current assets from the **date the cost is incurred**.
- (c) Those which can be used **exclusively** with an item of property, plant and equipment are accounted for **as property, plant and equipment**.

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- (d) It is necessary to decide the unit of measurement for non-current assets to determine:
- (i) whether a particular item qualifies for recognition; and (ii) what value is to be taken.

The IAS does not prescribe any unit. It is left to the **judgement** of management. It may be appropriate to **aggregate individually insignificant** items while applying the criteria.



Test Yourself 1

Comment on whether the following items purchased by an entity can be recognised as property, plant and equipment:

- (a) Small spares for Tshs50,000.
- (b) Standby equipment expected to be used for 3 years.
- (c) Machinery under the custody of a bank as security, which the bank has refused to release to the entity because the purchaser has not paid back a loan secured on it.

1.5 Costs and measurement

It is necessary to understand the meaning and relationship of the concepts of **initial and subsequent costs, measurement at recognition, and measurement after recognition.**

Costs here refer to an **act of incurring expenditure** on the non-current assets.

Measurement at recognition refers to the **valuation** of the cost incurred (whether the cost is an initial cost or a subsequent cost).

Measurement after recognition refers to the calculation of the **carrying value** in the **subsequent** financial statements. It is **not related to any accounting transaction.**

Initial and subsequent costs



Definition

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 or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs e.g. IFRS 2 Share-based Payments.

IAS 16 Para 6

On breaking down this definition, we can see that:

- (a) cost is the amount paid to acquire the asset e.g. Tshs500,000 to buy a table OR
- (b) the value of anything else given in exchange for the asset e.g. a computer with the fair value of Tshs1,500,000 was given in return for receiving a table OR
- (c) the valuation method given by other standards for something given in exchange for the asset e.g. share options worth Tshs90,000 were given in return for receiving a table.

Tangible non-current assets are normally **used for more than one year**. An entity may incur costs on these when they are **acquired initially as well as subsequently**, to maintain the assets or to renovate or upgrade them. Therefore, the costs incurred on property, plant and equipment may be of two types.

1.6 Initial costs

These are the costs incurred initially **for bringing the asset to the location and in the condition necessary for its intended use** e.g. acquisition costs, construction costs, erection costs.



Example

The purchase price of a machine is Tshs110 million. Other costs are as follows: freight Tshs2 million, import duty Tshs5 million, installation expenses Tshs1 million. These are all initial costs. The total initial cost is Tshs118 million (Tshs110 million + Tshs2 million + Tshs5 million + Tshs1 million).

1.7 Elements and measurement of costs

Measurement at recognition

Based upon the principles discussed above, once it is decided that an item of the asset is to be recognised, the next question that arises is: **at what value?**

IAS 16 gives the following guidance at Para 15:

“An item of property, plant and equipment that qualifies for recognition as an asset **should be measured at its cost.**”

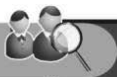
Going one step further, now we need to know the **elements of cost.**

The following are included in cost:

- (a) Purchase price
- (b) Costs directly attributable to bringing the asset to its location and in the condition so as to make it available for its intended use
- (c) Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located

All of these are discussed in detail in the following sections:

(a) Purchase price: This is considered after deducting trade discounts and rebates and adding duties and non-refundable taxes.



Example

The total price paid for machinery is Tshs110 million; this is the basic price of Tshs100 million plus Value Added Tax (VAT) of Tshs18 million (18%). The entity gets a credit of VAT paid on the machinery, while calculating the tax payable on the finished goods sold. Tax paid of Tshs10 million while purchasing the machinery will be treated as refundable and hence not included in the cost of machinery. The cost will simply be Tshs100 million.

The price to be considered is the **cash price** equivalent **at the recognition date.** If the asset is acquired on **deferred credit** i.e. credit beyond the normal credit period, then the difference between the cash price and the total payment is treated as **interest** and recognised over the credit period.



Example

The total cost of a large computerised machine is Tshs40 million. Butter Co do not have enough cash, so agree to pay for it a year later, however they will pay Tshs45 million. Tshs5 million (Tshs45 million - Tshs40 million) will be treated as interest payable and not included in the cost of the asset.

Purchase price in exchange transactions

Sometimes, the asset is acquired not in exchange for money but in exchange for monetary or non-monetary assets. If the asset given up is a monetary asset, then the question of measurement is easier, since its amount is easily determined. However, if it is a non-monetary asset, then it may be necessary to measure its value.

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Fair value

The cost of assets involved in the exchange is determined at fair value (of the asset received or the asset given up) unless:

- (a) the transaction lacks commercial substance; or
- (b) the fair value of neither of the two assets is reliably measurable.



Example

A piece of machinery is acquired in exchange for a plot of land. The fair value of the machinery is agreed at Tshs200 million and the fair value of the plot at Tshs250 million (its book value is Tshs225 million). The difference of Tshs50 million is to be settled by cash. The machinery acquired will be recorded at Tshs200 million.

The accounting entry will be

	Tshs'000	Tshs'000
Dr Machinery	200,000	
Dr Cash	50,000	
Cr Land		225,000
Cr Profit on sale of land		25,000

Being the sale of land partially in exchange of machinery and partially for cash and the resultant profit accounted for.

Carrying amount: If any of the above mentioned exceptions apply i.e. the transaction lacks commercial substance, or the fair value of neither of the assets is reliably measured, and therefore the asset cannot be valued at fair value, then the cost of the asset acquired is measured at the carrying amount of the asset given up.



Example

Continuing the above example of the machinery

If there was just an exchange of the two assets with no cash component, and the fair value of neither two assets is reliably measurable, then the book value of land, being the asset given up i.e. Tshs225 million, should be recorded as the cost of the asset acquired i.e. the machinery.

-
- (b) **Costs directly attributable** to bringing the asset to its **location and in the condition** so as to make it available for its intended use. Examples are as follows:
 - (i) Costs of employee benefits (as defined in IAS 19 Employee Benefits) arising from construction or acquisition of property, plant and equipment.
 - (ii) Costs of preparing the site.
 - (iii) Initial delivery and handling costs (e.g. freight).
 - (iv) Installation costs (e.g. wages to install machinery).
 - (v) Testing costs net of revenue generated, such as sale proceeds of material produced during a test run (e.g. material and wages directly related to test production).
 - (vi) Professional fees (e.g. architects' fees).
 - (c) **Initial estimate of the costs of dismantling and removing** the item and restoring the site on which it is located. However, such cost can be recognised only if the obligation for dismantling and restoring the site is incurred either:
 - (i) when the item is acquired
 - (ii) as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

 **Example**

Rohan Plc set up fire safety devices around its factory premises. The price paid for devices is Tshs110 million (Tshs100 million plus VAT of Tshs18 million). The entity gets a credit of Tshs18 million while calculating the tax payable on the finished goods sold.

Additional costs are freight Tshs2,million, import duty Tshs5 million, installation expenses Tshs1 million. The initial estimate of dismantling and removing the item is Tshs3 million. After the machine was put to use, Tshs1.5 million was spent for maintenance. Calculate the initial cost of the asset.

Answer

The cost should be computed as:

	Tshs'000
Purchase price (excluding refundable tax of Tshs10,000)	100,000
Freight	2,000
Import duty	5,000
Installation expenses	1,000
Initial estimate of dismantling and removing the item	3,000
Total initial cost	111,000

Maintenance charges of Tshs1.5 million are to be shown as an expense in the statement of profit or loss, and not as an asset.

It **follows** that after the asset is brought to the location and in condition, **recognition of the costs included in the carrying amount** (i.e. capitalisation) **ceases**.

The following are NOT included in cost:

- (i) Administration and general **overhead** costs e.g. rent of office.
- (ii) **Costs of launching** a new product or service e.g. advertising.
- (iii) Expenses on **opening a new business** facility or conducting business at a new place e.g. expenses of an inaugural function.
- (iv) Costs of **relocating** e.g. costs of shifting a factory consequent to a government order.
- (v) **Initial** losses when the asset operates at a **low capacity**; e.g. a plant has a capacity of 1,000mt. Since initially it operates only at 400mt capacity, not enough gross profit is generated to cover fixed costs. Any loss arising cannot be added to the cost of the plant.
- (vi) Costs of **incidental operations** not necessary to bring the asset to its required location and condition. The reason is that the asset is capable of operating in the manner intended by management even without such operations. The expenses and income related to such operations are recognised in the statement of profit or loss.

 **Example**

Specialised machinery for a manufacturing company requires engineers to set it up properly to get it into working order. Then the company also calls in specialist painters to paint the machinery in the company colours. The expenses incurred for setting up the machine is capitalised. However, the painting expenses are not capitalised, but shown as an expense.



Test Yourself 2

Daffodils Perfumeries Enterprise is in the process of negotiating the acquisition of specialised machinery for the perfumery process. The following activities are accordingly carried out.

- (a) A special site has to be prepared for the machinery installation. Hence the old machines, which the company was using earlier on site, were dismantled at a cost of Tshs10 million and the required modifications were done for the new machinery. Scrap recovered from this process was sold for Tshs0.8 million. Cost of construction of the special site amounted to Tshs60 million.
- (b) Negotiations were successful and it was decided that the old machinery which had a carrying value of Tshs50 million but was now valued at Tshs40 million will be exchanged for new specialised machinery valued at Tshs200 million. The difference will be settled in cash.
- (c) It spent Tshs4 million on freight and Tshs3 million on installation.
- (d) It spent materials worth Tshs3 million and wages Tshs1.2 million on the trial run.
- (e) Machinery was finally installed but owing to low capacity utilization, it incurred loss of Tshs10 million.
- (f) Daffodils incurred costs of Tshs5 million for launching the new product.

Required:

Give your opinion on how to account for above mentioned transactions as per IAS 16 and the final cost of the new asset

1.8 Self-constructed assets

- For self-constructed assets, the cost is determined using **the same principles as for an acquired asset**.
- If the entity constructs similar assets for sale, then the **cost of constructing** those items may be used as an indication of the cost of self-constructed assets. This is to be done after eliminating internal profits.



Example

An X department transfer's material to the Y department at a profit of 15%, and Y uses the materials in manufacturing products for sale. One such product is to be used by the company as a non-current asset. The average transfer cost of the material received by Y from X per product is Tshs11.5 million and the average other costs are Tshs3.5 million and total cost, Tshs15 million. What is the amount to be recognised as non-current asset?

Answer

The amount to be recognised initially as an asset is:

	Tshs'000
Total cost of similar products sold:	15,000
Less: internal profits: $11,500 \times 15/115$	(1,500)
Amount to be recognised in non-current assets	13,500

- Costs of **abnormal wastage** of resources such as material and labour are **not included** in the cost to be recognised.
- **Borrowing costs** may be recognised as a part of the carrying amount, if they comply with the requirements of IAS 23 Borrowing Costs (see below).

 **Example**

An entity constructs a building for its own use. It spends Tshs50 million on materials (Tshs2 millions of which was lost in a fire) and Tshs5 million on wages and other direct expenses. For constructing the building, it uses borrowed funds of Tshs30 million on which it pays interest of Tshs3 million, up to the date of completion of construction.

The total cost is calculated as:

	Tshs'000
Cost of materials (excluding abnormal loss)	48,000
Wages and other direct costs	5,000
Interest Total	3,000
	56,000

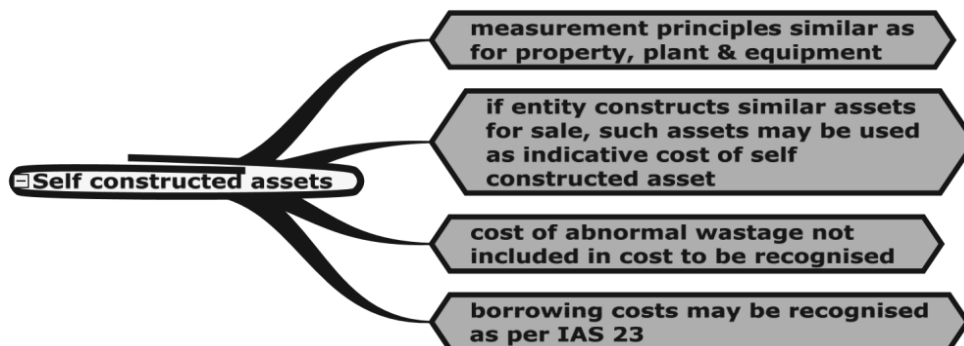
 **Test Yourself 3**

The Head office at Moscow sent steel costing Tshs200 million to the Qatar branch and raised an invoice for Tshs240 million. The branch was expected to sell the steel locally. It paid freight and clearing charges of Tshs10 million on the consignment. Later, the steel was entirely used in a plant erected for use by the branch itself rather than being sold.

Required:

Advise as to how the steel cost should be calculated and accounted for.

SUMMARY



2. Account for borrowing costs in accordance with international accounting standards [Learning Outcome b]

Borrowing costs and qualifying assets

 **Definition**

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

 **Definition**

Qualifying asset: A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

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IAS 23 does not state what 'substantial period of time' means. It's up to management to decide when an asset is a qualifying asset, taking into account, among other factors, the nature of the asset. An asset that normally takes more than a year to be ready for its intended use will usually be a qualifying asset. US GAAP does not include the term "substantial" while defining qualifying assets.

Thus, depending upon the circumstances, qualifying assets can be:

- inventories
- manufacturing plants
- power generation facilities
- intangible assets e.g. internally developed software
- investment properties

From the definition of qualifying assets, it is clear that the necessity of a substantial period of time to get ready for intended use is the primary condition for being a qualifying asset. As a result, inventories that are manufactured over a short period of time are not qualifying assets. Similarly, assets that are ready for their intended use or sale when acquired are not qualifying assets.

Two types of assets that would otherwise be qualifying assets are excluded from the scope of IAS 23:

- (1) Qualifying assets measured at fair value, such as biological assets accounted for under IAS 41 Agriculture.
- (2) Inventories that are manufactured or otherwise produced, in large quantities on a repetitive basis and that take a substantial period to get ready for sale (e.g. maturing whisky).

Borrowing costs can only be capitalised on **qualifying assets**.

Prior to revision, IAS 23 allowed an option to the entity to:

- Either capitalise (add to the cost of asset) the borrowing cost **relating to qualifying asset**.
- Or expense the borrowing cost in the period in which they are incurred i.e. they are reflected in the statement of profit or loss.

However the IAS 23 has now been revised. The revised IAS 23 removes this option to expense the borrowing costs and requires the entity to capitalise the borrowing costs attributable to qualifying assets.

(1) Capitalisation of borrowing costs

According to **Para 8 of IAS 23**, an entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.



Tip

Note that borrowing costs not attributable to qualifying assets are recognised as expenses in the period in which they are incurred.

(2) Borrowing costs eligible for capitalisation

According to **Para 10 of IAS 23**, the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying assets had not been made.

(a) Specific borrowing costs, e.g., interest on the funds borrowed specifically

Interest on the funds borrowed **specifically** for the purpose of obtaining / constructing a particular qualifying asset, less any investment income on the temporary investment of these borrowings is eligible for capitalisation.



Example

An office building is constructed for Tshs100 million, out of which Tshs75 million is borrowed and interest of Tshs7.5 million was paid. At some point when the loan was not needed, part of the Tshs75 million borrowed was put into a high interest deposit account and interest of Tshs2 million was received. The net interest paid (Tshs7.5 million - Tshs2 million) can be capitalised subject to the rules of commencement and cessation of capitalisation discussed later in this section.

(b) Borrowing costs on funds borrowed generally and used for the purpose of obtaining a qualifying asset. Sometimes, a specific loan may not be taken out. Instead, the company may use part of general loans to finance the construction of an asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, **other than** borrowings made specifically for the purpose of obtaining a qualifying asset.



Example

The weighted average borrowing cost of funds borrowed generally by a company is 9%, out of which Tshs80 million is used for a machine. The company also has a specific loan for the construction of the machine of Tshs10 million, where the interest rate is 12%. Tshs7.2 million (Tshs80 million x 9%) can be capitalised subject to the rules of commencement and cessation of capitalisation discussed later in this section.

(3) Commencement of capitalisation

According to Para 17 of IAS 23, an entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date is the date when the entity first meets all the following conditions:

- (a) it incurs expenditure for the asset;
- (b) it incurs borrowing costs; and
- (c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.



Example

A term loan for construction of a building was obtained on 1.1.X6 and interest started accruing on the loan from that date. Construction materials were purchased on the same date. Actual construction also commenced on the same date.

All the three conditions are satisfied and the company can commence to capitalise the interest.

(4) Cessation of capitalisation

According to Para 22 of IAS 23, an entity shall cease capitalising borrowing costs when all the activities necessary to prepare the qualifying asset for its intended use or sale are substantially complete.



Example

Erection of machinery is fully completed on 30 September 20X7. However, due to administrative reasons, it is not used till 31 December 20X7. Interest capitalisation, i.e. adding the interest accrued to the cost of asset, will cease on 30 September 20X7. Interest after 30 September 20X7 will be shown as an expense in the statement of profit or loss.

When the physical construction of an asset is completed in parts

In this situation, capitalisation of borrowing costs shall cease when all the activities necessary to prepare that part for its intended use or sale are substantially completed.

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Example

When a complex of many buildings is being constructed, and each building can be used separately, capitalisation of interest on each building is stopped as soon as each building is ready for its intended use.

However, when a continuous process plant is being erected, it cannot be used until the last part is completed. In such a case, capitalisation of interest on the entire plant will continue till the last part is completed.



Test Yourself 4

Wellnorth is constructing a stadium as on 31 October 20X7 the construction of the stadium is completed to a large extent. The ticket booking office and the doors of the stadium are the only remaining parts to be completed.

The auditor of Wellnorth insists that capitalisation of borrowing costs should be stopped at 31 October 20X7.

Required:

As an accountant give your opinion on this issue.

(5) Suspension of capitalisation

The above are the rules of commencement and cessation of capitalisation of interest. In between, sometimes capitalisation may have to be temporarily stopped.

According to Para 20 of IAS 23, an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.



Example

Construction work on a partially completed building is halted due to an order by the local authorities. Borrowing costs should not be capitalised during this period.

However, IAS 23 gives certain instances where capitalisation of borrowing costs need not be suspended.

- When it carries out substantial technical and administrative work.
- When a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.

3. Describe and illustrate the subsequent measurement of tangible non-current assets, including their revaluation and disposal.

[Learning Outcome c]

3.1 Measurement after recognition

IAS 16 gives two options of accounting policy to choose from:

- either the **cost model**;
- or the **revaluation model**.

The entity should apply the policy that it selects to an **entire class** of property, plant and equipment.

The two models are explained as follows:

Cost model

According to Para 30 of IAS 16, after recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation model

According to Para 31 of IAS 16, after recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably 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 should 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 end of the reporting period.

3.2 Determination of fair value under the revaluation model

The **fair value** of an asset is required to be determined **under the revaluation model**. IAS 16 gives guidance on how to **determine the fair value**:

(1) If there is market-based evidence

- (a) Land and buildings - derived from market-based values as evidenced by an appraisal that is normally undertaken by professionally qualified valuers.
- (b) Plant and equipment - based on the market value determined by an appraisal conducted by experts.



Example

Zodiac enterprises purchased a building at the cost of Tshs500 million on 1Januray 20X8. Professionally qualified and recognised experts value them at Tshs700 million as at 31 December 20X9. Ignore depreciation.

These revalued amounts will be recognised as follows:

Dr	Building account	Tshs200 million	
	Cr Revaluation surplus - OCI part		Tshs200 million
	Being revaluation of building and plant		

(Figures in Tshs'000)

Presentation in the financial statements

Zodiac Enterprises SOCI as at 31 December 20X9		
	Tshs'000	Tshs'000
Revenue	X	
Cost of sales	(X)	
Gross profit	X	
Other income	X	
Distribution costs	(X)	
Administrative expenses	(X)	
Other expenses	(X)	
Tax expense	(X)	
Profit for the year		X
Other comprehensive income - Not reclassified subsequently		
Gains on property revaluation	200,000	
Total other comprehensive income		X
Total comprehensive income for the year		X

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Statement of changes in equity for the period 31 December 20X9

	Share capital	Retained earnings	Investments in financial assets	Cash flow hedges	Revaluation surplus	Total	Non controlling interest	Total equity
Balance at 31/12/20X8	X	X	X	X	X	X	X	X
Changes in equity for 20X7								
Issue of share capital Dividends Total comprehensive income for the year Transfer to retained earnings Balance at 31/12/20X9					200,000			
	X	X	X	X	X	X	X	X

Notes (Figures in Tshs'000)

Zodiac Enterprises SOFP as at 31 December 20X9		
Assets		
Plant		
Cost on 01/01/20X9	500,000	
Additions:	-	
Deductions:	-	
Revaluation	200,000	
	700,000	
Net value on 31/12/20X9		700,000
Total		X
Capital and liabilities		
Share capital		
Retained earnings		
Revaluation surplus		
Total	200,000	X

- We must increase the value of the building by Tshs200 million to make it equal to the fair value. Hence we debit the plant account.
- Revaluation gain shall be recognised in other comprehensive income part of statement of profit or loss and other comprehensive income and will accumulate as revaluation surplus under equity. The accumulated revaluation surplus will be shown in the statement of financial position under other components of equity.

Gain on revaluation surplus is an unrealised gain and hence it is recognised in other comprehensive income.

(2) If there is no market-based evidence

An alternative suggested is to estimate the fair value using an income or a depreciated replacement cost approach.



Example

Equipment which was purchased 4 years ago, costs Tshs80 million today. The rate of depreciation applicable to this item is 10% straight line. Depreciated replacement cost is:

$$\text{Tshs80 million} - (\text{Tshs80 million} \times 10\% \times 4 \text{ years}) = \text{Tshs80 million} - \text{Tshs32 million} = \text{Tshs48 million}.$$

This can be taken as the fair value.

(3) Frequency of revaluations

A further revaluation is called for when the fair value of a revalued asset differs materially from its carrying amount. Some items may experience significant and volatile changes in fair value, and annual revaluations may be more appropriate for these. For others, a revaluation every three or five years may be sufficient.

(4) Treatment of accumulated depreciation after revaluation

When an item is revalued, we get its present value, which is **compared to** its carrying value, i.e. **gross value minus depreciation**. This raises the issue of how the accumulated depreciation should be treated. IAS 16 gives two options. The accumulated depreciation may be:

- (a) **Restated proportionately** so that the carrying amount of the asset after revaluation equals its revalued amount. This method is normally used when an asset is revalued by applying an index to its depreciated replacement cost.



Example

The net value of a building owned by Zazie Co is Tshs500 million. Its gross value is Tshs600 million, and accumulated depreciation is Tshs100 million.

There is a 40% increase in the net value (Tshs500 million + 40% of Tshs500 million = Tshs700 million).

The gross value as well as accumulated depreciation should be increased by 40%, to Tshs840 million (Tshs600 million + 40% thereof) and Tshs140 million (Tshs100 million + 40% thereof) respectively.

This will give a carrying amount of Tshs700 million (i.e. Tshs840 million - Tshs140 million), which is equal to the revalued amount

- (b) **Eliminated** against the gross carrying amount of the asset, with the net amount restated to its revalued amount. This method is used more in practice.



Example

Jay Co needs to revalue a building that it owns. The building was bought for Tshs500 million and has been depreciated for the last 10 years on a 2% straight line basis.

The revaluation report states that the building is worth Tshs750 million on 31 December 20X6.

	Tshs
Building stated at cost	500,000
Accumulated depreciation (500,000 x 2% x 10)	(100,000)
Net book value	400,000

54: Elements of Financial Statements

To include the revaluation, we need to have a zero balance in the accumulated depreciation account. So:

		Tshs'000	Tshs'000
Dr	Accumulated depreciation	100,000	
	Cr Building (Asset)		100,000
	Being the removal of accumulated depreciation on a revalued property		
and			
Dr	Cost of building	350,000	
	Cr Revaluation surplus		350,000
	Being the revaluation of the building		

Now the building is revalued to Tshs750 million. From 20X7, this will be depreciated over 40 years (2% depreciation implies 50 years, and 10 years have passed).

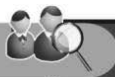
3.3 Accounting for the revaluation adjustment

There are two possibilities:

- (i) either an asset's carrying amount is increased;
- (ii) (ii) or an asset's carrying amount is decreased.

(1) If an asset's carrying amount is increased

The increase should be **recognised in other comprehensive part of statement of profit or loss and other comprehensive income and accumulated in equity** under the heading of revaluation surplus (as discussed above). If there was a **revaluation decrease** of the same asset **earlier** (which was recognised in SOPL), as required by IAS 16), then the increase should be recognised in the SOPL to the extent that it reverses a revaluation decrease.



Example

The carrying value of machine B is Tshs80 million. It is revalued at Tshs88 million. On the previous revaluation, its value was decreased by Tshs5 million. Show the accounting adjustments.

Answer

Increase in the value is Tshs8 million (Tshs88 million – Tshs80 million).

The previous reduction of Tshs5 million must have been recognised in the profit or loss part of statement of profit or loss and other comprehensive income, according to IAS 16. The following entry should now be made:

		Tshs'000	Tshs'000
Dr	Machine	8,000	
	Cr Reversal of impairment loss(Profit or loss part)		5,000
	Cr Revaluation surplus – OCI part		3,000
	Being the accounting for the increase in the value of machine		

(2) If an asset's carrying amount is decreased

The decrease should be recognised in **profit or loss** (SOPL). However, if there is a balance in the revaluation surplus under equity in respect of that asset (which had resulted from a **revaluation performed earlier**), such a decrease is recognised in other comprehensive income part of the statement of profit or loss and other comprehensive income.

The decrease recognised in other comprehensive income part reduces the amount accumulated in equity under the heading of revaluation surplus.



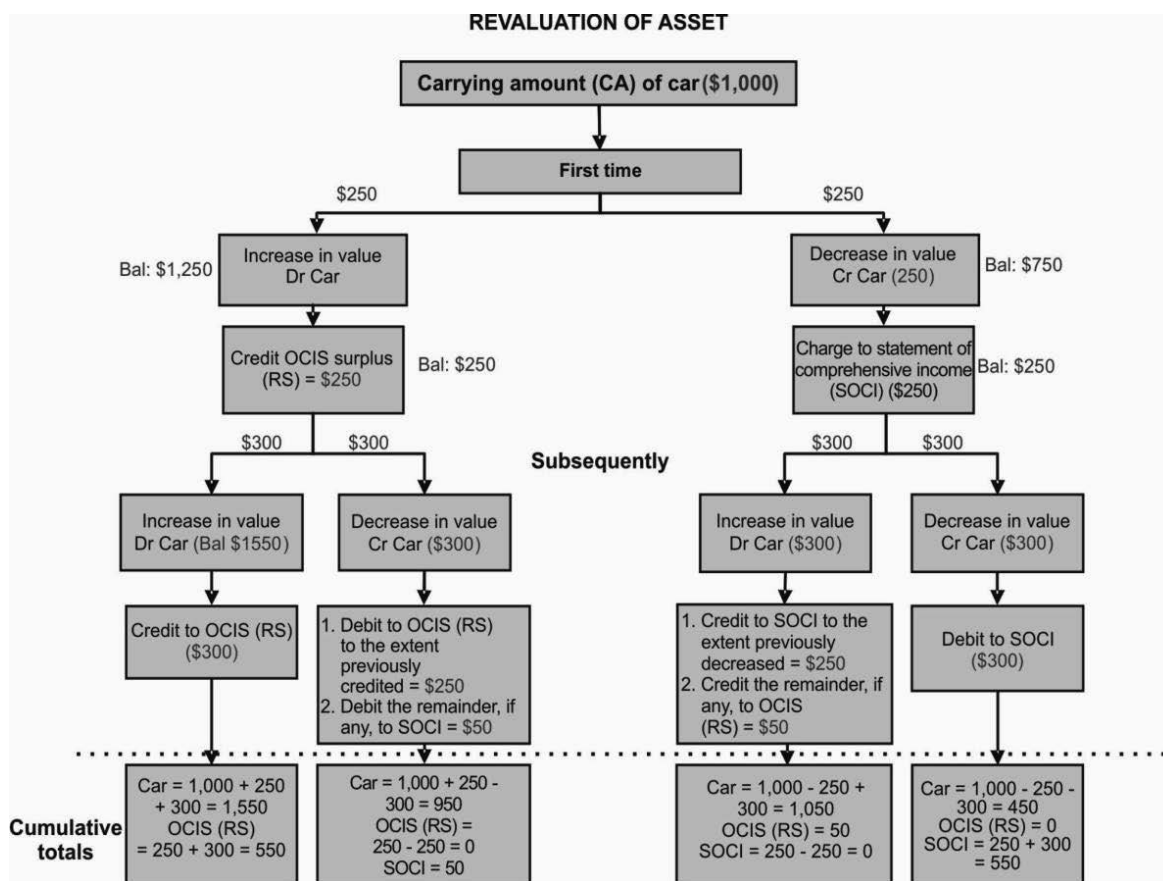
Test Yourself 5

The carrying value of machine A is Tshs60 million. It is revalued at Tshs50 million. On the previous revaluation, its value was increased by Tshs7 million (the amount in the revaluation surplus).

Required:

What would the accounting entries be?

Diagram 2: Carrying amount



Note:

(RS) = Revaluation surplus

OCIS = Other comprehensive income part of the statement of profit or loss and other comprehensive income



Test Yourself 6

The carrying value of machinery X is Tshs70 million and machinery Y is Tshs40 million. The revaluations performed show Tshs85 million and Tshs35 million respectively. On the previous revaluations, X's value had been increased by Tshs4 million (a credit in the revaluation surplus against this asset) and Y's value had decreased by Tshs3 million. (Ignore depreciation)

Required:

How should this transaction be accounted for?

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3.4 Entire class to be revalued

If an item of property, plant and equipment is revalued, **the entire class** of assets to which that asset belongs **should be revalued**.

A class is a grouping of assets of a **similar nature and use** in an entity's operations e.g. land, machinery, motor vehicles. An entity may, for the purpose of revaluation, adopt narrower classes. However, these classes should meet the requirements according to the definition in order to be classified as class.



Example

Kevin Inc owns a number of buildings. Some of them are located in industrial areas and are used as factory buildings, while others, located in residential areas, are used to operate its retail business. These buildings can be easily segregated into two classes for revaluation, as both the classes form groups of assets of similar nature, used in an entity's operation.

The purpose of revaluing the entire class simultaneously is:

- (i) to **avoid selective revaluation** of assets; and
- (ii) Hence financial statements may then have **values that are a mixture** of costs and values as at different dates.

Both situations **may distort the financial statements** and therefore reduce their utility.

Items in a class **may be revalued on a rolling basis** provided that the revaluation is **completed within a short period** and the revaluations are **kept upto date** (e.g. all items in plant and machinery may be revalued over a period of 3 years).



Example

Caro Co owns 3 buildings in 3 cities – Pala, Ruritania and Zaroo. They were each bought for Tshs100 million, and were all revalued in 20X6.

Prices in Zaroo have increased dramatically as large multinationals have set up their establishments there, and similar buildings in Zaroo are now worth on average Tshs175 million on the open market. The prices in the other two cities remained more or less constant at Tshs110 million in Pala and Tshs105 million in Ruritania.

In this case, all 3 buildings should be revalued in 20X7 again, even though only prices in Zaroo have increased, since IAS 16 requires that the revaluations should not be done selectively. Once done, they shall be applied to the entire class of assets.

3.5 Treatment of revaluation reserve and profit or loss on sale

When the asset is derecognised (sold), the revaluation surplus included in equity should be transferred directly to retained earnings. Profit or loss on sale will be calculated in the usual manner i.e. sales proceeds less carrying value (in this case, revalued).



Example

An asset had a carrying value of Tshs50 million. It was revalued at Tshs60 million by crediting the increase of Tshs10 million to revaluation surplus. Later it was sold for Tshs75 million.

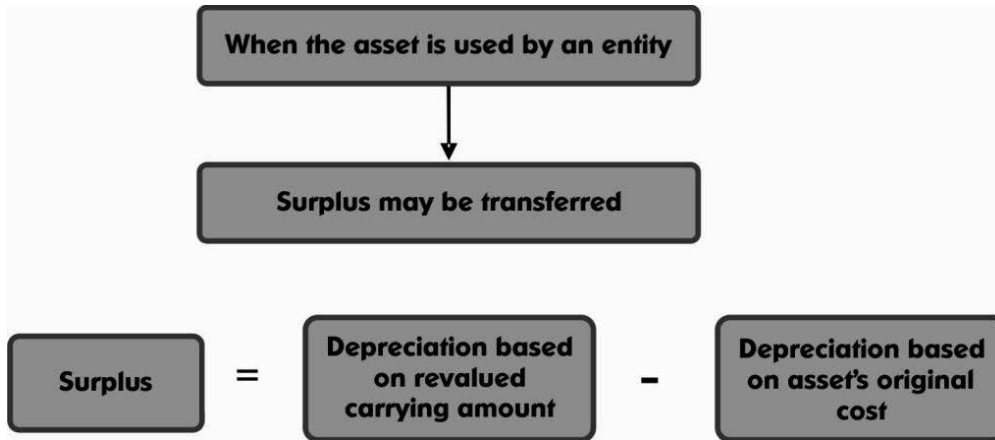
The profit on sales is Tshs15 million (Tshs75 million - Tshs60 million) and it is presented in the statement of profit or loss. The revaluation reserve of Tshs10 million is transferred directly from the revaluation surplus account to the retained earnings.

When the asset is used by an entity, some of the revaluation surplus may be reallocated to retained earnings. In this case, the amount of the surplus transferred to retained earnings would be the **difference** between the

depreciation based on the revalued carrying amount of the asset and the depreciation based on the asset's original cost (refer to paragraph 41 of IAS 16).

The transfers mentioned are not made through the statement of profit or loss and other comprehensive income, but directly from the revaluation surplus to retained earnings.

Diagram 3: Treatment of revaluation surplus



Test Yourself 7

Blue Ltd has two buildings, P and Q, against which there were revaluation surplus of Tshs535 million and Tshs265 million respectively. P was disposed of; Q is still in use. Depreciation on the original cost of Q was Tshs40 million and on the revalued carrying amount, Tshs66.5 million.

Required:

Explain the accounting treatment for the revaluation surplus for both.

Significance of the transfer

Both the revaluation surplus and retained earnings appear under the heading 'equity' in the statement of financial position. So why is this transfer needed? Normally the revaluation surplus is not a disposable profit, whereas retained earnings are. An entity can **distribute dividends** out of retained earnings but normally not from the revaluation surplus. Hence, by making this transfer, companies could distribute more dividends.

3.6 Derecognition: Disposal gains and losses

'Derecognition' is the opposite of recognition. By 'recognition' of an asset, we mean recognising the item as an asset in the accounting records and statement of financial position. Derecognition means **removing it from property, plant and equipment in the statement of financial position**. It may be converted into either other assets (e.g. from non-current asset to cash) or a loss / gain on derecognition or both.



Important

The carrying amount of an item of property, plant and equipment should be derecognised:

- (a) On disposal; or
- (b) 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 should be included in profit or loss when the item is derecognised (unless IAS 17 requires otherwise on a sale and leaseback).

58: Elements of Financial Statements

Gains on the disposal of property, plant and equipment should not be classified as revenue. In other words, they are shown under '**other income**'. The disposal can happen in a **variety of ways** (e.g. by sale or by entering into a finance lease or by donation).

In determining the **date of disposal** of an item, an entity applies the criteria in IAS 18 Revenue for recognising revenue from the sale of goods (see Study Guide B5). Similarly, it applies the criteria in IAS 17 to a disposal by a sale and leaseback.

If an entity **recognises** the **cost of a replacement** for part of the item in the carrying value of an asset, (i.e. if it capitalises this cost), then it **derecognises** the carrying amount of the **replaced part** irrespective of whether the replaced part had been depreciated separately. The following examples ignore depreciation.



Example

The damaged control panel of a continuous process plant producing special film has been replaced at a cost of Tshs100 million. The entity capitalises this cost. The carrying value of the damaged part which was replaced was Tshs60 million.

The entity should derecognise the latter amount, by:

		Tshs'000	Tshs'000
Dr	Loss on retirement of plant - Profit or loss part	60,000	
	Cr Plant account		60,000

Being the carrying value of the damaged control panel derecognised

If it is **impractical to determine the carrying amount** of the replaced part, an entity may **use the cost of the replacement as an indication** of what the cost of the replaced part was at the time it was acquired or constructed.



Example

Continuing the special film example

Suppose the carrying value of the replaced part is not known but it is known that the cost of the new part (Tshs100 million) is 10% of the plant total's value today. The total cost of the plant when it was purchased earlier was Tshs600 million.

An indicative value of the cost of the replaced part (at the time it was acquired) can be taken at Tshs600 million x 1/10 = Tshs60 million.

3.7 Determination of the amount of gain or loss

The gain or loss arising from the derecognition of an item of property, plant and equipment is determined as the **difference between the net disposal consideration, if any, and the carrying amount of the item.**



Example

To continue further the previous example of special films

If the control panel derecognised is sold at Tshs25 million, then the loss on derecognition will be Tshs35 million (Tshs60 – Tshs25). If there was no sales values, then the loss on derecognition will be the entire carrying amount of Tshs60 million.

Accounting entries for derecognition:

		Tshs'000	Tshs'000
Dr	Disposal of plant account	60,000	
	Cr Plant account		60,000

Being entry to transfer the carrying value of control panel to the disposal of plant account

Accounting entries for sale at Tshs35 million:

		Tshs'000	Tshs'000
Dr	Cash	35,000	
Dr	Loss on disposal of plant (IS)	25,000	
	Cr Disposal of plant account		60,000
Being sale of the control panel and loss incurred			

If there was no sales value:

		Tshs'000	Tshs'000
Dr	Loss on retirement of plant (IS)	60,000	
	Cr Disposal of plant account		60,000
Being loss on derecognition of control panel			

The consideration receivable on disposal of an asset is **recognised initially at its fair value**. If payment is deferred, then it is taken at the **cash price equivalent**. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with IAS 18.



Test Yourself 8

Laurel and Hardy started the business of manufacturing Fancy Towels, in the year 20X0 and witnessed many ups and downs in the business. The events faced by Laurel and Hardy are summarised as below; you are required to suggest appropriate accounting treatment for each year.

Year	
1/1/20X0	Started the business and purchased Machinery worth Tshs1,000 million. The useful economic life of the machinery on that date is 10 years.
1/1/20X1	Owing to the overall depression in the economy, the value of machinery reduced to Tshs800 million.
1/1/20X2	The economy soared back up and the value of machinery was now Tshs1,100 million.
1/1/20X3	Superior versions of Machinery were introduced in the market and accordingly machines possessed by Laurel and Hardy were now again valued at Tshs750 million.

Laurel and Hardy are really confused about the accounting treatment to be given to above transactions. Machineries are accounted as per revaluation model.

Required:

Suggest treatment as per IAS 16.

4. Account for depreciation and disclosures in financial statements.

[Learning Outcome d]

4.1 Depreciation - Definition and purpose



Definition

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

IAS 16 Para 6

Purpose

- (i) Assets such as buildings, machinery and equipment last for more than one year, but not indefinitely. They are used up in the process of running the business. The **portion that is used up is reported as an expense** in the statement of profit or loss. The corresponding amount is reduced from the value of the asset in the statement of financial position. Thus, a portion of the value is transferred from the statement of financial position to the statement of profit or loss in each accounting period.

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- (ii) **The accruals assumption** requires that expenditure should be recognised when there is a decrease in future economic benefit, as represented by a reduction in the value of an asset.
- (iii) **Retention of funds:** The charge for depreciation reduces disposable profits. Drawings or disposals of resources to the owners are normally restricted to profit after depreciation.

4.2 Complex assets: Significant parts to be depreciated separately

Some assets may have one or more significant parts:



Important

Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item **should be depreciated separately**.

IAS 16 Para 436



Example

The airframe and engines of an aircraft are two distinct parts and have a significant cost in relation to the total costs. Therefore, it would be appropriate to depreciate them separately.

If two or more significant parts of an item have the **same useful life** and depreciation **method**, these parts may be **grouped together** to determine the depreciation charge.



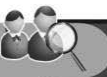
Example

Where there are four engines of an aircraft, they will have the same useful life and depreciation method; therefore, they would be grouped together.

An entity **may** choose to depreciate the parts of an item separately if they **do not have a cost that is significant** in relation to the total cost of the item. This means that where parts have a cost that **is significant** in relation to the total cost of an item, the entity is **required** to depreciate it separately. Where **it is not significant**, the entity **may**, if it so chooses, depreciates it separately, although this is not required by the IAS.

Not significant parts (remainder)

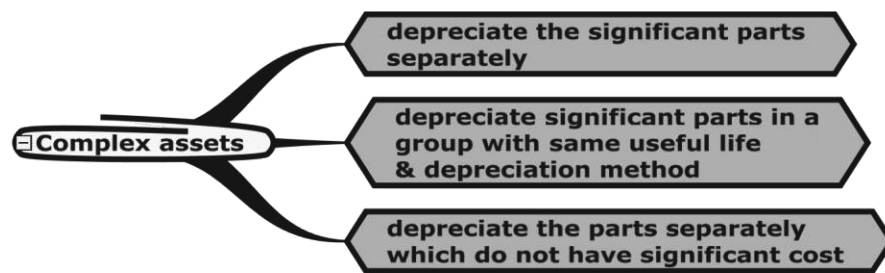
After the significant parts of an asset are treated separately for the purpose of depreciation, what remain are the parts that are individually not significant. They are **collectively known as the remainder**, and these are depreciated separately. If there are varying expectations (about useful life and residual value) for these parts, approximation techniques may be used.



Example

The engines, seats and body of an aircraft are treated as significant parts and depreciated separately. The total of other insignificant parts may be treated as the remainder, and are likely to be depreciated over an average period, say 5 years.

SUMMARY



Test Yourself 9

The accountant of Simplex Cosmetics LLC informs the board that profits of the company for 20X6 are much lower than expected due to heavy repairs and maintenance expenses. An analysis of the repairs and maintenance account shows that it included:

- Upgrade of machinery, increasing its production capacity by 10% to Tshs175 million.
- Tshs62.5 million for the replacement of major worn-out components in an old piece of machinery. (You receive additional information that the carrying value of the old parts was Tshs7 million. It was sold as scrap and the proceeds of Tshs4 million were credited to the sales account.)
- Servicing costs: Sundry materials of Tshs8 million and wages of Tshs1 million.
- Simplex Cosmetics borrowed Tshs200 million @ 10% from a financial institution for general business. However this loan was also used for financing the upgrading of machinery to the tune of Tshs175 million. The total interest of Tshs200 million was expensed to the statement of profit or loss. Included in it was interest attributable to the upgrading of Machinery of Tshs12.52 million.

Required:

Advise the accountant as to whether, these expenses are shown correctly.

4.3 Recognition of the depreciation charge

According to Para 48 of IAS 16, the depreciation charge for each period should be recognised in the profit or loss unless it is included in the carrying amount of another asset.

Depreciation of an asset is a **necessary charge against profit**. Repairs and maintenance of an asset do not negate the need to depreciate it.

Sometimes an asset may be used to **generate another asset**. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount.

**Example**

In the manufacture of plant and equipment, depreciation is one of the elements included in the costs of conversion of inventories.

4.4 Important terms

- Depreciable amount** is the cost of an asset, or other amount substituted for cost, less its residual value.

According to Para 50 of IAS 16, the depreciable amount of an asset should be allocated on a systematic basis over its useful life.

Depreciable amount is determined after **deducting residual value from cost**. In practice, the residual value may often be insignificant and therefore immaterial in the calculation of the depreciable amount.

62: Elements of Financial Statements

So long as the asset's residual value does not exceed its carrying amount, depreciation is recognised even if the fair value of the asset exceeds its carrying amount.

- (2) **Residual value** is the value which the entity expects to realise from the disposal of the asset at the end of its useful life.
- (3) **Useful life** is the **period** over which the asset is likely to be in existence for an entity's use. It may also be denoted in terms of the **number of units** expected to be obtained from the asset.

The residual value and useful life of an asset should be **reviewed** at least at each financial year-end. If expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with IAS 8 **Accounting Policies, Changes in Accounting Estimates and Errors**.



Example

A firm follows a cost model of depreciation.

The carrying value of machinery is Tshs40 million and its residual value, Tshs20 million. Its fair value is Tshs50 million. Depreciation should be charged on Tshs40 million - Tshs20 million = Tshs20 million which is the depreciable amount. The fact that fair value exceeds carrying value is of no consequence for this purpose.

Once the residual value becomes equal to or greater than the asset's carrying amount, then the depreciation charge becomes zero. This continues until its residual value subsequently decreases to an amount below its carrying amount.



Example

The carrying value of machinery is Tshs20 million and its residual value is Tshs21 million. The depreciation charge should be zero, as the residual value is greater than the carrying value.

4.5 When does depreciation begin and cease?

Depreciation **begins** when the asset is available for use at the location and in the condition intended by management.

Depreciation of an asset **ceases** at the **earlier** of the following:

- The date on which the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5; and
- The date on which the asset is derecognised.

Depreciation **does not cease** when the asset becomes idle or is retired from active use, unless it is fully depreciated.

However, **under the usage method of depreciation**, if there is no production, the depreciation charge can be zero.



Example

Sunto Ltd has two factories. At factory 1, depreciation is charged on a time basis and at factory 2 it is charged on a usage basis. There is a machine costing Tshs50 million at each factory.

During 20X5-20X6, both machines remained idle.

For factory 1, depreciation will be charged as it is based on the time method; whereas for factory 2, it will not be charged, as it is based on the usage method.

4.6 Estimation of useful life

The estimation of the **useful life** of the asset is a matter of judgement, based on the entity's experience with similar assets.

The useful life is determined in terms of the asset's expected **utility to the entity**, and it may therefore **be shorter than its economic life**.



Example

A piece of equipment has an economic life of 20 years. However, it is available for use to an entity for 15 years only. The period relevant for depreciation calculations will be this useful life i.e. 15 years.

All the following **factors are considered in determining the useful life** of an asset:

1. Expected **usage**, with reference to the assets expected capacity or physical output. A machine working at full capacity right from the beginning may have a lower useful life in terms of years than one gradually increasing capacity utilisation.
2. Expected **physical wear and tear**. This depends on operational factors such as the number of shifts planned for the asset and the repair and maintenance schedule, e.g. a machine working for three shifts may have a shorter life than one operating two shifts.
3. Technical or commercial **obsolescence** i.e. changes or improvements in a production process or technique, or changes in the market demand for the asset.



Example

In the electronics industry, where technology changes at a fast pace, the expected life of a machine producing components may be lower.

4. **Legal or similar limits** on the use of the asset, e.g. the expiry dates of patents related to the process used on the machine.

4.7 Land and buildings

The land and building class of assets is a peculiar one and requires some special considerations.

Land and buildings are separate assets. Therefore, they are **accounted for separately**, even when they are acquired together.

With some exceptions (such as quarries or mines), **land** has an unlimited useful life and therefore **is not depreciated**.

If the cost of site dismantlement, removal and restoration is included in the value of land, then that portion is depreciated over the period of benefits obtained by incurring those costs. Examples of these costs would be clean-up costs from contamination; or taking down an oil rig that is on land.



Example

The total value of a plot of land is Tshs400 million, including the costs of site dismantlement, removal and restoration worth Tshs50 million, which will result in benefits for 10 years. The cost of the land itself i.e. Tshs350 million should not be depreciated. However, the other costs of Tshs50 million should be depreciated over the period of 10 years.

64: Elements of Financial Statements

In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it. For example, land acquired for a quarry (mining etc.) may be given on a 10-year licence. It would then be depreciated over 10 years.

Buildings have a limited useful life and therefore **are depreciable assets**.

An **increase in value of the land** on which a building stands **does not affect the split of the depreciable amount of the building**, since the two are separate assets guided by different principles, as discussed above.

4.8 Depreciation methods

According to Para 60 of IAS 16, the depreciation method used should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The method decided is to be **reviewed at the end of each financial year**. If there is a change in consumption pattern, the method may be changed. The impact of such a change should be accounted for as a change in accounting estimates in accordance with IAS 8.

An entity selects the method that **most closely reflects the expected pattern of consumption** of the future economic benefits embodied in the asset.

There are a **variety of depreciation methods**, including the **following main** methods:

- (i) The **straight-line** method: This results in a constant charge over the useful life if the asset's residual value does not change.
- (ii) The **reducing (diminishing) balance** method: This result in a decreasing charge over the useful life.
- (iii) The **units of production** method: This results in a charge based on expected use or output.

The method selected is to be **applied consistently** from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.



Test Yourself 10

On 1 January 20X6 Lagar Ltd bought a new asset for Tshs100 million that was estimated to have a working life of 5 years. Its realisable value thereafter was estimated at Tshs20 million. It is expected to produce 800,000 units of output during its useful life.

The actual production for the five years was:

20X6: 150,000 units
20X7: 200,000 units
20X8: 190,000 units
20X9: 150,000 units
20Y0: 110,000 units

Required:

- (a) Calculate the depreciation provision under units of production method.
- (b) Show the depreciation schedule.



Test Yourself 11

On January 1, 20X4, Kalbros Ltd purchased a second-hand item of plant for Tshs72 million and immediately spent Tshs48 million in putting the plant into working condition. On July 1, 20X4, additional plant costing Tshs48 million was purchased. On July 1, 20X6 the plant purchased on January 1, 20X4 became obsolete and was sold for Tshs60 million. On July 1, 20X6 another new item of plant was purchased at a cost of Tshs144 million. The firm provided depreciation on reducing balance method at 15% per annum according to the period of use in each year.

Required:

Show the machinery account and accumulated depreciation account for the calendar years 20X4 to 20X6.

4.9 Depreciation calculation and accounting after revaluation

After a revaluation, depreciation will be based on the revalued amount. The full depreciation amount is charged as an expense to the statement of profit or loss. As discussed earlier, an amount equal to the difference between depreciation on revalued amount and that on original cost may be transferred from revaluation surplus to retained earnings.



Test Yourself 12

Stanburt Tools acquired a machine on 1 Oct 19W8. Details of one of its machines at 30 September 20X6 are given below:

Component	Original cost (Tshs'million)	Depreciation basis
Engine	102	useful life of 40,000 hours
Outer casings	306	25 years straight-line
Other components of machine	153	12 years straight-line
	561	

During the year to 30 September 20X7, the following events took place:

	Tshs' millions
1. Engine , which had run for 30,000 hours to date developed serious problems It was replaced by a better engine with estimated life of 50,000 hours and a cost of Tshs142.6 million. The engine was used for 5,000 hours during the year.	142.80
2. Polishing and painting was done to the outer casings, costing	00.78
3. Other components were upgraded with a cost of	61.20
The remaining life of this is 5 years.	

For the purpose of depreciation calculations, assume that all the work mentioned above was completed at 1 October 20X6

Required:

Calculate the carrying amount of Stanburt's machine at 30 September 20X7 and its related expenditure in the statement of profit or loss for the year ended 30 September 20X7. Explain the treatment of each item.

4.10 Disclosure

The financial statements are required to disclose the following details, for each class of property, plant and equipment:

- (1) the **measurement bases** used for determining the gross carrying amount;
- (2) the **depreciation methods used**;
- (3) the **useful lives** of the assets or the depreciation rates used;
- (4) the **gross carrying amount** and the accumulated depreciation (along with accumulated impairment losses) at the beginning and end of the period; and
- (5) a **reconciliation** of the carrying amount at the **beginning and end** of the period showing:

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(a) additions

- **disposals**, including assets classified as held for sale or included in a disposal group classified as held for sale in accordance with IFRS 5;
- **acquisitions by way of business combinations**;
- **increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in equity**;
- **impairment losses recognised in profit or loss**
- **impairment losses reversed in profit or loss**;

(b) depreciation

net exchange differences arising on the translation of the financial statements; and other movements in intangible assets

A sample format of the disclosures is given below, with imaginary figures:

	Land & buildings Tshs	Plant & equipment Tshs	Total Tshs
Cost or revaluation			
Balance at 1/1/20X6	200,000	130,000	330,000
Additions in the year	40,000	25,000	65,000
Revaluation surplus	60,000	-	60,000
Disposals in the year	(30,000)	-	(30,000)
Balance at 31/12/20X6	270,000	155,000	425,000
Depreciation			
Balance at 1/1/20X6	80,000	39,000	119,000
Charge for the year	20,000	15,500	35,500
Elimination on disposals	(6,000)	-	(6,000)
Balance at 31/12/20X6	94,000	54,500	148,500
Net book value			
At 31/12/20X6	176,000	100,500	276,500
At 1/1/20X6	120,000	91,000	211,000

Information is also required to be disclosed on a number of ancillary items which included disclosures relating to the existence and amount of any restrictions on the title of PPE (where PPE has been pledged as security over some of the entity's liabilities), the amount of any expenditure recognised in respect of assets in the course of construction, the amount of any contractual commitments for the future acquisition of items of PPE and the amount of any compensation received in respect of impaired or lost assets.

Disclosures required for revalued assets:

- (a) the **effective date** of the revaluation;
- (b) whether **an independent valuer** was appointed for this purpose;
- (c) the **methods** and significant assumptions applied for the purpose of **computing the fair values** of the assets;
- (d) the extent to which fair values were determined by **reference to market prices** on arm's length terms or were estimated using other valuation techniques e.g. nature of indices, if any, used;

- (e) for each revalued class of asset, the **carrying amount** that would have been recognised had the assets been carried under the **cost model**; and
- (f) the **revaluation reserve**, also detailing the **changes during the period** and any restrictions on the distribution of the balance to shareholders.

5. Apply the provisions of international accounting standards to government grants and government assistance.

[Learning Outcome e]

5.1 Government grants

Economic decisions in free economies are left to private individuals or entities, who would take certain decisions if they saw some benefit from that action (e.g. an individual will decide to buy certain goods from one place and sell them at another, if he feels there is profit in it).

However, the results of such decisions based on private profit motives may not always be desirable for society. In order to induce private parties into taking such socially or economically desirable decisions, governments give various incentives. The government may provide the following help to an eligible entity:

- Pay a part of the cost of certain assets, e.g. 25% of the cost of machinery, if the entity establishes a factory in an undeveloped region.
- Allow certain assets to be used free of charge or at a subsidised rate e.g. licences.
- Sell certain assets or goods at a subsidised rate e.g. land.
- Reimburse the expenses incurred on certain objects e.g. on providing employment to disabled persons.

These incentives motivate individuals in taking socially desirable actions.



Example

Solar energy is very helpful in conserving natural resources and therefore desirable. However, it requires initial capital expenditure to install the associated equipment. Left to themselves, most entities might not opt for it. The government may thus give a subsidy to entities purchasing solar energy equipment.

IAS 20 **Accounting for Government Grants and Disclosure of Government Assistance** is to be applied in the accounting for, and disclosure of, government grants.



Definition

Government refers to government, government agencies and similar bodies whether local, national or international.

Government assistance can be defined as an action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government grants are 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.

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

IAS 20 Para 3

5.2 Conditions for recognition



Definition

Government grants, including non-monetary grants at fair value, should not be recognised until there is reasonable assurance that:

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(a) the entity will comply with the conditions attaching to them; and (b) the grants will be received.

IAS 20 Para 7



Example

The local government requires that the grant for solar energy equipment should be subject to the condition that, after the payment of the entity's share of cost and after the installation of the equipment, it will be verified and certified by the prescribed authorities. Similarly, it also requires an undertaking from the entity that it will comply with the maintenance requirements and standards for 10 years.

After the equipment is certified and the undertaking is given, the government authorities issue a letter confirming compliance. Once the letter is received, the conditions given in IAS 20 are satisfied and the entity may recognise the grant irrespective of the date of receipt.

The **receipt** of a grant **may not necessarily mean** that the **conditions** attaching to the grant have been or will be **fulfilled**.

The **manner of receiving the grant** (i.e. whether it is received in cash or as a reduction of a liability to the government) **does not affect the accounting method** to be adopted in regard to the grant.

A **forgivable loan** from the government is to be **recognised as a government grant** when there is **reasonable assurance that the entity will meet the terms** for forgiveness of the loan.

A **contingent liability or contingent asset** related to a government grant is treated in accordance with **IAS 37** Provisions, Contingent Liabilities and Contingent Assets.

5.3 Approaches

Income versus capital



Definition

Government grants should be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis. They should not be credited directly to shareholders' interests.

IAS 20 Para 12

Recognising the grants as income is known as the **income approach**; crediting them directly to shareholders' interests without recognising the grant in profit or loss is **the capital approach**. It is evident that the **IAS requires the income approach** to be followed. IAS 20 gives arguments in favour of both approaches, but concludes in favour of the income approach. The income approach requires that government grants are recognised in profit or loss on a systematic basis so as to match them with the related costs. Grants related to **depreciable assets** are usually recognised as income over **the periods and in proportions in which depreciation is charged** on the assets. There are some **variations**, which are discussed in a separate section later in this Study Guide.



Example

A machine was purchased on 1 January 20X6 for Tshs90 million, depreciable on a straight-line basis over 3 years. A government grant of Tshs27 million was received.

Depreciation p.a. is 90 million / 3 = Tshs30 million and grant income to be recognised p.a. is Tshs27 million / 3 years = Tshs9 million. The alternatives regarding presentation of this are discussed in the next section.

Grants that are given as compensation for expenses or losses already incurred, or for the purpose of giving financial assistance with no related costs, should be **recognised as income in the period when it becomes receivable**.

5.4 Grants related to assets

**Definition**

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term 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.

IAS 20 Para 3

Two alternative methods are available for presentation of these grants:

- (1) Deferred income; or
- (2) Deduction from asset value.

(1) Deferred income

This method treats government grants as deferred income, recognised as income over the useful life of the assets. The balance not yet recognised as income is presented in the statement of financial position as deferred income. Each year an appropriate part of that should be transferred to statement of profit or loss.

(2) Deduction from asset value

This method deducts the government grant from the carrying amount of the asset. As the carrying value is reduced, the depreciation charge is reduced. By reducing the charge of depreciation, indirectly the grant is recognised as income.

**Example**

Scorpio Co purchased a depreciating asset on 1 January 20X1 for Tshs100 million. It is expected to last for 5 years. Scorpio Co received a grant equal to 40% of this amount. The residual value is expected to be negligible. The company uses the straight-line method of depreciation.

In this case the accounting for the grant and depreciation under the two alternatives is as follows:

Deferred income method

Here, the asset is depreciated as normal

Calculation of depreciation				
Year	Net book value at beginning of year	Depreciation for year	Accumulated depreciation	Net book value at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
1	100,000	20,000	20,000	80,000
2	80,000	20,000	40,000	60,000
3	60,000	20,000	60,000	40,000
4	40,000	20,000	80,000	20,000
5	20,000	20,000	100,000	-
		100,000		

When the grant is received:

Dr Cash	Tshs40 million	
Cr Grant		Tshs40 million
Being grant received from the government		

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Each year, part of the grant is taken to the statement of profit or loss, as shown below:

Year	Grant at beginning of year	Credit to IS for grant	Accumulated credits	Grant at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
1	40,000	8,000	8,000	32,000
2	32,000	8,000	16,000	24,000
3	24,000	8,000	24,000	16,000
4	16,000	8,000	32,000	8,000
5	8,000	8,000	40,000	-
		40,000		

This means that while depreciation of Tshs20 million is deducted as an expense, Tshs8 million is credited as income each year, giving an annual net expense of Tshs12 million (i.e. Tshs20 million - Tshs8 million) in the statement of profit or loss.

The amounts in the 'depreciation for the year' column will be charged and the amounts in the 'credit to statement of profit or loss for grant' column will be credited to statement of profit or loss.

The statement of financial position will disclose the carrying values of the asset and the grant (deferred income), as shown in the last columns.

Thus the disclosures under this method for the first year will be:

In the statement of profit or loss	Tshs'000
Grant income	8,000
Depreciation charge	20,000

In the statement of financial position	Tshs'000
Assets	
Property, plant & equipment	80,000
Liabilities	
Grant - deferred income	32,000

Method of deduction from asset value

When the grant is received, the accounting entry is:

Dr Cash	Tshs40 million	
Cr Asset		Tshs40 million
Being grant received from the government		

The initial carrying amount of the asset itself reduces to Tshs60 million (Tshs100 million - Tshs40 million).

Calculation of depreciation

Year	Net book value at beginning of year	Depreciation for the year	Accumulated depreciation	Net book value at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
1	60,000	12,000	12,000	48,000
2	48,000	12,000	24,000	36,000
3	36,000	12,000	36,000	24,000
4	24,000	12,000	48,000	12,000
5	12,000	12,000	60,000	-
		60,000		

Thus the depreciation to be charged will be based on this net amount. Separate accounting for the grant in subsequent years will not be needed.

The presentation in the financial statements will be:

In the statement of profit or loss	Tshs'000
Grant income	NA
Depreciation charge	12,000

In the statement of financial position	Tshs'000
Assets	
Property, plant & equipment	48,000
Liabilities	
Grant - deferred income	NA

Non-monetary government grants

The government may transfer a non-monetary asset such as land to an entity. It is **usual to record** the grant as well as the asset at **fair value**. **Alternatively**, it may be recognised at a **nominal amount**.



Example

Government allotted a plot of land free of charge to Cosmo Co, which was setting up a plant in an undeveloped area. The value of the plot in the market is Tshs400 million. Cosmo Co may record this grant at Tshs400 million (fair value) or at a nominal value of, say Tshs20 million.

Dr Land account X
Cr Grant account X

Being land allotted free of charge by the government brought into the books at value.

Grants related to **non-depreciable assets** are likely to require **fulfilment of certain conditions**. They should be recognised over the periods which bear the cost of meeting the obligations.



Example

If the grant of land has a condition attached to it that a building should be constructed on it, and then the grant will be recognised over the life of the building.

5.5 Grants related to income



Definition

Grants related to income are government grants other than those related to assets.

IAS 20 Para 3

These grants may be presented:

- (a) Either as income (a separate credit or under 'other income' in the statement of profit or loss); (b) Or as a deduction from the related expense.

One opinion is that the separation of the grant from expenses facilitates comparison between expenses in the sense that the expense figure is not distorted. However, some argue that an entity might not have incurred those expenses if they were not sure of receiving the grant. Therefore it is appropriate to deduct the grant from the related expense.

The IAS explains arguments in favour of both approaches and concludes that **either method is acceptable**.



Test Yourself 13

An entity spends Tshs5 million on the welfare of orphan children and receives Tshs4 million as a grant for this specific purpose from the local government. Give the possible accounting treatment.

5.6 Government loan received at interest rate below the market rates

The benefit of a government loan received at interest rate below market rate of interest is treated as a government grant. These loans are required to be recognised and measured in accordance with IAS 39 Financial Instruments: Recognition and Measurement. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IAS 39 and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.



Important

The provision related to Government loan received at an interest rate below the market rate can be summarised as:

- (1) Loan received is to be recognised and measured at fair value in accordance with IAS 39 (i.e. using an imputed rate of interest).
- (2) Difference between initial carrying amount computed in (1) above and actual proceeds received is treated as Government Grants.

5.7 Repayment of government grants



Definition

A government grant that becomes repayable shall be accounted for as a revision to an accounting estimate (see IAS 8).

IAS 20 Para 32

(1) Repayment of grants related to income

- (a) If IAS 20 provisions were applied while accounting for the grant related to income, the entire grant should normally have been recognised in the statement of profit or loss and there may not be any unamortised deferred credit. In this case, the entire repayment should be immediately recognised as an expense.
- (b) Students may note that where grants related to income are discussed, IAS 20 does not specifically mention the possibility of deferred credits being carried forward in the statement of financial position. However, where they are to be reduced from the expenditure and the expenditure itself is incurred over a period of more than one year, part of the grant may be deferred to future years for being set off against the expenses.

In this case, the following applies:

- (i) To the extent of the unamortised deferred credit available against the grant, the repayment should be applied to reduce / eliminate the deferred credit.
- (ii) The excess of the repayment over the unamortised credit or (where no deferred credit exists) the entire repayment should be recognised immediately as an expense.



Example

An entity received a grant of Tshs50 million, related to income.

To date it has recognised Tshs30 million in the statement of profit or loss and carries the unamortised balance of Tshs20 million in the statement of financial position.

A partial amount of Tshs25 million is repaid, owing to non-fulfilment of the conditions.

The payment will be debited first to the unamortised grant account (Tshs20 million) and the balance of Tshs5 million will be recognised in the statement of profit or loss.

(2) Repayment of grants related to an asset

The accounting treatment depends upon how the grant was disclosed initially when it was received:

- (a) The repayment should be recorded as an **increase in carrying value** of the asset (if the original receipt of the grant was reduced from the carrying value);
- (b) Or it may be recorded by **reducing the deferred income balance** by the amount payable (if the original receipt of the grant was treated as a deferred income).

In either of the above cases, the **cumulative additional depreciation** that would have been recognised to date as an expense if there was no grant should be recognised immediately as an expense.

The fact that the grant had to be repaid may require an entity to consider the possible impairment of the new carrying amount.



Test Yourself 14

Tipla Chemicals LLC operates in a poor area. During 20X4, it installs a special pollution control device at a cost of Tshs6 million and receives a grant of Tshs4 million from the local government. During 20X6, the government finds out that Tipla has not complied with the terms of the grant and asks it to repay the grant. After protracted negotiations, Tipla gives up and repays Tshs4 million. It had deducted the grant from the carrying amount of the asset and charged depreciation at 10% under the straight-line method for two years.

Required:

Show the accounting treatment of the refund.



Test Yourself 15

In the above example (Tipla Chemicals LLC), assume that the company had opted for the **deferred income method** of presenting the grant.

Required:

What adjustments would be required?

5.8 Government assistance

From the definition of grants, some forms of government assistance are excluded:

- (a) It may not be possible to reasonably **estimate a value** to be placed on some transactions (e.g. free technical advice, provision of guarantees).
- (b) It may not be possible to **distinguish transactions** with governments from those with others (e.g. some goods are purchased from the entity by the government as a result of its procurement policy).

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These are excluded since it **may not possible to place a value** upon them, or the value even if arrived at, **may be arbitrary**.

However, they may still bring significant benefits to the entity. In order that the financial statements may not be misleading, **disclosure of the nature, extent and duration of the assistance is necessary**.



Example

An entity receiving free technical advice may disclose the nature and extent of technical advice, and the period for which such free advice is available.

5.9 Disclosure related to government grants

The following matters should be disclosed:

- (a) the accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements;
- (b) the nature and extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited; and
- (c) unfulfilled conditions and other contingencies attaching to government assistance that has been recognised

6. Describe the criteria for non-current assets to be classified as held for sale, either individually or as a disposal group.

[Learning Outcome f]

6.1 Definition of non-current assets held for sale

Before examining the case of non-current assets held for sale, let us first understand the types of tangible non-current assets:

- (1) **Property, plant and equipment** e.g. building, machinery, computers used for the business. Traditionally these assets are called non-current assets. In some cases, these may also be called owner-occupied properties and used for the business of the owners.
- (2) **Investment properties** e.g. rented plot of land held for capital appreciation only.
- (3) **Non-current assets held for sale**: These are dealt with by IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

What distinguishes non-current assets held for sale from the other categories mentioned above? They are held for sale, whereas the other categories of assets are expected to be used for the business or for earning rent income or capital appreciation.

Property, plant and equipment and investment property have a value in use for the entity, whereas non-current assets held for sale are expected to bring value by way of sale.



Definition

An entity shall classify a non-current asset (or disposal group) as **held for sale** if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

IFRS 5 Para 6

A distant possibility of sale is not sufficient. The asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be **highly probable**.

For the sale to be treated as being **highly probable**, the following conditions are to be met:

- An appropriate level of management must be committed to sell the asset or the disposal group.
- An active programme to locate a buyer and complete the plan must have been initiated.
- The sale should be expected to qualify for recognition as a completed **sale within 1 year**.
- It is unlikely that any significant changes to the plan will be made or that the plan will be withdrawn.



Example

Generic Neon Signs stopped using a plant during 20X3. In the same year, it let the plant out on lease to Garry Electrical and now foresees that the plant will be of no further use to it. It is now negotiating the sale of the plant to Garry Electrical.

Therefore, in its financial statements for 20X3, Generic will present the plant as held for sale rather than on lease.

Sometimes, the period to complete the sale may extend beyond one year. If the delay is for reasons beyond the control of management, and management remains committed to its plan to sell the asset or the disposal group, the entity can continue to classify the asset or the disposal group as held for sale.



Test Yourself 16

Jerome Sales Services is an entity which has a manufacturing facility. It intends to sell the facility. On the date of contract, it has uncompleted customer orders.

Required:

Show whether it meets the criteria specified in IFRS 5 para 7 if:

- it transfers the operations and the unexecuted customer orders
- It transfers only the manufacturing facility, after completion of the remaining orders.

An appropriate level of management must be committed to sell the asset or the disposal group. An active programme to locate a buyer and complete the plan must have been initiated.



Example

Empress Mill Plc has stopped using a plant during 20X6. It leased out the plant to Tigress Mill during 20X6 and is negotiating for an outright sale to the same company.

In its financial statements for 20X6, Empress shows the results of the plant in as held for sale.

Events or circumstances may extend the period to complete the sale beyond one year. If the delay is for reasons beyond the control of management, and management remains committed to its plan to sell the asset or the disposal group, the entity can continue to classify the asset or the disposal group as held for sale.

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6.2 A disposal group



Definition

A disposal group is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

The group includes goodwill acquired in a business combination if the group is a **cash-generating unit** to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of IAS 36 Impairment of Assets (as revised in 2004) or if it is an operation within such a cash-generating unit.

Appendix A to IFRS 5

If we analyse the above definition, we identify the following components of the definition:

- (a) It is a group of **assets and the liabilities** directly associated with it.



Example

An item of plant was acquired for Tshs5 million with the help of a bank loan for which the plant was offered as a security. The outstanding balance on the loan is Tshs2 million. The plant cannot be sold unless the loan is either repaid, or taken over by the purchaser of the plant. The liability is directly associated with the plant.

- (b) The group is to be **disposed** of in a **single transaction**.

- (c) If the group is the **cash-generating unit** to which goodwill has been allocated, or an operation in such a unit, it will **include the value of the goodwill**.



Test Yourself 17

Plomouth holds the following assets:

1. A property given on rental
2. A machinery used for production
3. A car not in use for which a prospective buyer is being looked for.
4. A property worth Tshs5 million with furniture worth Tshs1 million, which are charged as a security for a loan of Tshs3 million which was specifically taken for the property. Advertisements have been issued about the intention to sell the properties with the loan thereof.

Required:

How would these assets, be disclosed in the financial statements?

7. Illustrate the accounting for non-current assets and disposal groups that are held for sale.

[Learning Outcome g]

7.1 Measurement of a non-current asset (or disposal group) classified as held for sale

A non-current asset (or disposal group) classified as held for sale is **measured at the lower of its carrying amount and fair value less costs to sell**. It can be seen that this method of valuation is similar to the valuation of inventory rather than property, plant and equipment. The reason is that the nature of these assets is similar to inventory which is a current asset expected to be sold soon.

- (a) If an asset (or disposal group) is **newly acquired** as part of a business combination, it shall be measured at **fair value less costs to sell**.

(b) **If the sale is expected to occur** after more than one year, the costs to sell would be incurred in the future and their future value should be used only after conversion into present value, i.e. they should be discounted. Any increase in such costs which arises from the passage of time is recognised as a financing cost.

 **Example**

A plant's fair value is calculated to be Tshs250 million and the costs to sell the plant after two years will be Tshs20 million. The present value of cost to sell is estimated to be Tshs17.50 million.

Therefore the costs to sell are taken to be Tshs17.50 million, and the fair value less costs to sell will be Tshs250 million - Tshs17.50 million = Tshs232.50 million.

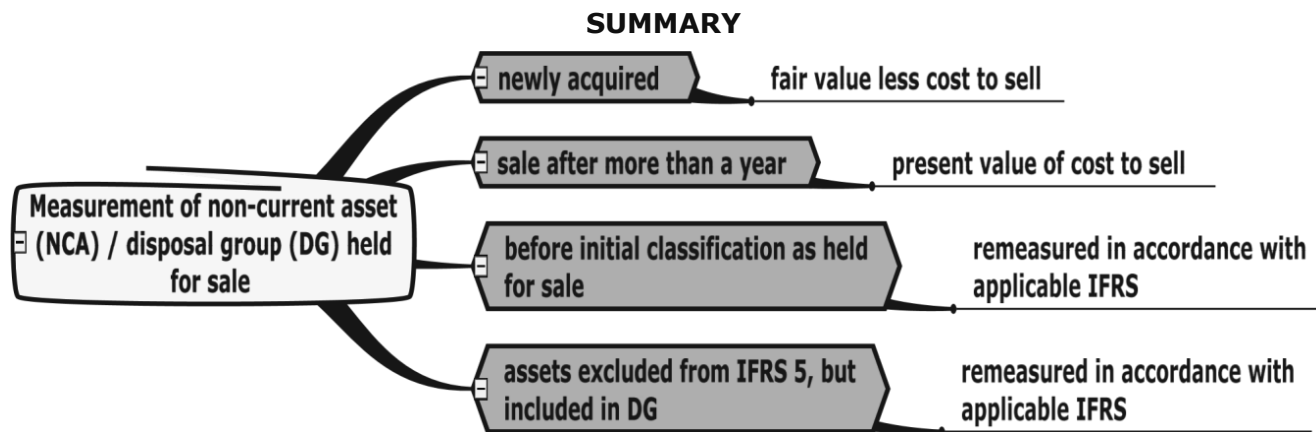
(c) **Just before the initial classification of the asset as held for sale, the** asset shall be remeasured in accordance with the applicable IFRS.

(d) **What happens if** certain assets are excluded from the scope of IFRS 5, but which form part of the disposal group?

Such assets are to be measured in accordance with the applicable IFRS, before the rule of measurement stated above is applied to the group. This is to be done both at the time of initial classification of the group as a disposal group and on subsequent measurement.

 **Example**

IFRS 5 excludes deferred tax assets, which are governed by IAS 12 Income Taxes. If the disposal group includes a deferred tax asset, it is remeasured in accordance with IAS 12 immediately before initial classification of the group as held for sale or its subsequent remeasurement.



7.2 Impairment loss

The above valuation method may lead to a situation where the carrying value of a non-current asset (or disposal group) classified as held for sale needs to be reduced to **fair value less costs to sale (which is lower than the carrying value)**. The shortfall is recognised as an impairment loss.

Subsequent increase in value

When fair value less costs to sell increases subsequently, an entity recognises the gain only to the extent of any cumulative impairment loss previously recognised in accordance with IFRS 5 or IAS 36.

In the case of a disposal group, on subsequent remeasurement of the asset, if some gain has already been recognised, then that part is not again recognised as a gain.

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When the asset (or disposal group) is sold.

A gain or loss not previously recognised by the date of the sale of a non-current asset (or disposal group) shall be recognised at the date of derecognition.

No depreciation or amortisation

While an asset is classified as held for sale or belongs to a group classified as such, it is not depreciated or amortised.

For an impairment loss of a disposal group, which asset values are to be changed?

In the accounting books, accounts of individual assets are maintained. Therefore, the change in value of the group has to be allocated, in the order of allocation set out in paragraphs 104(a) and (b) and 122 of IAS 36 Impairment of Assets (as revised in 2004). The relevant provisions are as follows:

The impairment loss shall be allocated in the following order:

- (a) First, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and;
- (b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

These reductions in carrying amounts shall be treated as impairment losses on individual assets and recognised as such.



Example

Rex & Rays detect an impairment loss of Tshs24 million on a disposal group of one of their business units. The goodwill of that particular unit was Tshs6 million. The other assets in the disposal group are building and machinery. The carrying value of the building is Tshs120 million and machinery Tshs60 million.

The loss is allocated in the following way:

	Tshs'000
Goodwill	6,000
Balance of impairment loss (Tshs24,000 - Tshs6,000)	18,000

This is allocated as follows :(Figures in Tshs'000)

Building: Tshs12,000 i.e. $(Tshs18,000 \times Tshs120,000 / Tshs180,000)$

Machinery: Tshs6,000 i.e. $(Tshs18,000 \times Tshs60,000 / Tshs180,000)$



Tip

Impairment loss is discussed in more detail in the next Study Guide B2.

A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata to the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised as such.

7.3 Changes to a plan for sale

If the criteria discussed above are not met, an entity should **cease to classify an asset or a disposal group as held for sale**.

These assets are measured at **the lower of:**

- (a) **The possible carrying value of the asset at the date of subsequent decision not to sell if it was not classified earlier as held for sale.** In other words, its carrying amount before the asset (or disposal group) was classified as held for sale, adjusted for any depreciation, amortisation or revaluations that would have been recognised had the asset (or disposal group) not been classified as held for sale and
- (b) **Its recoverable amount at the date of the subsequent decision not to sell.** If this is lower, it would indirectly mean the recognition of impairment loss based on the carrying value of the asset had the asset not been classified as held for sale?

Some adjustments would be needed in the carrying value in the period in which the classification is changed. The adjustments are included in income from continuing operations.



Example

On 1 January 20X5, the carrying value of an asset was Tshs60 million when it was classified as held for sale. Had it not been classified as held for sale, then the depreciation for 20X5 and 20X6 would have amounted to Tshs6 million each year and there would not have been any impairment loss.

On 31 December 20X6, the carrying value of the asset held for sale is Tshs50 million and the company does not intend to sell it any more. The recoverable amount of the asset is Tshs49 million.

If the asset had not been classified as held for sale then the carrying amount would have been Tshs60 million - Tshs6 million - Tshs6 million = Tshs48 million. Its recoverable amount would have been Tshs49 million.

The lower of the two is Tshs48 million. The asset is measured at this value on 31 March 20X6. This is compared to the current carrying amount i.e. the carrying amount on 31 March 20X6 which is Tshs50 million. Therefore the loss of Tshs2 million is recognised under continuing operations in the statement of profit or loss.

7.4 Changes in an individual asset or liability forming part of the disposal group

If the group (after the removal of individual items) still satisfies the criteria:

If an individual asset or liability is removed from the group, the remaining assets and liabilities will continue to be measured as a group only if the group meets the criteria mentioned under the definition of 'held for sale' given above.

Otherwise:

The group of assets would no longer exist. The assets would be split into those satisfying the criteria and those not satisfying the criteria:

- The assets which **satisfy** the criteria will be individually measured at the lower of the carrying amount and the fair value less costs to sell.
- The assets that **do not meet** the criteria **cease to be classified as held for sale**. Thereafter, the assets will be dealt with according to the applicable standard.

7.5 Non-current assets that are to be abandoned

Non-current assets or disposal groups that are to be abandoned are not classified as held for sale. The reason is that their value is expected to be recovered principally through continuing use.

However, if the disposal group meets the criteria for discontinued operations, it may be classified as a discontinued operation.

7.6 Presentation of a non-current asset or disposal group classified as held for sale

- (1) Non-current assets classified as held for sale or assets belonging to the disposal group are presented separately from the other assets in the statement of financial position.

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Example

An entity classifies a group of assets as a disposal group held for sale. It shall not present those assets under property, plant and equipment or current assets. It shall instead present the group separately in the statement of financial position.

- (2) Similarly, the liabilities of the disposal group classified as held for sale are presented separately from other liabilities in the statement of financial position.
- (3) Assets and liabilities are not offset and presented as a single amount.
- (4) Major classes of assets and liabilities are presented separately except a newly acquired subsidiary classified as held for sale on acquisition.
- (5) Any cumulative income or expenses related to the assets that are recognised directly in equity is separately presented.
- (6) It is not necessary to represent or reclassify the assets or liabilities in prior periods.

Are assets held for sale / disposal groups and discontinued operations always the same?

Not necessarily. The two are defined separately. The definition of a discontinued operation states that it is a component of an entity that has either been disposed of or classified as held for sale, and satisfies certain conditions. This means that if a component of an entity that represents a discontinued operation is not yet disposed of but is proposed to be sold, it is likely to be classified as a disposal group classified as held for sale.

The discussion in the previous paragraph leads us to the issue of accounting when the two are not the same

There may be non-current assets (disposal group) classified as held for sale that do not meet the definition of discontinued operations. Any gain or loss on remeasurement of such assets **is included in profit or loss from continuing operations**.



Example

Brake Inc. held a group of assets for disposal which had a liability connected to it. However, the group still does not fulfill the condition of discontinued operations.

A loss of Tshs50 million has been discovered on remeasurement of these assets. This loss is not included in discontinued operations but in the statement of profit or loss from continuing operations.



Test Yourself 18

Paradise Motels has four outlets: Paradise Inn, Paradise Joint, Paradise View and Paradise Lodge. It appoints a business reorganisation expert, Mr. Ray, who suggests some restructuring which it carries out in 20X5.

Paradise Lodge is to be discontinued. The assets & liabilities are not disposed of at the statement of financial position date, but will be disposed of in a single transaction. The profit shows a figure of Tshs50 million, assets Tshs350 million and liabilities Tshs125 million.

Part of Paradise View, i.e. a building along with its furniture, is being sold in a single transaction. The part has a loan liability which is also passed on in the same transaction. The business of the division is continued from an alternative location. On remeasurement of the assets, a loss of Tshs30 million occurs.

Required:

Show the presentation of the above restructuring in the financial statements.

8. Apply the requirements of international accounting standards to investment properties.**[Learning Outcome h]****8.1 Meaning of Investment property**

The properties discussed in the earlier sections were **owner-occupied properties**, used for the purpose of the business (e.g. factory or office building) and the land on which they are built.

**Definition**

An 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:

- (a) use in the production or supply of goods or services or for administrative purposes; or
- (b) sale in the ordinary course of business.

IAS 40 Para 5**Example**

An investment property is:

- (1) Land held for long-term capital appreciation or for currently undetermined future use.
- (2) A building owned or held by the entity under a finance lease which is either leased out or is vacant, but held to be leased out.

**Example**

Assets which are not investment properties:

- (1) Property **intended for sale**.
- (2) Property constructed on behalf of third parties.
- (3) **Owner-occupied properties**.

8.2 Recognition**Important**

Investment property should be recognised as an asset **when and only when**:

- (a) It is probable that the **future economic benefits** that are associated with the investment property **will flow** to the entity; **and**
- (b) The **cost** of the investment property **can be measured reliably**.

IAS 40 Para 16**Example**

Modern Ventures Plc constructed a building at a cost of Tshs2 million with an intention to let it out. Municipal authorities contended that it has not followed the stipulated procedures or plans and ordered Modern Ventures to demolish a part of the building. Construction is complete: only an approval from the municipal authorities in the form of a 'completion certificate' is to be received.

If we look at the conditions mentioned earlier, the second condition is satisfied i.e. the cost of the property can be measured reliably. However, it is not yet probable that the future economic benefits associated with the property in the form of rent income or capital appreciation will flow to Modern. The first condition is not satisfied.

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Therefore, Modern should not recognise the property as investment property. It may have to consider an impairment loss under IAS 16.

8.3 Measurement at recognition to be at cost

According to Para 20 of IAS 40, an investment property should be **measured initially at its cost. Transaction costs should be included** in the initial measurement.

The meaning of cost is the same as that under IAS 16 Property, Plant and Equipment discussed earlier in this Study Guide.

8.4 Leases

From the definition of investment property, note that a lessee under a **finance lease** is treated on a par with the owner. In other words, the lessee **can recognise the property** in its financial statements.

A property held by a lessee under an operating lease may also be classified and accounted for as investment property if, and only if, it would otherwise meet the definition of investment property and the lessee uses the fair value model (see next section) for the asset recognised.

Property interest held under a lease (and classified as an investment property)

This will be guided by IAS 17, paragraph 20. The initial costs should be recognised as the **lower of the fair value of the property and the present value of the minimum lease payments** and an equivalent amount should be recognised as a liability. A premium paid for a lease is treated as part of the minimum lease payments.



Test Yourself 19

Khatir Holdings LLC holds a property lease, for which it paid a premium of Tshs1 million.

As per the terms, it has to pay Tshs0.2 million per annum for next five years, the present value of which is Tshs0.76 million. The asset's fair value is Tshs1.9 million.

Khatir wants to recognise the property as an investment property under IAS 40, as it intends to rent out the property. It seeks your advice to decide the initial cost of the property.

8.5 Measurement after recognition

IAS 40 stipulates that an entity should choose as its accounting policy:

- (i) either the **fair value model**; (ii)
or the cost model

The policy selected should be applied to all of its investment property.

The fair value model was previously allowed only for financial assets. It is only recently that it has been allowed for non-financial assets such as investment properties.

(1) Fair value model



Definition

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

IAS 40 Para 5

Let us understand the three key components of this definition.

The buyer and seller are said to be **knowledgeable** when they have full information about the **nature and uses of the property and market conditions** at the end of reporting period.

A **willing buyer** is motivated, but not compelled to buy; a **willing seller** is neither an over-eager nor a forced seller.

An arm's length transaction is one between parties who are not related in such a way as to influence prices.

Fair value should be based on market conditions **at the end of reporting period**.



Example

Wilcox Inc owns an investment property. It applies the fair value model. At the end of reporting period, it has the following information:

An estate agent who deals in similar properties in the same locality gives the opinion that the fair value of the property is Tshs1.5 million and supports it with market data. The finance manager says that Mr Peter has given an offer of Tshs0.9 million and that the company should value the property at Tshs0.9 million only. Mr Peter is related to the majority shareholder of the company. Advise the company.

In this case

IAS 40 clearly lays down that the market-based value should be selected. The offer given by Mr Peter is uncharacteristic of market conditions, since he is a relative of the majority shareholder. Hence the value of Tshs1.5 million should be treated as the fair value of the property.

After initial recognition, an entity selecting the fair value model should measure **all of its investment property at fair value**. We have seen that initial recognition will be at cost for all the investment properties.

There is a rebuttable presumption that an entity can determine fair value on a continuing basis. Only in rare exceptions change from fair value model to cost model is permitted.

The IAS expects that once an entity measures an investment property at fair value, it should continue to do so **until**:

- (a) disposal; or
- (b) the property becomes owner-occupied property; or
- (c) the entity begins to develop the property for subsequent sale.

While determining fair values, double-counting is to be avoided in the case of assets or liabilities that are recognised as specific assets or liabilities.



Example

The fair value of a leased furnished office will normally include the fair value of furniture also. In this situation, it should be ensured that the furniture value is not counted again.

A change in accounting policy from the fair value model to the cost model is allowed only when the change will result in a more appropriate presentation. The IAS adds that it is highly unlikely that a change from **fair value model to the cost model** will result in more appropriate presentation; it therefore discourages a change in this direction.

Gain or loss on change in the fair value



Definition

A gain or loss arising from a change in the fair value of investment property should be **recognised in the profit or loss** for the period in which it arises.

IAS 40 Para 35



Test Yourself 20

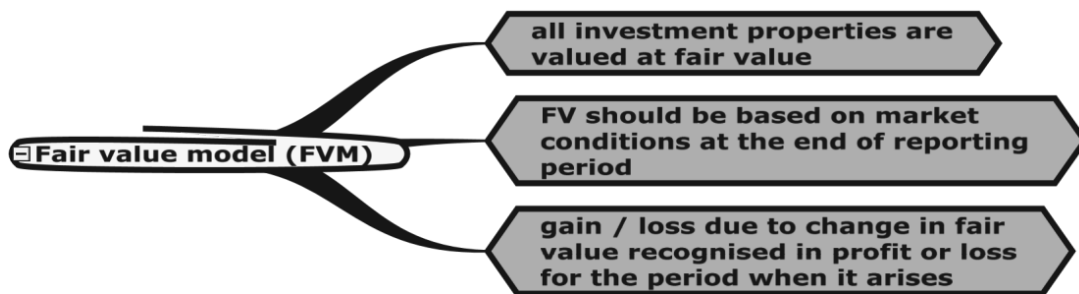
The carrying values of buildings A and B are Tshs60 million and Tshs80 million respectively. Their fair values are determined at Tshs50 million and Tshs88 million. Discuss the accounting under the fair value model.



Tip

Compare the above solution with the revaluation model under IAS 16. You will find that in the revaluation model, you need to keep track of the history of the earlier revaluations and their accounting. This is not required here in the fair value model. Whatever the gain or loss, is recognised in the statement of profit or loss.

SUMMARY



(2) Cost model

After initial recognition, an entity that chooses the cost model should measure all of its investment property in accordance with IAS 16's requirements for that model, other than those that meet the criteria to be classified as held for sale.

After initial recognition, investment property is accounted for in accordance with the cost model as set out in IAS 16, Property, Plant and Equipment, i.e. at cost less accumulated depreciation less accumulated impairment losses.

Transfers

We have seen that a property satisfying certain conditions is classified as an investment property. If the conditions change, a necessity may arise to **transfer a property from investment to another category and vice-versa**. The IAS states that such transfers should be made when and only when there is a **change in use**.

Transfer type	Manner of transfer
(1) When the entity uses the cost model (for any kind of non-current asset.)	At carrying amounts.
(2) Investment property carried at fair value to owner - occupied property or inventories.	The properties deemed cost for subsequent accounting in accordance with IAS 16 or IAS 2 should be its fair value as on the date of change.
(3) Owner - occupied property to investment property to be carried at fair value.	An entity should apply IAS 16 up to the date of change; any difference between carrying value and fair value should be treated as a revaluation surplus in accordance with IAS 16.
(4) Inventory to investment property to be carried at fair value.	Any difference between fair value (as an investment property) and previous carrying value (as inventory) should be recognised in profit or loss.



Example

A building held as investment property has a carrying value of Tshs150 million. If transferred to owner-occupied property (governed by IAS 16), its cost will be deemed to be Tshs150 million.



Example

A building depreciates and has a net depreciated carrying value of Tshs75 million. It is transferred to investment property at a fair value of Tshs100 million. The difference of Tshs25 million should be accounted for as a revaluation surplus.

8.6 Retirement or disposal

An investment property shall be derecognised (eliminated from the statement of financial position) 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 are:

- (a) Equal to the difference between net disposal proceeds and carrying amount of the asset.
- (b) Recognised in the statement of profit or loss in the period when the asset is sold or retired.

For sale and leaseback transactions, IAS 17 should be followed.



Test Yourself 21

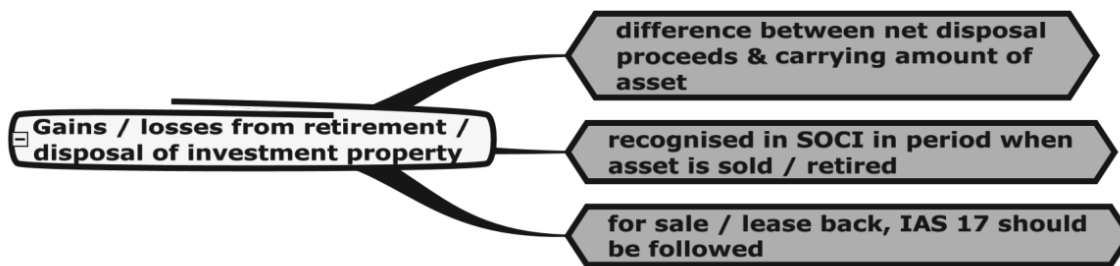
Kevin & Co had an investment property with an original cost of Tshs 3 million and carrying value of Tshs4 million. It sells the property for Tshs5 million, incurs brokerage of Tshs0.2 million and stamp duty of Tshs0.25 million for the transaction.

Required:

Show the correct accounting treatment.

Compensation received: If an investment property was impaired or lost and any compensation is received from third parties, it should be recognised in the statement of profit or loss when the compensation becomes receivable.

SUMMARY



Test Yourself 22

James Mettles owns an investment property X which it accounts for under the cost model. On 1 January 20X7, its cost is Tshs250 million, and the accumulated depreciation Tshs75 million. It sells the property on the same day for Tshs180 million. It has another investment property Y, with a cost of Tshs45 million and accumulated depreciation Tshs20 million. The property is transferred to the inventory category.

Required:

Explain the accounting for these transactions / events.

Answers to Test Yourself

Answer to TY 1

- (a) Small spares are treated as inventory and recognised in the statement of profit or loss when consumed. They are not to be recognised as property, plant and equipment.
- (b) The standby equipment is recognised under the heading 'property, plant & equipment', because it is expected to be used during more than one period and future economic benefits will flow to the company.
- (c) The machinery is **not** recognised as property, plant & equipment, since it is doubtful whether future economic benefits will flow to the entity.

Answer to TY 2

Cost to be capitalised of new specialised machinery

	Tshs'000
Cost of construction of new site	60,000
Cost of new machinery	200,000
Cost of Installation	3,000
Freight	4,000
Trial run cost	4,200
Total cost of Machinery	271,200

Notes: (Amounts figures in Tshs'000)

- (i) Since it is an existing site, which Daffodil was already using for the old machine, the dismantling costs would have been added to the old machinery and a provision for dismantling cost would have been created accordingly. Also, the scrap value recovered will be credited to the old machinery account. Hence these two items are to be ignored for the purpose of calculating the cost of the new machine.

(ii) The new machinery is valued at the fair value given. Accordingly, the journal entry for acquisition of new machinery will be:

Dr New machinery	Tshs200,000	
Dr Loss on old machinery (Tshs50,000 - Tshs40,000)	Tshs10,000	
Cr Old machinery		Tshs50,000
Cr Cash		Tshs160,000
Being new machinery purchased		

(Remember, this is a combined entry and the valuation of the new machinery is already given in the question - i.e. Tshs200,000 - which will be settled by exchanging old machinery for Tshs40,000 and paying the balance in cash Tshs160,000.)

(iii) Cost of launching and the initial loss are not to be included in cost of machinery (IAS 16 states that costs of introducing a new product or service and initial operating losses are not to be considered costs of the asset). Trial run costs are included in the cost of the machinery to ensure that the machine is in working condition.

Answer to TY 3

The cost of steel is to be taken at Tshs200 million plus the freight & clearing (Tshs10 million) = Tshs210 million. This value will be added to the cost of plant (a tangible non-current asset).

In addition to the cost of steel, the cost of other material used and wages paid to the workers to erect the plant will be added to the cost of plant. Internal profit of Head Office is not to be included in the cost.

Answer to TY 4

The stadium cannot be used unless the Ticket booking office and the doors of the stadium are completed. We cannot say that it is substantially ready for its intended use. Therefore, capitalisation of borrowing costs need not be stopped, according to the provisions of IAS 23 until these final areas are completed.

Answer to TY 5

The revaluation **decrease for machine A** is Tshs10 million (Tshs60 million - Tshs50 million). The credit balance in revaluation surplus against this asset is Tshs7 million. The following entry should be made:

	Tshs'000	Tshs'000
Dr Revaluation surplus (in equity)	7,000	
Dr Loss on revaluation - Profit or loss part	3,000	
Cr Machinery		10,000
Being revaluation decrease transferred to machinery account		

Answer to TY 6

The revaluation increase for X is Tshs15 million (Tshs85 million - Tshs70 million)

The credit balance in revaluation surplus against this asset is Tshs4 million.

The following entry should be made:

	Tshs'000	Tshs'000
Dr Machinery	15,000	
Cr Revaluation surplus (equity)		15,000
Being the entry to record the increase in the valuation of machinery		

This brings the asset value to Tshs85 million and the revaluation surplus to Tshs19 million (Tshs4 million +Tshs15 million).

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Decrease for Y is Tshs5 million (Tshs40 million - Tshs35 million). The previous reduction was Tshs3 million. This must have been recognised in the statement of profit or loss, according to IAS 16. The following entry should now be made:

		Tshs'000	Tshs'000
Dr	Loss on revaluations	5,000	
	Cr Machinery		5,000

Being the entry to record the decrease in the valuation of machinery

Answer to TY 7

Building P: the revaluation surplus of Tshs535 million is transferred directly to retained earnings:

		Tshs'000	Tshs'000
Dr	Revaluation surplus	535,000	
	Cr Retained earnings		535,000

Being revaluation surplus of building P transferred to retained earnings on sale of the building

Building Q: Blue Ltd may transfer Tshs26.5 million (i.e. Tshs66.5 million - Tshs40 million, the difference between the depreciation based on the revalued carrying amount of the asset and that based on its original cost) to retained earnings:

		Tshs'000	Tshs'000
Dr	Revaluation surplus	26,500	
	Cr Retained earnings		26,500

Being the surplus transferred from revaluation surplus to retained earnings.

Answer to TY 8

Treatment to be given by Laurel and Hardy in their accounts

	20X0	20X1	20X2	20X3
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Cost / revalued amount of machineries	1,000,000	900,000	711,111	962,500
Impairment /Revaluation		800,000	1,100,000	750,000
Less : Depreciation	(100,000)	(88,888) (note 4)	(137,500)	(107,142)
Balance (WDV)	900,000	711,111	962,500	642,857
Revaluation gain / (loss)		(100,000)	388,888	(212,500)
Transfer to revaluation surplus		-	288,888	(76,388) (note 3)
Transfer to statement of profit or loss		(100,000) (note1)	100,000 (note 2)	

(Amounts in Tshs'000)

Note 1: Debit to the statement of profit or loss.

Note 2: Credit to the statement of profit or loss.

Note 3: The balance in the Revaluation surplus will be (Tshs288,888 - Tshs212,500) = Tshs76,388 to be carried forward in the year 20X4.

Note 4: Depreciation calculated on revalued amount i.e. Tshs800,000 for remaining useful life of 9 years.

Answer to TY 9

(a) The cost of upgrading machines is capital expenditure as it improves their earning capacity. It should be debited to the machinery account. Assuming that there is no replacement of any parts, no derecognition is required. The entry for correction is:

Dr Machinery account	Tshs175 million	
Cr Repairs and maintenance		Tshs175 million

Being the cost of upgrading the machines Depreciation will be charged on Tshs175 million.

(b) The cost of the new part for Tshs62,500 will be capitalised, and depreciation charged thereon, along with the other assets.

The entry for correction is

Dr Machinery account	Tshs62.5 million	
Cr Repairs and maintenance		Tshs62.5 million

Being the cost of new plant wrongly debited to repairs and maintenance, now transferred to machinery account

The old part should be derecognised from machinery and transferred to a disposal account, as:

Dr Disposal of machinery account	Tshs7 million	
Cr Machinery account		Tshs7 million

Being machinery disposed and machinery account nullified

Sale proceeds have been wrongly credited to sales. The following rectification entry is needed:

Dr Sales account	Tshs4 million	(Since wrongly credited)
Dr Loss on disposal of machinery parts	Tshs3 million	
Cr Disposal of machinery account		Tshs7 million

Being amount wrongly credited to sales now corrected and the loss on sale of machinery accounted for

- (c) Servicing costs are correctly debited to repairs and maintenance account. No correction is required.
- (d) The interest attributable to upgrading of machinery has to be capitalised with the machinery as it is borrowing cost for machinery.

Dr Machinery	Tshs12.52 million	
Cr Interest		Tshs12.52 million

Being interest attributable to machinery is capitalised

Answer to TY 10

(a) **Depreciation** =
$$\frac{\text{Cost of asset} - \text{residual value of asset}}{\text{Total estimated units of output}}$$

$$= \frac{\text{Tshs } 100\text{m} - \text{Tshs } 20\text{m}}{800,000 \text{ units}}$$

$$= \text{Tshs } 100 \text{ per unit}$$

We now use the value of Tshs 100 per unit by the number of units of output per year.

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(b) Depreciation schedule

Year ended 31 December	Production	Annual depreciation	Carrying value
	Units	Tshs'000	Tshs'000
		-	100,000
20X6	150,000	15,000	85,000
20X7	200,000	20,000	65,000
20X8	190,000	19,000	46,000
20X9	150,000	15,000	31,000
20Y0	110,000	11,000	20,000

Note: Carrying value at 31 December 20Y0 is Tshs20 million (the value at which it is expected to be sold).

Answer to TY 11

To identify the items of plant, let us give them nos. I, II and III.

Plant & machinery account

Dr			Cr		
20X4	Particulars	Tshs'000	20X4	Particulars	Tshs'000
1-Jan	Bank (purchase: plant I)	72,000			
1-Jan	Conditioning of plant I	48,000			
1-Jul	Bank (purchase: plant II)	48,000	31-Dec	Balance c/f Plant I	120,000
				Plant II	48,000
20X5		168,000	20X5		168,000
1-Jan	Balance b/f Plant I	120,000			
	Plant II	48,000	31-Dec	Balance c/f Plant I	120,000
				Plant II	48,000
		168,000			168,000
20X6			20X6		
1-Jan	Balance c/f Plant I	120,000		Plant disposal account	120,000
	Plant II	48,000			
1-Jul	Bank (purchase: plant III)	144,000	31-Dec	Balance c/f Plant II	48,000
				Plant III	144,000
		312,000			312,000

Accumulated depreciation account

Property, Plant and Equipment: 91

20X4			20X4		
			31-Dec	Depreciation On plant I (W1)	18,000
				On plant II (W1)	3,600
31-Dec	Balance c/f Plant I	18,000			
	Plant II	3,600			
		21,600			21,600
20X5			20X5		
			1-Jan	Balance b/f Plant I	18,000
				Plant II	3,600
			31-Dec	Depreciation On plant I (W2)	15,300
				On plant I (W2)	6,660
31-Dec	Balance c/f Plant I	33,300			
	Plant II	10,260			
		43,560			43,560

20X6			20X6		
			1-Jan	Balance b/f Plant I	33,300
				Plant II	10,260
31-Jul	Plant disposal Account (Accumulated depreciation on plant I transferred)	39,803	31-Jul	Depreciation Plant I (W2)	6,503
			31-Dec	Depreciation On plant II (W3)	5,661
				On plant III (W3)	10,800
31-Dec	Balance c/f Plant II	15,921			
	Plant III	10,800			
		66,524			66,524

Plant disposal account

Dr			Cr		
20X4	Particulars	Tshs'000	20X4	Particulars	Tshs'000
1-Jan	Plant & machinery account (plant I)	120,000	1-Jul	Accumulated depreciation	39,803
			1-Jul	Bank (sale proceeds: plant I)	60,000
			1-Jul	SOPL - loss on sale (W4)	20,197
		120,000			120,000

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Workings (All figures in Tshs'000)

W1 Depreciation (20X4)

- Plant I (full year) $((\text{Tshs}72,000 + \text{Tshs}48,000) \times 15\%) = \text{Tshs}18,000$
- Plant II (6 months) $(\text{Tshs}48,000 \times 15\% \times 6 / 12) = \text{Tshs}3,600$

W2 Depreciation (20X5)

	Tshs'000
Plant I (full year) $((120,000 - 18,000) \times 15\%)$	15,300
Plant II (full year) $((48,000 - 3,600) \times 15\%)$	6,660

W3 Depreciation (20X6)

	Tshs'000
Plant I (6 months) $((\text{Tshs}102,000 - \text{Tshs}15,300) \times 15\% \times 6/12)$	6,503
Plant II (full year) $((\text{Tshs}44,400 - \text{Tshs}6,660) \times 15\%)$	5,661
Plant III (6 months) $((\text{Tshs}144,000 \times 15\% \times 6/12)$	10,800

W4 Profit / loss on sale of plant

	Tshs'000
Sale proceeds	60,000
Less: carrying value:	
Cost	120,000
Accumulated depreciation	(39,803)
$(18,000 + 15,300 + 6,503)$	(80,197)
Loss on sale	(20,197)

Answer to TY 12

This is a case of a complex asset, where different components are treated differently for the calculation of depreciation. First we need to calculate the carrying value of the components at 30 September 20X6 (after the completion of 8 years)

Component	Cost	Depreciation	Carrying value
	Tshs'million	Tshs'million	Tshs'million
Engine	102.00	(76.50) $(102/40,000 \times 30,000)$	25.50
Outer casings	306.00	(97.92) $(306/25 \times 8)$	208.08
Other components of machine	153.00	(102.00) $(153/12 \times 8)$	51.00
	561.00	(276.42)	284.58

The following adjustments are needed before we calculate the depreciation charge for the year:

1. The carrying value of the existing engine (Tshs25.5 million) is derecognised i.e. written off. The cost of the new engine (Tshs142.8m) is recognised as an asset.
2. Polishing and painting (Tshs0.78 million) is an expense and is to be charged to statement of profit or loss as a repairs and maintenance expense.
3. The upgrade of other components is recognised as an asset. Since there is no replacement of existing parts, there is no derecognition.

Depreciation for the year to and the carrying value at 30 September 20X7

(All figures in Tshs'million)

Component	Cost	Additions	Deductions	Total	Depn b/fwd	Depn for year	Deductions	Total	Carrying amount
Engine	102	142.80	(102.00)	142.50	76.50	14.28	(76.50)	14.28	128.52
Casings	306	-	-	306.00	97.92	12.24	-	110.16	195.84
Components	153	61.20	-	214.20	102.00	22.44	-	124.44	89.76
Total	561	204.00	(102.00)	662.70	276.42	48.96	(76.50)	248.88	414.12

Notes:

- No depreciation is provided on the old engine. The charge for the new engine is Tshs142.8 million / 50,000 hours x 5,000 hours = Tshs14.28 million.
- The charge for the casings is Tshs306.0 million / 25 years = Tshs12.24 million, as calculated earlier for the b/fwd figures.
- Carrying amount of old components will be depreciated over 5 years: (Tshs153.0 million – Tshs102.0 million) / 5 years = Tshs10.2 million.

New additions to the components will also be depreciated over 5 years: (Tshs61.2 million / 5 years = Tshs12.24 million). Total depreciation on these two is Tshs10.2 million + Tshs12.24 million = Tshs22.44 million.

Answer to TY 13

It can **either** show the grant of Tshs4 million as an income item and Tshs5 million expense as an expenditure item, **or** deduct the grant from the expense and show a net expense of Tshs1 million (with appropriate disclosures).

Answer to TY 14

The carrying value of the asset as on the date of repayment was:

	Tshs'000
Gross cost	6,000
Less: Grant received	(4,000)
Carrying value	2,000
Depreciation for 2 years	(400)
Net carrying value	1,600

During 20X4 Tipla Chemicals has to return back the government grant received

At that point of time

- Depreciation on Tshs6 million (ignoring grant) = Tshs1.2 million (for 2 years)
- Additional accumulated depreciation = Tshs0.8 million (Tshs1.2 million – Tshs0.4 million).

The following **two accounting adjustments** should be made:

Repayment of the grant of Tshs4 million should be debited to the equipment account, thereby increasing its carrying amount:

Dr Equipment Tshs4 million
 Cr Bank Tshs4 million

Being increase in cost due to repayment of grant

Additional depreciation worth Tshs0.8 million should be charged in the statement of profit or loss and credited to accumulated depreciation. The revised gross amount should be Tshs6 million (Tshs2 million + Tshs4 million) accumulated depreciation, Tshs1.2 million (Tshs0.4 million + Tshs0.8 million) and the carrying value, Tshs4.8 million (Tshs1.6 million + Tshs4.0 million – Tshs0.8 million).

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Note that this would have been the carrying value had there been no grant since beginning .i.e. Tshs6 million – Tshs1.2 million (2 years' depreciation at 10% straight-line) = Tshs4.8 million.

Answer to TY 15

The repayment of Tshs4 million should be first reduced from the balance in the grant deferred income account to the extent of Tshs3.2 million, making it zero. The excess of Tshs0.8 million (Tshs4.0 million - Tshs3.2 million) Tshs0.8 million should be recognised as an expense immediately. It should be noted that this is equal to that part of the grant that was earlier recognised as income.

Answer to TY 16

(a) Jerome intends to sell the manufacturing facility with the operations. The incomplete customer orders on the sale date will be transferred to the customer.

This transfer of incomplete customer orders on the sale date does not have any effect on the timing of the transfer of the product. The requirement of IFRS 5 para 7 would be met on the sale commitment date.

(b) Jerome still intends to sell the manufacturing facility, but only after the completion of orders. The delay caused in the timing shows that the product is not available for immediate sale. The requirement of IFRS 5 para 7 therefore cannot be met until the customers' orders are executed, although the entity's purchase commitment for future transfer of the product was received earlier.

Answer to TY 17

1. A property given on rental is shown under investment properties.
2. Machinery used for production is shown under Plant and Machinery of non – current assets group.
3. A car not in used for which a prospective buyer is being looked for is shown as an asset held for sale.
4. The property under mortgage along with the loan is shown in financial statements as disposal group held for sale.

Answer to TY 18

Paradise Lodge satisfies the definition of discontinued operations. Therefore, the profit of Tshs50 million is included in the amount of discontinued operations, along with the details of revenue, expense, pre-tax profits, tax and post-tax profits.

The assets and liabilities satisfy the definitions of a disposal group held for sale. They are re-measured and the gain / loss on re-measurement are also disclosed along with the income tax expense related to the gain / loss in results from discontinued operations.

The assets and liabilities are disclosed separately in the statement of financial position as a disposal group held for sale.

Paradise View: The assets satisfy the criteria for recognition as a disposal group held for sale and are disclosed separately in the statement of financial position.

However, the measurement loss of Tshs30 million is not presented under discontinued operations, since the assets do not meet the criteria. Instead, it is included in the profit or loss from continuing operations.

Answer to TY 19

Khatir Holdings LLC can recognise the property as an investment property, as it intends to rent it out.

The present value of minimum lease payments is Tshs1.76 million (including the premium), while the fair value is Tshs1.9 million. The lower of the two (i.e. Tshs1.76 million) will be recognised as the initial cost of the investment property.

Answer to TY 20

For building A, there is a loss of Tshs10 million (Tshs50 million – Tshs60 million). The accounting entry is:

Dr	Loss on valuation of investment property (profit or loss part)	Tshs10 million	
	Cr	Investment property (Building)	Tshs10 million

Being loss on revaluation of property recorded

For building B, there is a gain of Tshs8 million (Tshs88 million – Tshs80 million):

Dr	Investment property (Building)	Tshs8 million	
	Cr Profit on valuation of investment property (profit or loss part)		Tshs8 million
	(Profit on valuation of investment property)		
Being profit on valuation of property recorded			

Both of these should be recognised in profit or loss part of statement of profit or loss and other comprehensive income.

Answer to TY 21

	Tshs'000
Net disposal proceeds (Tshs5,000 – Tshs200 – Tshs250)	4,550
Carrying amount	(4,000)
Gain on disposal	550

Answer to TY 22

The accounting entry for the sale of property X will be:

	Tshs'000	Tshs'000
Dr Bank / cash	180,000	
Dr Accumulated depreciation	75,000	
Cr Property X		250,000
Cr Profit on sale of investment property		5,000
Being entry to record the sale of property and the profit on sale		

The entry for the transfer of property Y will be

	Tshs'000	Tshs'000
Dr Inventory	25,000	
Dr Accumulated depreciation	20,000	
Cr Property Y		45,000
Being entry to transfer investment property Y to inventory		

Quick Quiz

1. "An asset expected to be realised within twelve months is a non-current asset." True or false?
2. What is the difference between measurement at recognition and measurement after recognition?
3. On revaluation, the value of a property increased by Tshs100 million. On the previous occasion, its value had decreased by Tshs60 million. Select the correct amount to be credited to revaluation surplus: (a) Tshs100 million; (b) Tshs40 million; (c) Tshs60 million.
4. Bilton Flasks has a revaluation reserve Tshs350 million generated by revaluation of a property 5 years ago. The property is still being used for the business. The accountant of Bilton has recommended that, since the balance is old, it should be transferred to retained earnings in its entirety. Advise.
5. What is the ideal rate of depreciation on land in normal circumstances?
6. "Deducting a grant related to an asset from the value of the asset amounts to the capital approach whereas the IAS 20 recommends the income approach." Discuss in brief.
7. An asset stands at Tshs80 million in the statement of financial position at 31 December 20X5. A grant worth Tshs50 million received for that asset is shown as a deferred income. The entity has to repay the grant forthwith. Will the asset's carrying value change? If so, by how much?

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8. Regarding unrealised gains / losses on changes in fair values, what is the difference between the recommendations of IAS 16 and IAS 40?

Answers to Quick Quiz

1. False.
2. Measurement at recognition refers to measuring the value of an asset **for initial recording**. Measurement after recognition refers to determining the carrying value **after initial recognition**.
3. (b) (revaluation increase less previous decrease written off to statement of profit or loss (Tshs100 million–Tshs60 million)) = Tshs40 million.
4. Since the property is still in use, Bilton cannot transfer it to retained earnings in its entirety. The amount that can be transferred from revaluation surplus to retained earnings is the difference between the depreciation on the revalued amount and the depreciation of the original cost. (For the period after the revaluation date)
5. No depreciation should be charged on land in the normal circumstances.
6. No. It is still an income approach in the sense that the depreciation amount is reduced and, indirectly, income is increased.
7. No. The repayment should be debited to deferred income.
8. In the revaluation model governed by IAS 16, you need to keep track of the history of earlier revaluations and their accounting. This is not required in the fair value model governed by IAS 40: whatever the gain or loss is recognised in profit or loss.

Self-Examination Questions

Question 1

Sintel Plc purchased a depreciating asset, expected to last for 4 years, for Tshs500 million. It received a grant equal to 60% thereof. Residual value is expected to be negligible. Explain the accounting for the grant and the depreciation under the straight-line method, showing the alternative computations under the deferred income method and the deduction from assets method. Also show statement of financial position presentations at the end of the third year under the two methods.

Question 2

The carrying value of property X is Tshs120 million and of property Y, Tshs160 million. They are revalued at Tshs100 million and Tshs176 million respectively. On the previous revaluations, X's value was increased by Tshs14 million (being the amount lying to the credit of revaluation surplus against this asset) and Y's value decreased by Tshs10 million. Show the accounting entries under the alternative assumptions that the properties are:

1. owner-occupied properties
2. investment properties

Question 3

Alpha follows the cost model when measuring its property, plant and equipment. One of its properties was carried at Tshs5.70 million in the statement of financial position as at 31 March 20X8. The depreciable amount of this property was estimated at Tshs3.42 million on 31 March 20X8 and the estimated future economic life of the property on 31 March 20X8 was 25 years. Alpha depreciates its properties on a monthly basis.

On 1 January 20X9 Alpha decided to dispose of the property as it was surplus to its requirements and began to actively seek a buyer. On 1 January 20X9, Alpha estimated that the market value of the property was Tshs6.745 million and that the costs of selling the property would be Tshs76,000. These estimates remained appropriate on 31 March 20X9.

The property was sold on 1 June 20X9 for the net proceeds of Tshs6.65 million.

Required:

Explain, with relevant calculations, how the property would be treated in the financial statements of Alpha for the year ended 31 March 20X9 and the year ending 31 March 20Y0.

Question 4

Glenplast Plc purchased a plant for Tshs120 million on 1 January 20X6. The company incurred an expenditure of Tshs24 million for installation and transportation of the plant to the factory. It was expected to have a residual value of Tshs4 million, and its useful life was estimated at 10 years. The company uses straight line method for charging depreciation. After 3 years, it was discovered that the original estimate of useful life was wrong and that the actual total useful life would be only 8 years. Furthermore the expected residual value of the plant was Tshs2 million only.

Required:

Calculate the revised depreciation.

Answers to Self-Examination Questions

Answer to SEQ 1

Straight-line method of depreciation

Year	Deferred income method of grant accounting				Deduction from asset	
	Depreciation	Carrying	Grant income	Carrying	Net	Carrying
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
	a	b	c	d	e	f
1	125,000	375,000	75,000	225,000	50,000	150,000
2	125,000	250,000	75,000	150,000	50,000	100,000
3	125,000	125,000	75,000	75,000	50,000	50,000
4	125,000	-	75,000		50,000	-
	500,000		300,000		200,000	

Note that column a – c = e
Similarly, column b – d = f

Extracts from the statement of financial position at the end of the third year:

	Deferred income method (Tshs'000)	Deduction from asset method (Tshs'000)
Non-current assets	125,000	50,000
Deferred income (grant)	75,000	Not applicable

It may be noted that the net asset value under both the methods is equal to Tshs50 million.

Answer to SEQ 2

1. If the properties are owner-occupied

Revaluation **decrease in case of property X** is Tshs20 million (Tshs120 million – Tshs100 million). Credit balance in revaluation surplus against this asset is Tshs14 million.

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The following entry should be passed:

Dr	Revaluation surplus (In equity)	Tshs14 million	
Dr	Profit / loss on revaluations (profit or loss part) (This account will be transferred to the (SOCl))	Tshs6 million	
Cr	Property		Tshs20 million

Being loss on revaluation accounted for.

Increase regarding property Y is Tshs16 million (Tshs176 million – Tshs160 million). Previous reduction Tshs10 million

This must have been recognised in profit or loss, according to IAS 16.

The following entry should be passed:

Dr	Property	Tshs16 million	
Cr	Profit / loss on revaluations		Tshs10 million
Cr	Revaluation surplus (in equity)		Tshs6 million

Being profit on revaluation accounted for.

2. If the properties are investment properties

The gains or losses caused by increase or decrease in the fair values will be recognised in the profit or loss immediately. There is no need to keep track of the earlier variations in the values.

For property X

Dr	Loss on investment properties	Tshs20 million	
Cr	Investment property X		Tshs20 million

Being loss on revaluation of investment property transferred to statement of profit or loss.

For property Y

Dr	Investment properties	Tshs16 million	
Cr	Profit on investment property Y		Tshs16 million

Being profit on revaluation of investment property transferred to statement of profit or loss.

Answer to SEQ 3

(All figures in Tshs'000 unless stated otherwise)

Year ended 31 March 20X9

On 1 January 20X9 the property would be designated as 'held for sale'. The implications of this treatment are that the property would cease to be depreciated, and will be presented as a separate line item in the statement of financial position as non-current assets held for sale.

The depreciation on the property to the date of classification as held for sale would be Tshs103 (Tshs3,420 x 1/25 years x 9/12 months) and this would be charged as an operating expense in the statement of profit or loss.

The carrying value of the property immediately before reclassification of Tshs5,597 (Tshs5,700 - Tshs103) would be compared with its 'fair value less costs to sell' of Tshs6,669 (Tshs6,745 - Tshs76). The new carrying value of the property is the lower of these two amounts - in this case Tshs5,597.

Year ended 31 March 20Y0

No depreciation will be charged on the property.

At the date of sale, the profit on sale amounting to Tshs1,053 (Tshs6,650 - Tshs5,597) will be reported in the statement of profit or loss.

Answer to SEQ 4

Step 1: Calculate the carrying value (CV) of asset

The initial depreciation under the straight-line method is calculated as:

$$\begin{aligned} \text{Depreciation (p. a.)} &= \frac{\text{Depreciable amount}}{\text{Estimated useful life}} \\ &= \frac{(\text{Tshs } 120\text{m} + \text{Tshs } 24) - \text{Tshs } 4}{10 \text{ years}} \\ &= \text{Tshs}14,000 \end{aligned}$$

Depreciation charged for 3 years = Tshs14 million x 3 = Tshs42 million

Carrying value after 3 years = Tshs140 million - Tshs42 million = Tshs98 million

Step 2: Calculate the revised depreciable amount

$$\text{Revised depreciable amount (RDA)} = \frac{\text{CV} - \text{Revised}}{\text{Old residual value}}$$

Residual value (revised) = Tshs2 million

Therefore revised depreciable amount (RDA) = Tshs98 million - Tshs2 million = Tshs96 million

Step 3: Determine revised useful life

(RUL) = Re-estimated useful life – No. of years already depreciated

Revised remaining useful life (RUL) = 8 years – 3 years = 5 years

Step 4: Revised depreciation

$$= \frac{\text{RDA}}{\text{RUL}}$$

Revised depreciation = Tshs96 million / 5 years
= Tshs19.20 million

STUDY GUIDE B2: IMPAIRMENT

Get Through Intro

Most companies have assets that are recorded on their statement of financial position at historical cost. These assets are depreciated annually. What happens if an asset is no longer used by the entity, but is not sold? Should the entity still have it on the statement of financial position? If so, at what value? For example, take a specialised computer which was bought for Tshs3 million. It is now two years old and has already been depreciated by Tshs1.5 million as its useful life was estimated at four years. Although its net book value in the accounts is Tshs1.5 million, it has only been used for very basic functions, as the company has bought up to date, faster machines. Does it make sense to still have it valued at Tshs1.5 million in the accounts? Probably not, since its usefulness to the company is now extremely limited, as the future economic benefits are likely to be low. We say that the computer has been 'impaired'. The question now arises: at what value should it be stated in the financial statements?

By reading this Study Guide, you will understand the concept of impairment and be able to carry out related calculations and accounting entries. With this, you will be able to deal with impairment of any assets that your company holds. This is extremely important as often non-current assets are among the most important items on the statement of financial position and you need to ensure that they are fairly valued.

Learning Outcomes

- a) Define impairment losses and identify circumstances that may indicate that an impairment of an asset has occurred.
- b) Recognise and measure impairment loss.
- c) Define a cash-generating unit and allocate impairment loss to the assets of a cash-generating unit.

1. Define impairment losses and identify circumstances that may indicate that an impairment of an asset has occurred.

[Learning Outcome a]

1.1 Impairment of assets



Definition

An **impairment loss** is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.

IAS 36 Para 6

In order to understand the definition of an impairment loss it is necessary to understand the meaning of the following terms.



Definition

An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Framework Para 49



Definition

A **cash-generating unit** is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

IAS 36 Para 6

This basically means that the entity's assets are broken down into groups of assets. Each of these groups can independently generate cash flows for the entity. Cash generating units will be explained in detail later in this Study Guide.



Definition

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

IAS 36 Para 6

The carrying amount of an asset is the net value of the asset. The carrying amount can be calculated by deducting the accumulated depreciation accumulated amortisation and accumulated impairment losses from the value at which the asset was originally recognised.



Example

Smart had purchased a machine for Tshs500 million in 20X8. The accumulated depreciation on that machine as on 31 December 20Y3 is Tshs150 million.

The carrying amount of the machine as on 31 December 20Y3 is:

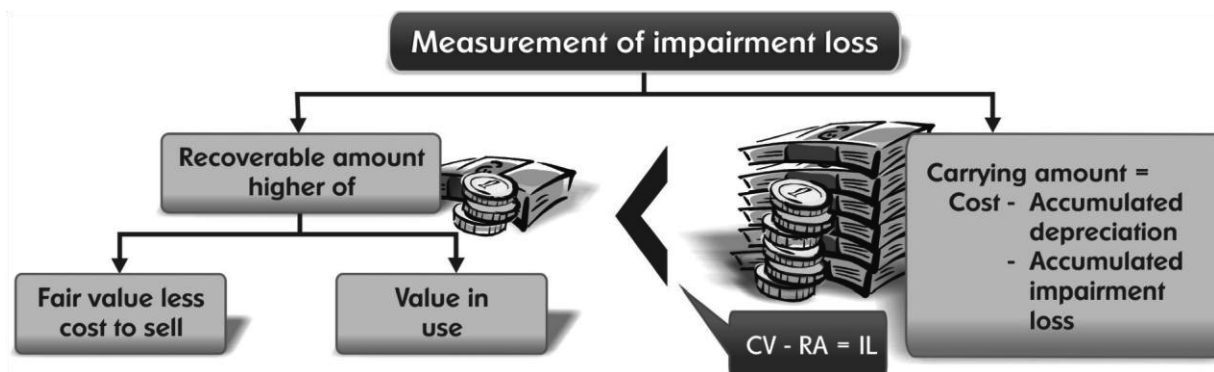
	Tshs'000
Original cost of machine (gross value)	500,000
Less: Accumulated depreciation	(150,000)
Carrying amount of machine (net value)	350,000

Definition

The **recoverable amount** of an asset or a cash-generating unit is the higher of its **fair value less costs to sell** and its **value in use**.

IAS 36 Para 6

Diagram 1: Measurement of Impairment Loss



Let us now understand the above diagram in detail.

1. Fair value

Definition

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, Para 9

The best way to determine the fair value of an asset is by taking the rate at which you could sell the asset to an independent person or entity. When there is no such agreement, then the market value of the asset or the outcome of recent transactions for similar assets within the same industry can be considered as fair value.

2. Costs to sell include

- (a) **Cost of disposal** e.g. legal costs, stamp duty and transaction taxes
- (b) **Direct incremental costs** e.g. cost of dismantling an asset to bring it to a 'ready-for-sale' condition.

Example

Great Co has a machine worth Tshs50 million. This machine is fixed to the ground. The cost of unfastening the machine is Tshs2.5 million. The fair value of the machine is Tshs40 million. In this case the fair value less cost to sell of the machine is:

	Tshs'000
Fair value of the machine	40,000
Cost to sell the machine	(2,500)
Fair value less cost to sell of the machine	37,500

Note: The cost of unfastening the machine (Tshs2.5 million) is considered to be a cost to sell because it will not be possible to sell the machine unless it is unsecured from the ground.

3. Costs to sell do not include

- (a) **Termination benefits**



Test Yourself 1

Pace Co has a machine that originally cost Tshs75 million. If it sells the machine, then it will no longer require the services of 3 workers. The termination benefit which Pace Co would have to pay to the three workers is Tshs6 million. The cost to dismantle the machine is Tshs3.5 million. The fair value of the machine is Tshs50 million.

Required:

Calculate the fair value less cost to sell the machine.

(b) Costs associated with **reducing or reorganising a business** after the disposal of an asset.



Test Yourself 2

Track Co has a group of machines worth Tshs375 million which together work on a conveyor-belt. If the group of machines were sold, then it would lead to a reorganisation of the company. The estimated costs of reorganisation are Tshs42.50 million.

The fair value of the group of machines is Tshs250 million. The stamp duty for the contract of sale would be Tshs2.5 million and the cost of dismantling the group of machines from the conveyor-belt is Tshs25 million.

Required:

Calculate the fair value less cost to sell the machine.

4. Value in use

In order to calculate the value in use of any asset, an entity has to **estimate the future cash flows** that it expects to derive from the asset, keeping in mind the **time value of money** and the **possible variations** in the **amount or timing of those future cash flows**. **Basically this means that the entity would need to estimate future cash flows and then discount them in order to obtain their value at today's date.**



Definition

Value in use is the **present value of the future cash flows** expected to be derived from an asset or cash generating unit.

IAS 36 Para 6

Precautions in determining value in use

After making an estimate of the future cash flow, the entity has to apply an appropriate discount rate to them. This rate should represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset.

Management should ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes and predicted future changes.

After making an estimate of the future cash flow, the entity has to apply an appropriate discount rate to them. This rate should represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset.

Management should ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes and predicted future changes.

The revised IAS 36 clarifies that the following elements should be reflected in the calculation of an asset's value in use:

1. An estimate of the future cash flows the entity expects to derive from the asset.
2. Expectations about possible variations in the amount or timing of those future cash flows.
3. The time value of money, represented by the current market risk-free rate of interest.
4. The price for bearing the uncertainty inherent in the asset.
5. Other factors (such as illiquidity) that market participants would consider while pricing the future cash flows the entity expects to derive from the asset.



Test Yourself 3

Air Co has a machine whose original cost was Tshs25 million. The accumulated depreciation on the machine is Tshs8.5 million. Air recently sold another similar machine for Tshs34 million and the selling expenses were Tshs2.3 million. Management has determined the value in use of the machine as Tshs33 million.

Required:

What is the recoverable amount of the machine?



Tip

If either the fair value less cost to sell or value in use of an asset **exceeds** its carrying amount, the asset is not impaired and it is not necessary to estimate the other amount. In practice, it is easier to find out the fair value less costs to sell, if that is higher than the carrying value and then there is no need to find out the value in use.

1.2 Indicators of impairment

At the end of each reporting period an entity will assess whether there is any indication that an asset may be impaired. If any such indication exists, the entity will estimate the recoverable amount of the asset. If no indicators are present, then no impairment test is required.

The circumstances that indicate impairment to assets can be split into two categories.

- External indicators and
- Internal indicators

There are numerous examples on the indicators of impairment of asset. What follows below is a convenient general list:

1. External sources of information

- (a) During the period, an asset's market value has declined significantly, more than would be expected as a result of the passage of time or normal use.



Example

Jet Co owns a fleet of cars (of a specific make) which it gives out on hire to various companies for transportation of their personnel. These cars are running efficiently and do not require more servicing than the industry norms. However, the company manufacturing these cars has discontinued production of this specific make.

The market value of these cars has declined significantly more than would be expected as a result of the passage of time or normal use. Buyers are wary of purchasing these cars as they wonder whether there would be adequate spare parts available for servicing them.

Hence, these cars have been impaired as their resale value has declined considerably.

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- (b) Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future in the technological, the market, and the economic or legal environment of an entity.



Example

Tryst is a hotel. It had purchased LCD television sets for each of its luxury suites. These television sets which were newly introduced in the market cost Tshs300,000 in total.

However, now that the price of LCD television sets has fallen considerably, owing to increased availability, the fair value of Tryst's sets has declined to Tshs225,000.

Hence, the LCD sets have been impaired because of changes in the economic environment during the period. This is an indication of impairment in the value of the LCD television sets. Tryst has to now estimate the recoverable amount of the assets or the CGU and the extent of impairment.

- (c) Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use, and decrease the asset's recoverable amount materially.



Example

Short-term interest rates have increased. This will have an effect on the value in use of short-term assets, but will not affect the value in use of long-term assets.

- (d) The carrying amount of the net assets of the entity is more than its market value.

2. Internal sources of information

- (a) Evidence is available of obsolescence or physical damage of an asset.
- (b) Significant changes have taken place during the period or are expected to take place in the near future. These changes have an adverse effect on the entity in the extent to which, or manner in which, an asset is used or is expected to be used. For example plans to discontinue or restructure the operation to which an asset belongs or reassessing the useful life of an asset as finite rather than indefinite.
- (c) Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.



Tip

The above list of circumstances which indicate impairments to assets are not exhaustive. Both internal as well as external sources of information have to be considered while deciding whether an asset has been impaired or not.

1.3 Annual impairment test in case of certain assets

The revised IAS 36 requires that the recoverable amount of an asset should be measured whenever there is an indication of impairment of an asset. In addition, annual impairment tests are required for the following assets, irrespective of the fact that there are indicators of impairment:

- intangible asset with an indefinite useful life
- intangible asset not yet available for use (which includes on-going developmental work) goodwill acquired in a business combination

2. Recognise and measure impairment loss.**[Learning Outcome b]****Recognition and measurement of an impairment loss**

If the **recoverable amount of an asset is less than its carrying amount**, the carrying amount of the asset should be **reduced to its recoverable amount**. That reduction is an impairment loss.

**Example**

Krome Co has a building that originally cost Tshs165 million. The accumulated depreciation of the building is Tshs24 million. The market value of the building as on end of the reporting period is Tshs150 million. The company estimates that the direct selling costs would be Tshs35 million. The management determines the value in use of the building is Tshs140 million.

In this case, **the carrying amount of the building is calculated as:**

	Tshs'000
Original (gross value)	165,000
Less: Accumulated depreciation	24,000
Carrying amount (net value)	141,000

The recoverable amount of the building is determined as:

1. Fair value less cost to sell:

	Tshs'000
Market value	150,000
Less: Direct selling costs	35,000
Recoverable amount	115,000

2. Value in use as determined by management Tshs140 million
3. Recoverable amount of the building is Tshs140 million
((1) or (2) whichever is higher)

Impairment loss

	Tshs'000
Carrying amount	141,000
Less: Recoverable amount	(140,000)
	1,000

Recognition of an impairment loss**(a) If the asset is not carried at revalued amount**

The impairment loss is to be recognised immediately in the **profit and loss part** of the statement of profit or loss and other comprehensive income.

Journal entries for recording the impairment loss of Tshs1 million in the above example are:

Dr Loss on building impairment – Profit and loss part	Tshs1m	
Cr Building /accumulated impairment loss		Tshs1m

Being the loss on impairment recorded in the books

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(b) If the asset is carried at revalued amount

- The impairment loss is recognised in the **other comprehensive income part** of the statement of profit and loss and other comprehensive income to the extent the impairment loss does not exceed the amount in revaluation surplus for the same asset.



Example

In 20X2, Brand Co revalued a machine that originally cost Tshs30 million to Tshs40 million. An impairment test conducted in 20X3 leads to an impairment loss of Tshs7.5 million.

In this case, the journal entry is:

Dr Revaluation Surplus (OCI part)	Tshs7.5 m	
Cr Machine A/c		Tshs7.5 m

Being the loss on impairment transferred to the revaluation surplus.

- If the impairment loss is higher than the revaluation surplus, the difference is recognised in the profit or loss part of statement of profit and loss and other comprehensive income.



Example

In 20X2, Dare Co revalued a machine that originally cost Tshs30 million to Tshs40 million. An impairment test conducted in 20X3 concludes an impairment loss of Tshs12.5 million.

In this case, the journal entry is:

Dr Loss on machine impairment (profit or loss part)	Tshs2.5m	
Dr Revaluation Surplus (OCI part)	Tshs10m	
Cr Machine A/c		Tshs12.5m

Being loss on impairment transferred to revaluation surplus and balance transferred to the statement of comprehensive income.

Note:

The revaluation surplus initially has a credit balance of Tshs10 million (Tshs40 million – Tshs30 million). The impairment loss is higher than this:

1. It is recognised against the full amount of the revaluation surplus through the other comprehensive income part of the statement of profit or loss and other comprehensive income (Tshs10 million).
2. The balance of Tshs2.5 million (Tshs12.5 million – Tshs10 million) is recognised in the profit or loss part of the statement of profit or loss and other comprehensive income.



Test Yourself 4

Water Co has a machine that originally cost Tshs350 million. Its accumulated depreciation is Tshs50 million. The market value of the machine is Tshs300 million, the cost of dismantling it is Tshs10 million, and the direct selling costs are Tshs20 million. The costs of restructuring the company if the machine is sold are Tshs100 million. The value in use as determined by management is Tshs275 million. The remaining estimated life of the machine is 5 years and estimated residual value at the end of this life is Tshs25 million.

Required:

Account for the loss on impairment. Also, calculate the depreciation charge on the machine after the impairment loss has been recognised.

3. Define a cash-generating unit and allocate impairment loss to the assets of a cash-generating unit.

[Learning Outcome c]

3.1 Cash-generating units

At times a group of assets are linked with each other in such a manner that:

- It is **not possible to ascertain the cash flows to be derived from a single asset**.
- An individual asset may have a **negligible value in use by itself**, but its **value in use could be much higher when considered along with a group of assets**.
- The asset's **value in use cannot be estimated to be close to its fair value less costs to sell**.

At such times, it becomes necessary to assess whether this whole group of interlinked assets (called a cash generating unit) have impaired or not.

While identifying a cash-generating unit, it is essential to remember that:

1. Cash-generating units **should be capable of generating cash inflows by themselves**.
2. Cash-generating units should be identified **consistently** from period to period for the same asset or types of assets, **unless a change is justified**.

If one group of assets depends on another asset or group of assets to generate cash flows, then the cash generating unit will include all the assets required to generate the cash flow.

Various factors determine whether cash inflows from an asset / group of assets are largely independent of the cash inflows from other assets / groups of assets, for example:

- how the management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas);
- how the management makes decisions about continuing or disposing of the entity's assets and operations.

If the recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.



Example

In the above example of Dare Co, the machine along with its attachment is capable of producing only semi-finished goods that cannot be sold in the market. These semi-finished goods are then polished with the help of another machine (which is used only for this purpose).

In this case, the machine and attachment are not capable of generating cash inflows by themselves. The cash generating unit will consist of the main machine, attachment and the polishing machine.



Test Yourself 5

A catering company provides catering services under contract with a municipality that needs to provide lunch in four separate schools. Assets attributable to each school and the cash flows from each school can be identified separately. The catering company has paid a deposit with the municipality and it cannot discontinue providing catering services at any of the schools. Irrespective of the amount directly collected at each school, the municipality pays a lump sum amount as fees each month.

Required:

Determine the cash-generating unit for this contract.

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If part or all of the output produced by an asset or group of assets is used by other units of the entity, this asset or group of assets forms a separate cash-generating unit, if the entity can sell the output in an active market. If the future cash inflows from the cash generating unit are affected by internal transfer pricing, an entity shall use the management's best estimate of future prices in an arm's length transaction while estimating:

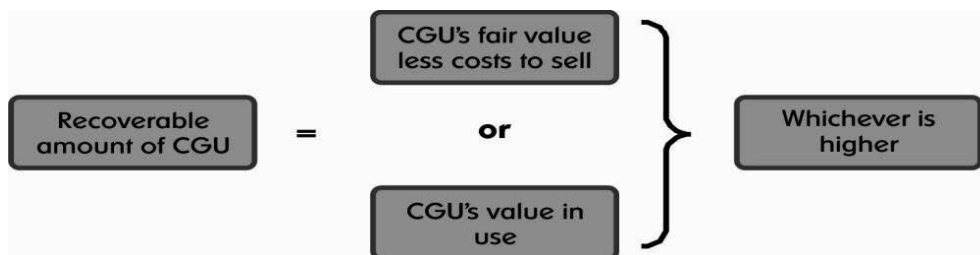
- The future cash inflows used to determine the assets or cash generating unit's value in use.
- The future cash outflows used to determine the value in use of any other assets or cash generating units that are affected by the internal transfer pricing.

An impairment loss shall be recognised for a **cash-generating unit** if the **recoverable amount of the unit is less than its carrying amount**.

3.2 The recoverable amount of a cash-generating unit

This is the **higher of the cash-generating unit's fair value, less costs to sell and its value in use**. It is determined in the same way as the recoverable amount of an asset.

Diagram 2: Recoverable amount of cash generating unit



3.3 Allocation of an impairment loss

The impairment loss will be allocated to reduce the carrying amount of the assets of the unit in the following order:

1. If it is not practicable to estimate the recoverable amount of each individual asset of a cash-generating unit:
 - (a) First, reduce the carrying amount of any goodwill allocated to the cash-generating unit.
 - (b) Then (if there remains an unallocated impairment loss) make an arbitrary allocation to the unit's other assets (usually pro rata the carrying amount of each asset in the unit). It is done in this way because all assets of a cash-generating unit work together.

These reductions in the carrying amounts will be treated as impairment losses on individual assets and recognised according to the treatment for impairment of assets.



Example

The following are the details of cash-generating unit of Supreme Ltd, which consists of the following assets:

	Tshs'000
Goodwill	14,000
Machine 1	50,000
Machine 2	40,000
Machine 3	30,000
Conveyor-belt	10,000
Total assets of cash-generating unit	144,000

This cash-generating unit suffered an impairment loss of Tshs40 million. It is not practicable to estimate the recoverable amount of each individual asset.

If it is not practicable to estimate the recoverable amount of each individual asset, the impairment loss is to be allocated as follows:

Assets	Carrying value	Impairment allocated	Value after impairment
	Tshs'000	Tshs'000	Tshs'000
Goodwill	14,000	(14,000) W1	-
Machine 1	50,000	(10,000) W2	40,000
Machine 2	40,000	(8,000) W2	32,000
Machine 3	30,000	(6,000) W2	24,000
Conveyor belt	10,000	(2,000) W2	8,000
	144,000	(40,000)	104,000

Workings (All figures in Tshs'000)

W1 Goodwill

Goodwill is always reduced to zero first. Hence Tshs40,000 - Tshs14,000 = Tshs26,000 remaining impairment loss (to be allocated).

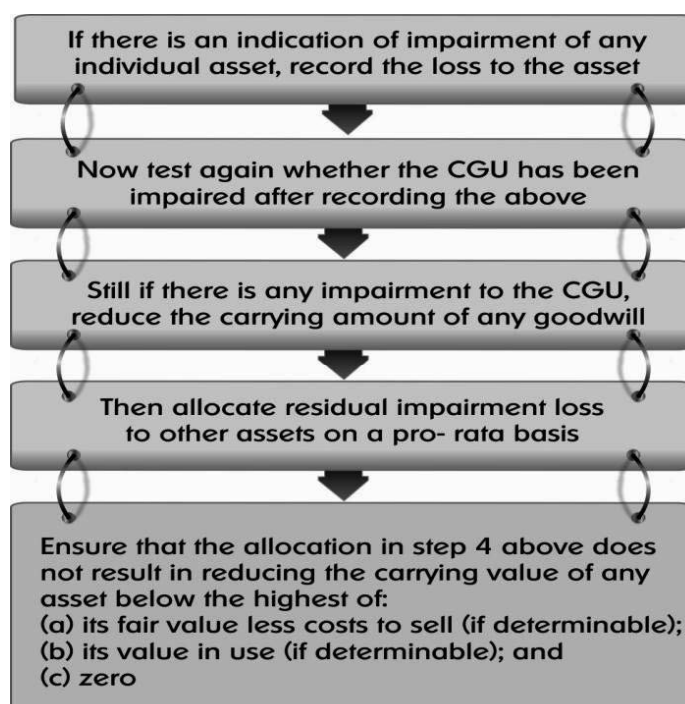
W2 Other assets

Tshs26,000 is now split on a pro-rata basis

	Machine 1	Machine 2	Machine 3	Conveyor belt
Carrying amount	Tshs50,000	Tshs40,000	Tshs30,000	Tshs10,000
Proportion of impairment allocation	5/13	4/13	3/13	1/13
Impaired amount	Tshs10,000	Tshs8,000	Tshs6,000	Tshs2,000

2. If it is practicable to estimate the recoverable amount of any individual asset of a cash-generating unit.

Diagram 3: Allocation of goodwill





Test Yourself 6

Continuing with the above example of Supreme Ltd, but with more information:

	Tshs'000
Goodwill	14,000
Machine 1	50,000
Machine 2	40,000
Machine 3	30,000
Conveyor-belt	10,000
Total assets of cash-generating unit	144,000

The cash generating unit has suffered an impairment loss of Tshs40,000. Some more information about the impairment of individual assets:

	Machine 1 Tshs'000	Machine 3 Tshs'000
Fair value less cost to sell	45,000	20,000
Value in use	43,000	23,000

Required:

Determine how the impairment loss is allocated. Calculate the revised carrying values of the assets of the cash generating unit.

Answers to Test Yourself

Answer to TY 1

In this case, the fair value less the cost to sell the machine is calculated as:

	Tshs'000
Fair value of the machine	50,000
Cost to sell the machine	(3,500)
Fair value less cost to sell of the machine	46,500

Note:

Costs to sell include the cost of dismantling the machine as it is a direct incremental cost of disposal. The termination benefits which would have to be paid to the workers are not considered as costs to sell, as they are not direct incremental costs of disposal.

Answer to TY 2

In this case, the fair value less the cost to sell the machine is calculated as:

	Tshs'000
Fair value of the machine	250,000
Cost to sell the machine	
Stamp duty	(2,500)
Dismantling of machines	(25,000)
Fair value less cost to sell of the machine	222,500

Note:

The estimated costs of reorganisation are not considered as costs to sell as they are not direct incremental costs of disposal.

Answer to TY 3

1. Recoverable amount:

	Tshs'000
Fair value less cost to sale	34,000
Less: Direct selling expenses	2,300
Market value of the machine is	31,700

2. Value in use (determined by management) Tshs33,000

Recoverable amount (higher of (1) and (2)) Tshs33,000

(**Note:** All figures in Tshs'000)

Answer to TY 4

Loss on impairment = Carrying amount – Recoverable amount

(All figures in Tshs'000)

1. Carrying amount

	Tshs'000
Cost	350,000
Less: Accumulated depreciation	(50,000)
Carrying amount	300,000

2. Recoverable amount

(a) Fair value less cost to sell

	Tshs'000	Tshs'000
Market value		300,000
Less: Selling expenses		
Dismantling of machine	10,000	
Direct selling costs	20,000	(30,000)
Fair value less cost to sell		270,000

(b) Value in use

	Tshs'000
As determined by management	275,000
Recoverable amount (higher of Tshs275,000 or Tshs270,000)	275,000

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3. Loss on impairment

	Tshs'000
Carrying amount	300,000
Less: Recoverable amount	(275,000)
Loss on impairment	25,000

4. The journal entry is

Dr Loss on impairment Tshs25,000
 Cr Machine A/c Tshs25,000
 Being loss on impairment recorded in books.

5. Depreciation charge

	Tshs'000
Revised carrying amount of machine	275,000
Less: estimated residual value	(25,000)
Amount to be depreciated	250,000
Depreciation charge (Tshs250,000 / 5 years)	50,000

Note:

The restructuring costs cannot be considered to be direct selling costs and hence have not been reduced from the fair value of the machine.

Answer to TY 5

A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Here, the cash flows from services provided at each school cannot be identified separately as there is a lump sum amount over the amount collected at each school.

The carrying amount of assets cannot be determined separately because the deposit paid to the municipality cannot be identified separately for each school.

The fair value less costs to sell for assets used at each school cannot be determined separately as the company cannot discontinue providing services at any school.

Hence, the cash-generating unit for this contract includes all the assets of the contract.

Answer to TY 6

Assets	Carrying value	Impairment allocated	Value after impairment
	Tshs'000	Tshs'000	Tshs'000
Goodwill	14,000	(14,000)(W3)	-
Machine 1	50,000	(5,000)(W1)	45,000
Machine 2	40,000	(11,200)(W4)	28,800
Machine 3	30,000	(7,000)(W2)	23,000
Conveyor belt	10,000	(2,800)(W4)	7,200
	144,000	(40,000)	104,000

If we have full information of the individual assets so as to determine their recoverable amounts, we need to allocate the impairment loss to the individual assets. In this case we have the information of Machine 1 and Machine 3.

Workings (All figures in Tshs'000)

W1 Impairment loss

Machine 1:

Recoverable amount Tshs45,000
(higher of fair value Tshs45,000 and value in use Tshs43,000)

Carrying amount Tshs50,000

Impairment loss (Tshs50,000 - Tshs45,000) Tshs5,000

Impairment loss remaining is Tshs40000 - Tshs5000 = Tshs35,000
(To be allocated)

W2

Machine 3:

Recoverable amount Tshs 23,000
(higher of fair value Tshs20,000 and value in use Tshs23,000)

Carrying amount Tshs 30,000

Impairment loss (Tshs30,000 - Tshs23,000) Tshs7,000

Impairment loss remaining is Tshs35,000 - Tshs7000 = Tshs28,000 (Still to be allocated)

After the loss is allocated to the individual assets, there is still some loss remaining. First reduce the goodwill and balance to other assets on pro-rata basis

W3 Reduce goodwill to zero

	Tshs'000
Remaining impairment	28,000
Less: Allocated to goodwill	(14,000)
Impairment loss still to be allocated	14,000

W4 - Tshs14,000 is now split on a pro-rata basis

	Machine 2	Conveyor belt
	Tshs'000	Tshs'000
Proportion of impairment allocation	40,000	10,000
	4/5	1/5
Impaired amount	11,200	2,800

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Quick Quiz

1. All selling costs are deducted from the fair value of an asset while arriving at its recoverable amount. True or false?
2. What is an impairment loss?
3. 'There is no need to check internal sources of information if we have to decide whether an asset is impaired or not.' True or false?
4. What is a cash-generating unit?

Answers to Quick Quiz

1. False. Only direct selling costs are deducted from the fair value of the asset while arriving at the recoverable amount.
2. An impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.
3. False. Both internal as well as external sources of information have to be considered while deciding whether an asset has to be impaired or not.
4. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Self-Examination Questions

Question 1

What circumstances lead to the formation of a cash-generating unit? What are the features of a cash-generating unit?

Question 2

Mefal Pharmacy's cash-generating unit consists of the following assets:

	Tshs'000
Goodwill	10,000
Machine A	30,000
Machine B	16,000
Machine C	4,000
Total	60,000

Additional information:

1. There has been an impairment loss of Tshs15 million.
2. The fair value less cost to sell of Machine A is Tshs28 million and its value in use is Tshs28.8 million.

Required:

Determine how the impairment loss is allocated and the revised carrying values of the assets of the cash generating unit.

Question 3

On 1 September 20X2, Comfort Travels acquired Swift Tours and Travels, a popular travel company in Brazil. The summarised statement of financial position of Swift Tours and Travels at fair value on 1 September 20X2, which shows the terms of the acquisition, is as follows:

	Tshs million
Goodwill	120
Operating licence	720
Property (bus stations and rest rooms)	180
Tow trucks	180
Bus coaches (4 coaches)	600
Purchase consideration	1,800

Swift Tours and travels had recently renewed its operating licence for ten years. It is recorded at its renewal cost. The carrying values of the property and tow trucks are stated at their estimated replacement cost. The bus coaches are valued at net selling price.

Two of the coaches rolled down a valley on 1 October 20X2 in a road accident which destroyed the two buses completely. The buses did not have any passengers on board as they were returning from the garage after a routine servicing. Luckily, the drivers of the coaches managed to escape. However, there was no way either of the coaches could be repaired or brought back into business. This affected the company's business, and at this date was valued at an estimated Tshs1,200 million. The other two buses had a recoverable value at least equal to the carrying value on 1 October 20X2 and 30 November 20X2.

After this incident the number of passengers fell considerably – even below the expected reduced capacity. The tourists felt they could not rely on the drivers of Swift Tours and Travels, as they were suspected of being drunk on the job, at the time of the accident. Therefore the business value was reassessed on 30 November 20X2 at Tshs1,080 million, and on the same day Comfort Travels obtained an offer of Tshs540 million for the license.

Required:

State the allocation of impairment losses in accordance with IAS 36 Impairment of Assets and the valuation of each asset of Swift Tours and Travels at 1 October 20X2 and 30 November 20X2 after impairment losses are recognized assuming that the company does not charge depreciation monthly.

Answers to Self-Examination Questions**Answer to SEQ 1**

A cash-generating unit is formed when a group of assets are linked with each other in such a manner that:

- (a) It is **not possible to ascertain the cash flows** to be **derived from a single asset**; or
- (b) An individual asset may have a **negligible value in use by itself**, but its **value in use could be much higher when considered along with a group of assets**; or
- (c) The asset's **value in use cannot be estimated to be close to its fair value less costs to sell**.

The features of a cash-generating unit are:

- (a) It **should be capable of generating cash inflows independently**.
- (b) If **part or all of the output produced by an asset or a group of assets is used by other units of the entity**, this asset or group of assets forms a **separate cash-generating unit if the entity could sell the output in an active market**.

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Answer to SEQ 2

Assets	Carrying value Tshs'000	Impairment loss allocated Tshs'000	Value after impairment Tshs'000
Goodwill	10,000	(10,000) (W1)	-
Machine A	30,000	(1,200) (W2)	28,800
Machine B	16,000	(3,040) (W3)	12,960
Machine C	4,000	(760) (W3)	3,240
	60,000	(15,000)	45,000

Workings (All figures in Tshs'000)

W1 Goodwill is always reduced to zero first. Hence Tshs15,000 - Tshs10,000 = Tshs5,000 remaining impairment loss (to be allocated).

W2 Allocation of impairment loss to Machine A:

	Tshs'000
Value in use	28,800
Fair value less cost to sell	28,000
Recoverable amount (higher of the two)	28,800
Carrying amount (per question)	30,000
Impairment loss (Tshs30,000 - Tshs28,800)	1,200

Impairment loss remaining is Tshs5,000 - Tshs1,200 = Tshs3,800 (to be allocated).

W3 Tshs3,800 is now split as

	Machine B Tshs'000	Machine C Tshs'000
Proportion of impairment allocation	16,000 4/5	4,000 1/5
Impaired amount	3,040	760

Since it is not possible to allocate an impairment loss to any asset, then the amount of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit (group of units).

Answer to SEQ 3

(All figures in Tshs' million)

	Assets 1 Sept 20X2	Impairment as at 1 Oct 20X2	Assets (revised) 1 Oct 20X2	Impairment as at 30 Nov 20X2	Assets (revised) 30 Nov 20X2
Goodwill	120	(120)	Nil	-	Nil
Operating licence	720	(120)	600	(60)	540
Property (bus stations and rest	180	(30)	150	(30)	120
Tow trucks	180	(30)	150	(30)	120
Bus coaches	600	(300)	300	-	300
	1,800	(W1)(600)	1,200	(W2)(120)	1,080

Workings**W1 Loss at 1 October 20X2**

	Tshs million
Carrying value	1,800
Recoverable value	(1,200)
Total loss to be recognised	600

Goodwill will be totally eliminated. The remaining impairment loss is Tshs480 million. We have to remove the value of the two buses that were destroyed (Tshs300 million), leaving tshs300 million for the remaining two buses. This is based on fair value (net selling price). We cannot reduce it below this, in view of the above rule.

After the values of the destroyed buses are removed, the unallocated impairment loss remains at Tshs180 million (i.e. Tshs480 million – Tshs300 million). This is allocated pro rata the remaining three classes of assets, as follows (720:180:180 or 12:3:3)

Operating licence Tshs180 million x 12/18 = Tshs120 million

Bus stations Tshs180 million x 3/18 = Tshs30 million

Tow trucks 180 x 3/18 = 30

W2 Loss at 30 November 20X2

	Tshs million
Carrying value	1,200
Recoverable value	(1,080)
Total loss to be recognised	120

Going by the ratios of the carrying values (600:150:150), the operating license will bear 2/3 of the loss i.e. Tshs80 million. The carrying value will thus be reduced to Tshs600 million – Tshs80 million = Tshs520 million. However, we cannot reduce the value of the asset below the fair (net selling) value i.e. Tshs540 million. Therefore, we can deduct only Tshs60 million from this asset.

The remaining loss of Tshs60 million (Tshs120 million – Tshs60 million) will be allocated equally to the bus stations and to the tow trucks, as their carrying values are equal i.e. Tshs30 million will be deducted from both of them.

STUDY GUIDE B3: INTANGIBLE ASSETS

Get Through Intro

Businesses have for long had various non-monetary assets with **no physical substance** e.g. import quotas, licences, marketing rights, copyrights and goodwill. Such assets are called 'intangible' assets.

The current era in which we live is also called the **knowledge age**. It is characterised by the enlargement of technology and knowledge frontiers. This has added some new kinds of intangible assets e.g. computer software and patents for new inventions.

Businesses now rely on increasing numbers of these assets. They form a **growing proportion** of the value of total assets. They are quite different from physical assets and have some **special accounting characteristics and requirements related to valuation, amortisation and impairment**.

A modern accountant needs to develop the skills required to be able to account for these types of assets.

Learning Outcomes

- a) Define intangible assets and distinguish goodwill from other intangible assets.
- b) Explain and apply the requirement of International Accounting Standard on Intangible asset to recognise and measure intangible assets.
- c) Explain the subsequent accounting treatment of intangible assets.
- d) Explain the accounting for research and development expenditure.

1. Define intangible assets and distinguish goodwill from other intangible assets. [Learning Outcome a]

1.1 Meaning of an intangible asset

The general meaning of 'intangible' is 'without physical substance'. There are some assets that may not have a physical substance, but are still a valuable resource for an entity. They enable the business to run and earn profits in the same manner as tangible assets do.

 **Definition**

An **intangible asset** is an identifiable non-monetary asset without physical substance.

IAS 38 Para 8

 **Example**

An entity uses a machine to manufacture a patented product which is a special screw for holding up pictures on a wall. The design of the product is 'patented' i.e., registered with the patent office. A 'patent' means an exclusive right over a certain design, process etc., which only the entity owning it can exercise.

The patent is as essential an item as the machine is. The patent ensures that no other company can use a similar machine without permission. This helps the entity get a good price for its product.

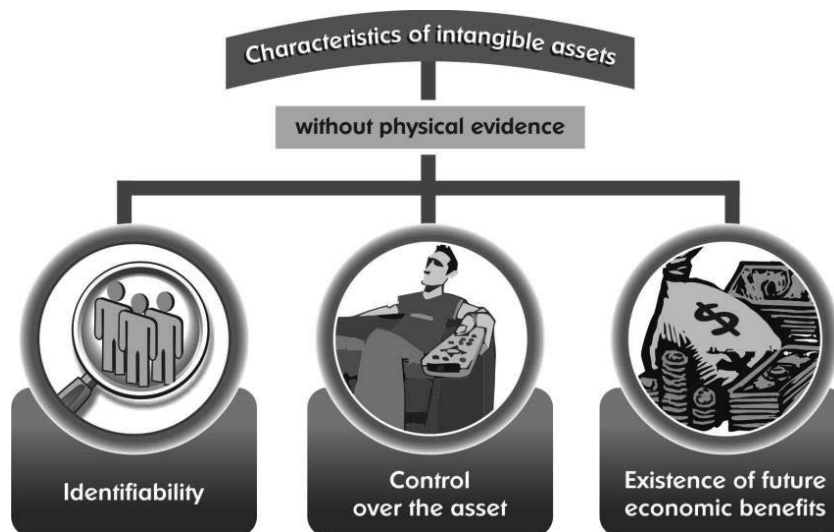
So, although the patent does not have any physical substance, it deserves to be recognised as an asset. It is as much of an asset as the machine. This is because it meets the definition of an asset as it brings future economic benefits, is controlled by the entity and its cost is measurable.

The only difference is the patent is an intangible asset while the machine is a tangible asset.

1.2 Characteristics of intangible asset

The definition of an intangible asset given by the IAS also contains a reference to the feature of being 'without physical substance'. In addition, the IAS specifies the following conditions to be satisfied by an item for it to be called an intangible asset.

Diagram 1: Characteristics of intangible assets



1. Identifiability: It arises from **any one** of the following.

- (a) **The intangible asset must be separable** i.e. it should be capable of being separated from the entity and sold / transferred.



Example

An import license for 500 tonnes of fish, given by the government, can be separated from the entity and sold.

- (b) When **the asset arises from contractual or other legal rights**, regardless of whether the asset is separable and transferable or not.



Example

Landing rights for aircraft awarded by the government to Southern Airways, an aviation company.

According to the terms of the contract, these rights are not transferable. These are intangible assets even if they are not transferable.

2. Control over the asset

This is normally indicated by:

- (a) **power to obtain future economic benefits**
 (b) **power to restrict the access of others to those benefits**

Therefore, power normally stems from a legal right e.g. copyright, but the legal right is not a necessary condition, because an entity may be able to control the future economic benefit in some other way.



Example

Some **examples** where control may or may not exist are discussed below:

- (a) Market and technical knowledge may be controlled by an entity if it has a legal right e.g. patents.
 (b) Talents: an entity does not usually have the power over employees to **force** them to stay with the entity. Therefore, there is no “control” and employees do not meet the definition of an intangible asset.

However, take an example of a famous footballer, e.g. David Beckham. His skill will be considered an intangible asset as he is under a contract with a football club to play for X years – so for these X years he is an asset of that club. (Footballers are bought and sold like in the market place!)

3. Existence of future economic benefits

These could exist in any one of the following ways:

- (a) **revenue from the sale of products or services**
 (b) **cost savings**
 (c) **other benefits resulting from the use of an asset**



Example

Zion Co manufactures automobile components. It acquires advanced technical knowledge from a Japanese firm. After the application of this knowledge into the production process, the future cost of production is expected to reduce.

Hence, the technical knowledge is an intangible asset.

1.3 Intangible assets can be of two types

Purchased intangible assets	Internally developed intangible assets
Purchased intangible assets are acquired from an outside entity.	Certain assets may be internally developed by an entity by using its own resources.
<p>Example</p> <p>An import license purchased for Tshs15 million is an acquired intangible asset.</p>	<p>Example</p> <p>A pharmaceutical company develops a new medicine through research and development. It spends material, man days and uses assets to carry out this task. This is an internally developed intangible asset.</p>

Goodwill, Brand names and publishing titles, Computer software Patents Copyrights Motion picture films Customer lists are some examples of intangible assets.

 **Test Yourself 1**

Discuss whether the following are intangible assets:

- (a) Finux Inc produced a piece of antivirus software and declared it as ‘open’ software. Anybody can download it for free from the internet and anyone can make changes to it.
- (b) TSC takes on new graduates to assist in the Research and development department. Reka Kovacs, a very bright graduate has been excelling at developing new products for the company. She has been asked to sign a 5 year contract which she can only break if she has an accident and can no longer work. However, Reka’s lawyers have told her that TSC cannot force her to work for them at all and she can leave if she wants to.
- (c) Jesta works on animation for computer games. It has developed a new technique for making computer images look completely human. Jesta believes that this product could be sold to film animation companies too.

1.4 Nature of goodwill

Goodwill refers to the good image of an entity in the minds of customers, because of which they keep on dealing with the entity. Many such satisfied customers also recommend the entity to their relatives, friends and associates. Goodwill is based on such factors as:

1. The reputation of a business for the high quality of its goods and services.
2. The work culture and personality of staff.
3. Cordial relationships with customers, reflected in prompt and helpful responses to their queries.

 **Example**

Sam completed a tailoring course from Grand Tailoring Institute in 20X0, and started a tailoring and garments business immediately. Tom completed the course in 20X6 and started a similar business in the same locality. Sam has many more customers than Tom.

Sam’s customers are satisfied and keep referring his name to friends and relatives. He is operating on a larger scale and has 50 employees to assist him. This brings him much higher profits compared with Tom. **Sam has goodwill** whereas Tom does not, as of 20X6.

Goodwill results in customer loyalty and growth and normally leads to higher profits compared with a similar new business. It is developed over a long period.

1.5 Internally generated goodwill

Even though goodwill is a very valuable asset, its assessment is not objective. When a business develops over the years, management can feel that there is goodwill but may find it difficult to measure it. Even if it is measured, the measurement is likely to be subjective and not objective.



Example

The soft drink 'Sespi' is a popular brand. People like it and consume it repeatedly. It sells more than the new entrant 'Thirst'.

You feel that Sespi has goodwill since it sells more. However, you may find it difficult to value the goodwill.

For the above reasons, **internally generated goodwill is not recognised in the financial statements**, unless it is purchased.

1.6 Purchased goodwill

If a business is sold as a going concern, along with other assets and liabilities, its goodwill is also sold. Purchased goodwill is recognised in the statement of financial position, since the element of subjectivity is reduced as the buyer has agreed how much to pay. Remember this payment represents purchase of the net assets and the remainder is for the goodwill.

The value of goodwill

Purchased goodwill is a combined result of so many factors. IFRS 3 'Business Combinations' states that it represents an asset representing **the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised**.

The value of goodwill is:

- normally based on the future profits expected or,
- may be agreed separately between buyer and seller or simply taken as

	Tshs'000
Value of purchase consideration	X
Add: Fair value of NCI	X
Add: Fair value of any previously held equity interest	X
Less: fair value of net assets acquired	(X)
Goodwill	X

The acquirer has to arrive at fair values for all the assets and liabilities, which may not be the same as the value in the books of the acquiree.

Goodwill is calculated as the difference between:

- Fair value of the consideration on the acquisition date + fair value of non-controlling interest in the acquiree + fair value of the acquirer's previously held equity interest in the acquiree on the acquisition date
- Fair values of the identifiable assets acquired and liabilities assumed on the acquisition date

$$\text{Goodwill} = A - B$$

We shall discuss the computation of goodwill in detail in Study Guide D1.



Important

Summarising the above discussion, goodwill is not recognised unless it is purchased (business combinations). Further IAS 38 requires that internally developed goodwill should not be recognised.

1.7 Distinction between goodwill and other intangible assets

Goodwill is a very valuable asset of an entity, but it normally lacks identifiability i.e. it is neither separable, nor does it arise from contractual or other legal rights. Other intangible assets may be identifiable.



Example

Assess whether the following items are separately identifiable:

- (a) Licence to operate buses on a route.
- (b) Mining rights granted by the government to a mining company.
- (c) Facility for an industrial unit to use the roads in an Industrial Development Area, which is not mentioned in any contract.

Answer

- (a) Separable as well as it arises from a legal right; therefore identifiable.
- (b) Arises from legal rights; therefore identifiable.
- (c) Neither separable, nor arising from contractual / legal rights; therefore not identifiable.



Tip

Remember, other intangible assets e.g. licences and patents are separable from the entity i.e. they can be sold or transferred on their own. Goodwill, however, cannot be separated.

As discussed above, goodwill does not exist separately from the business. It can normally be acquired only with the business.

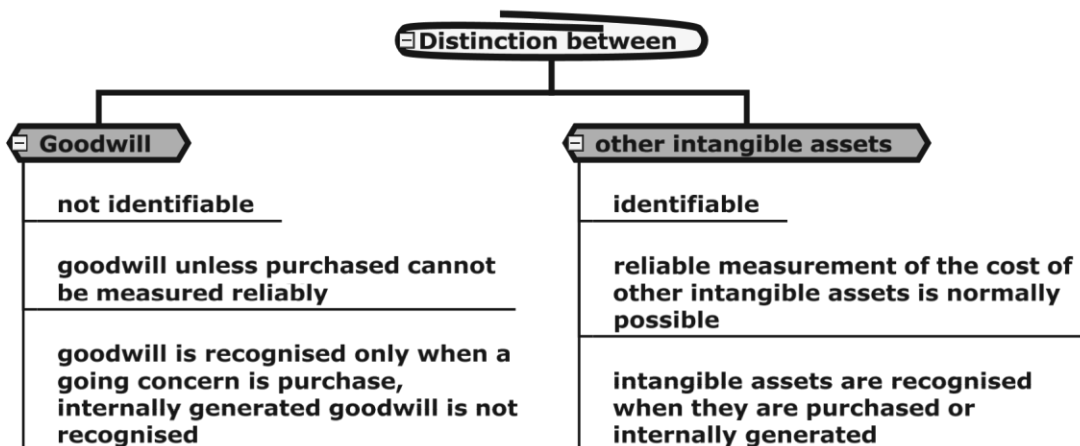
Unless goodwill is purchased, a reliable measurement of its cost may not be possible. As a result, goodwill is normally not recognised in the accounts unless it is purchased. Reliable measurement of the cost of other intangible assets is normally possible, whether they are acquired or internally developed.

In accordance with IFRS 3 Business Combinations, when a business is acquired, goodwill represents a payment made by the acquirer in anticipation of future economic benefits from assets that are **not capable of being individually identified and separately recognised**.

Goodwill is thus measured as the residual cost of the business combination after recognising all other assets and liabilities, including intangible assets. In fact, IFRS 3 recommends that all possible intangible assets should be separately identified and recognised before taking the value of goodwill as a residual cost.

Separate identification of all possible intangible assets is essential since the considerations for recognition, measurement and impairment may be different for different kinds of intangible assets.

SUMMARY



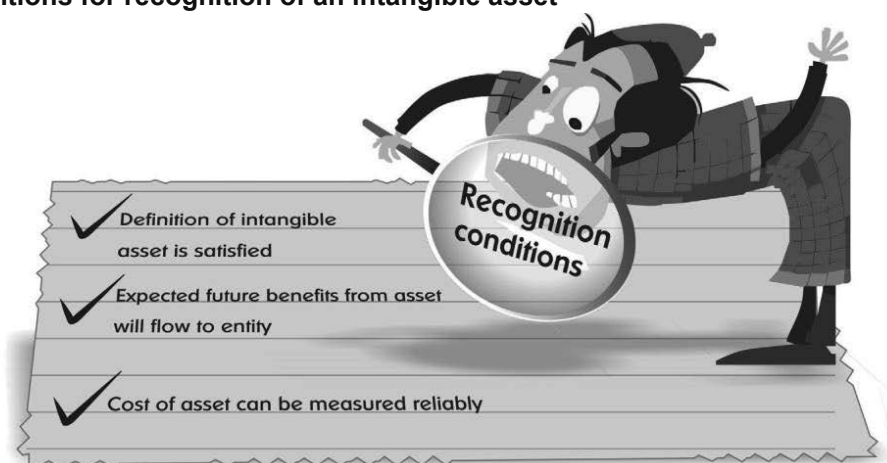
2. Explain and apply the requirement of International Accounting Standard on intangible asset to recognise and measure intangible assets.

[Learning Outcome b]

2.1 Initial recognition

According to Para 21 of IAS 38, after the asset meets the definition of an intangible asset as discussed in the earlier section, it can be recognised “if and only if the following conditions are met:

Diagram 2: Conditions for recognition of an intangible asset



It is a matter of judgment to assess the degree of certainty for future flows of economic benefits from an asset. An entity should give greater weight to external evidence on this matter.



Important

The above recognition criteria apply to both costs incurred to acquire intangible assets and those incurred to generate assets internally.

2.2 Measurement

After the recognition conditions as stated above are met, the next question is: at what value should the asset be recognised?



Important

An intangible asset shall be **measured initially at cost**.

IAS 38 Para 24

The recognition and measurement process depends upon the mode of acquisition or generation of an asset.

1. Separately acquired intangible assets

Initial recognition

In order to recognise an intangible asset, it should be probable that the expected future benefits related to the asset will flow to the entity. This condition is always considered to be satisfied for assets which are separately acquired, as the purchasing company would not have paid for an asset which was not going to give future economic benefits!

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The cost of such assets can be measured reliably, especially if the consideration is paid in cash or in other monetary assets.

Measurement

The **cost of an asset** comprises:

- (i) **the purchase price** (including non-refundable duties and taxes, and after deducting discounts and rebates);
- (ii) **directly attributable costs** e.g. professional fees, legal fees, cost of testing, etc.; and
- (iii) **borrowing costs** as permitted by IAS 23 'Borrowing costs'.

If payment is deferred beyond the normal terms of the credit period, the intangible asset is recorded at the cash price (present value) of the asset. The difference between the total payment made and the cash price is recognised as finance cost over the period of credit unless it is classified as borrowing cost under IAS 23 'Borrowing Cost'.



Example

High Spirits, a company in the liquor industry, purchased the popular drinks brand 'Makeover' from Tremendous Spirits for Tshs16.5m. It paid Tshs0.6m towards lawyers' fees for drafting the agreement and Tshs0.3m on registration of the agreement. The company also incurred training expenses of Tshs1 m to train the existing staff regarding manufacture of the new brand. Due to introduction of brand 'Makeover' the management decided to stop the production of one of its existing similar brands. The cost of closure is 2m.

The trademark acquired will be recognised as an intangible asset, at a cost of Tshs17.4m (Tshs16.5m + Tshs0.6 m+ Tshs0.3m)

2. Intangible assets acquired in a business combination

- (a) The costs of these intangible assets are their fair values at the acquisition date. In case the asset is freely traded in the market, the quoted value can be considered to be the fair value of the intangible asset acquired. If the intangible asset does not have an active market then the cost will be determined based on the amount that the enterprise would have paid in an arm's-length transaction at the date of acquisition.



Definition

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

IFRS 3 Appendix A

Historical costs in the transferor's records do not necessarily represent fair values.



Example

An intellectual property has a carrying value of Tshs200,000 in the books of the transferor company. If it was to be exchanged between knowledgeable, willing parties in an arm's length transaction, it would fetch Tshs350,000. This is its fair value, and the acquirer in a business combination records it at this value (Tshs350,000).

- (b) **There is a rebuttable presumption that the fair value of an intangible asset acquired in a business combination can be measured reliably.**

There were requirements in the erstwhile IAS 22 (now superseded by IFRS 3) and IAS 38 for identifiable intangible assets to be recognised separately from goodwill. However, entities did not recognise them separately but allowed them to form a part of the value of goodwill. This tendency necessitated the introduction of the new clause.



Example

An entity purchased a business. The assets taken over included an import quota for raw material. The quotas are bought and sold in the market. Their fair value can be easily recognised. This value must be recognised separately before arriving at the value of goodwill as an excess of cost over the fair value of net assets acquired.

- (c) Once it is confirmed that the value can be measured separately, the intangible asset is recognised separately from goodwill.
- (d) If the fair value can be determined, it indicates that the item has a value in the market. When the market puts a value on a certain item, it is very likely that the asset is capable of attracting a flow of future economic benefits. Therefore, the criterion of probability that the expected future benefits will flow to the entity is considered to be satisfied.

3. Intangible assets acquired by way of a government grant

Government grants may sometimes take the form of intangible assets e.g. licences to operate radio stations or airport-landing rights. In accordance with IAS 20, an intangible asset may be initially **recorded at:**

- (a) the fair value; or
- (b) a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use.

In some situations, import of commodities is controlled by the government, for various reasons e.g. scarcity, foreign currency shortage. Only an entity which has the quota can import the stated commodity.



Example

The government granted an import quota of 'naphtha' to Zeliem Ltd, as an incentive to set up a plant in a backward area. Zeliem can record the intangible asset "import quota" either at fair value or at a nominal amount.

4. Exchange of assets

Some intangible assets may be acquired not for money but in exchange for other non-monetary assets. The costs of these intangible assets are **measured at the fair value of the asset unless:**

- (a) the exchange transaction lacks commercial substance



Example

Dilbert and Rupert are close friends and businessmen. Dilbert owns a 100 seater staff coach and Rupert owns a 25 seater transport bus for which he has a licence to operate as public transport on a particular route. Rupert and Dilbert exchange the vehicles for a day. Dilbert also uses the licence to operate the coach.

The transaction lacks a commercial substance, and is not recorded as an exchange.

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(b) the fair value of neither the asset received nor the asset given up is reliably measurable.

If the cost cannot be measured at fair value then it is measured at the carrying value of the asset given up.



Example

Ciplax has developed a vaccine for the treatment of jaundice whereas Oregon has developed a vaccine to treat swine flu. Ciplax and Oregon entered into an agreement to swap these two products. The agreement provides that Ciplax will retain the marketing rights to its drug in all the European countries. The fair value of Ciplax's vaccine is Tshs8 million, which includes Tshs2 million relating to the Asian marketing rights. The carrying value of the vaccine is Tshs4 million.

In accordance with IAS 38, Ciplax should initially recognise the compound received from Oregon at the fair value of the part given up i.e. Tshs6 million (Tshs8 million – Tshs2 million).

The fair value of Tshs2 million relating to the marketing rights should be excluded from the calculation of the value of vaccine because the marketing rights have not been sold. Ciplax should also recognise a gain of Tshs3 million [Tshs6 – (Tshs4 – (2/8) x 4)] on the exchange.



Example

Genteel Cosmetics Plc. acquired two licences in exchange for two plots of land which have a carrying value of Tshs200 million each. The first licence had a fair value of Tshs300 million, but the fair value of the second one could not be determined.

The first license will be recorded at Tshs300 million (fair value of the equipment acquired) and the second at Tshs200 million (carrying value of the asset given up).

5. Internally generated goodwill

Internally generated goodwill **does not meet followings:**

- (i) the **identifiability component** in the definition of an intangible asset in the IAS
- (ii) the **recognition criteria** of reliable measurement of cost, because there is no specific expenditure on goodwill – it is the result of running a business well, to the satisfaction of the customers over a period of time

In order to meet the identifiability component, the item has to be separable or it should arise from a contractual or other legal rights. Internally generated goodwill is not separable from the entity. Similarly, it is not the result of a contractual or legal right. Therefore, internally generated goodwill **shall not be recognised** as an asset.

6. Recognition of intangibles as an expense

Expenditure on an intangible item shall be recognised as an expense, except where the expenditure is part of the cost of an intangible asset that meets the recognition criteria or the expenditure on an item acquired in a business combination. Examples (given by the IAS) of costs which should be considered as expenses include start-up expenditure, training expenditure, advertising and promotional expenditure, business relocation or reorganisation expenditure, etc.

Summary of treatment of intangible assets

1. Asset	2. Initial recognition: value	3. Why	4. Example
Separately acquired	Recognised at purchase price + attributable costs	Expected benefits will flow through use of assets or sale Costs measured as stated in column 2	Patent purchased
Acquired in business combinations	Recognised at fair value at acquisition date	Expected benefits will flow through use of assets or sale Costs measured as stated in column 2	Licence acquired as a part of a running business
Acquired by way of government grant	Recognised at fair value or nominal amount + expenses incurred	Expected benefits will flow through use of assets or sale Costs measured as stated in column 2	Licence to operate radio station; airport landing rights
Exchange of assets	Measures at fair value unless: exchange transactions lack commercial substance fair value is not reliably measured	Expected benefits will flow through use of assets or sale Costs measured as stated in column 2	Plot of land given in exchange for a machine
Internally generated goodwill	Not recognised as an asset	Costs cannot be measured	Business running for 25 years has goodwill, but we cannot measure the value
Recognition of an expense on an intangible asset	Recognised as an expense except where expense is part of cost of asset and meets the recognition criteria	Not probable that the future economic benefits will flow to the entity	Pharmaceutical company spending on initial trial of drugs on animals



Test Yourself 2

- (a) During the financial year, Sunbeam Airways spent Tshs200 million on acquiring rights to land at the airport, for the current financial year. Are these rights an intangible asset?
- (b) Powericon Plc. acquired a business for Tshs6m from Jerkoise. Net tangible assets acquired had a fair value of Tshs5.3m. Jerkoise had a valuable licence which was not recognised in its books. The Chief Accountant of Powericon calculates its value at Tshs0.7m and says that it is not necessary to record the licence separately. A reliable estimate of the fair value of the licence is placed at Tshs0.3m. Advise the accountant about the values he should consider for the goodwill calculation.
- (c) On 1 December 20X6, Zest Corporation acquired a transport licence (for running buses on a route) from Mayfair Enterprises at a cost of Tshs40 million. The licence expires on 1 January 20X7. It enables the holder to renew it further for a period of 3 years with a nominal cost. A new entrant has to pay a premium of Tshs50 million to the local authorities according to their rules. Zest Corporation renews its licence by paying a negligible fee of Tshs100,000. Ignoring amortisation, how should it treat the cost of Tshs40 million in the statement of financial position at 31 December 20X6?

3. Explain the subsequent accounting treatment of intangible assets.

[Learning Outcome c]

3.1 Subsequent measurement

After initial recognition, an intangible asset shall be valued by using either the cost model or the revaluation model.

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1. The cost model

According to Para 74 of IAS 38, after initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses.



Example

A property was purchased at Tshs300 million during 20X5. Annual depreciation of Tshs30 million was provided against the item during 20X6 and 20X7. At the end of 20X7, an impairment loss of Tshs15 million was determined.

Carrying value at end of 20X7 = Tshs300 million – (2 years x Tshs30 million) – Tshs15 million = Tshs225 million

2. The revaluation model

- (a) After initial recognition, an intangible asset shall be carried at a revalued amount, being its **fair value** at the date of the revaluation less any **subsequent** accumulated amortisation and any subsequent accumulated impairment losses.
- (b) **Initial recognition** of the asset will be **at cost** only. Fair value is not to be used for the initial recognition.
- (c) **Fair value**
 - (i) This will be determined by reference to an **active market**. Items such as taxi licences and production quotas may have an active market.



Example

Taxi cabs in New York have a concept of taxi 'medallions'. You can operate a taxi-cab if you own a 'medallion' – a special item which you display in your taxi to prove you have the right to operate a cab. So in New York there is an active market for the buying and selling of medallions, which sets the price.

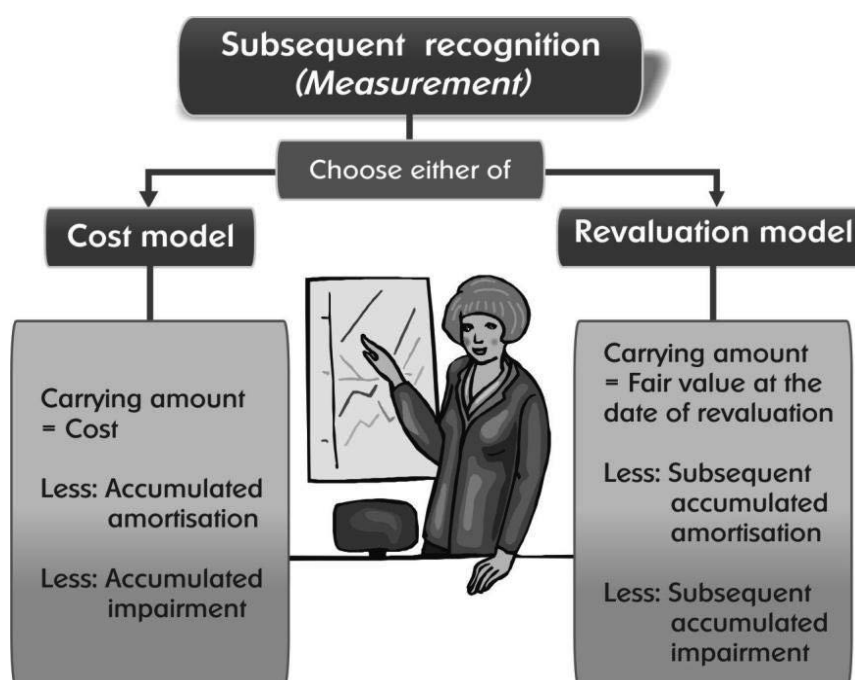
- (ii) For many intangible assets, **an active market may not normally exist** e.g. patents, copyrights, brands. For these, it is better to use the cost model rather than the revaluation model.
- (iii) If an intangible asset has been valued using the fair value model, all the other assets of its class shall be valued similarly, unless there is no active market for such assets.
- (iv) If no active market exists for an asset belonging to a class of revalued intangible assets, the asset may be valued using the cost model.
- (v) Revaluations shall be made with such regularity that the values carried in the statement of financial position do not differ materially from the fair values.



Test Yourself 3

- (a) A company has a licence costing Tshs50 million and a patent costing Tshs40 million. An active market is available for licences but not for patents. Which model of valuation under IAS 38 is more suitable?
 - (b) A company selected the revaluation model for valuation of intangible assets. The last revaluation was done in 20X5. Management feels that there is no need to spend money on getting them valued frequently, so the 20X5 value should be carried forward. Advise management.
-

Diagram 3: Subsequent measurement of intangible assets



3.2 Accounting for revaluations

The carrying amount of an intangible asset may increase or decrease as a result of revaluation. The accounting treatment depends on whether there is an increase or decrease.

Increase in carrying value	Decrease in carrying value
The increase should be recognised in the other comprehensive income part of statement of profit or loss and other comprehensive income and accumulated in equity under the heading of revaluation surplus.	The entire decrease shall be recognised in the profit or loss part of statement of profit or loss and other comprehensive income

The accounting principles discussed for non-current tangible asset also apply to intangible asset as well. These principles have already been explained in detail under Study Guide B1.



Example

The carrying values of licences A and B are Tshs70 million and Tshs90 million respectively. They are revalued to Tshs60 million and Tshs98 million. On the previous revaluations, A's value was increased by Tshs7 million (included in revaluation surplus) and B's decreased by Tshs5 million.

In this case licences A and B will be accounted for at their revalued amounts in the following manner:

The revaluation **decrease for licence A** is Tshs10 million (Tshs70 million – Tshs60 million). The credit balance in the revaluation surplus against this asset is Tshs7 million. The following entry should be made:

Dr	Revaluation surplus - OCI part	Tshs7 million	
Dr	Profit / Loss on revaluations (Profit or loss part)	Tshs3 million	
	Cr Licence		Tshs10 million

Being licence A accounted for at revalued amount

The new value of licence A is Tshs60 million

Increase in licence B: Tshs8 million (Tshs98 million – Tshs90 million)
Previous reduction: Tshs5 million

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This must have been recognised in the profit or loss part in the statement of profit or loss and other comprehensive income, according to IAS 16.

The following entry should be made:

Dr	Licence	Tshs8 million	
	Cr	Profit / Loss on revaluations (Profit or loss part)	Tshs5 million
	Cr	Revaluation surplus – OCI part (Revaluation surplus)	Tshs3 million
Being licence B accounted for at revalued amount			



Test Yourself 4

The carrying values of licenses X and Y are Tshs60 million and Tshs30 million respectively. They are revalued to Tshs75 million and Tshs25 million. On the previous revaluations, X's value was increased by Tshs4 million (included in revaluation surplus) and Y's decreased by Tshs3 million.

Required:

Advise on the accounting entries for revaluations

3.3 Selling an intangible asset which has been revalued

1. The revaluation surplus relating to an intangible is transferred to retained earnings when it is **realised**. It is realised when the asset is disposed of (sold) or retired (no longer used).
2. For assets still in use, **part of the revaluation surplus can be transferred to retained earnings**. It is calculated as the difference between amortisation based on the historical cost and amortisation based on the revalued amount.
3. The transfer does not appear in the profit or loss part in the statement of profit or loss and other comprehensive income; it is done directly through equity.



Example

Swentine Inc holds two trademarks, P and Q. There were revaluation surpluses of Tshs535 million and Tshs265 million respectively on these two. P was disposed of. Q is still in use. Amortisation on the original cost of Q was Tshs40 million and on the revalued carrying amount, Tshs66.5 million.

Advise the company on the accounting for the revaluation surplus.

Answer

Trademark P is sold off. Hence the revaluation surplus of Tshs535 million should be transferred directly to retained earnings, since it is realised.

The company is still using Trademark Q. The entity may transfer i.e. Tshs66.5 million – Tshs40 million = Tshs26.5 million to retained earnings. This is the difference between the amortisation based on the revalued carrying amount of the asset and the amortisation based on its original cost.



Test Yourself 5

Why does IAS 38 require that the transfer from revaluation surplus to retained earnings be done directly in equity and not through the profit or loss?

3.4 Useful life



Definition

Useful life is:

- (a) the period over which an asset is expected to be available for use by an entity; or
- (b) the number of production or similar units expected to be obtained from the asset by an entity.

IAS 38 Para 8

The accounting of an intangible asset depends on its useful life, i.e. whether it is **finite or indefinite**.

1. Finite useful life

- (a) Intangible assets that have a determinable life are classified under this head.
- (b) An intangible asset with a finite useful life **is amortised**. Amortisation means that a part of the asset value is transferred from the statement of financial position to the statement of profit or loss and other comprehensive income as a cost, in the same way as depreciation in the case of tangible assets.



Example

Sky Radios purchased a broadcasting licence on 1 January 20X6 for a period of 5 years through an auction process, for Tshs2 million. After 5 years, the process is likely to be repeated and the licence may go to the highest bidder.

The licence is an intangible asset, having a finite useful life. Shy Radios should recognise it as an asset, and amortise it over a period of 5 years.

Assuming that the economic benefits from the asset are expected to be received equally over the 5 years, a straight-line method shall be applied and Tshs0.4 million amortised each year.

- (c) The **amortised amount is allocated** on a systematic basis over its useful life. The useful life may be shorter than the legal or contractual life.



Example

The legal life of a licence is 30 years, but the entity has acquired a right to use it for 10 years only. For amortisation, the entity will consider a period of 10 years only. The reason is that the asset is only being used by the entity for the next 10 years and there will be no future benefits after this date.

- (d) The amortisation **period and method shall be reviewed** at least at the end of each financial year-end.
- (e) **Amortisation is not stopped when the asset is not in use**, unless it has been fully amortised or classified as held for sale.
- (f) Only if there is an indication of impairment, the recoverable amount is compared with the carrying amount and impairment loss is recognised if necessary.



Example

A licence to operate transport vehicles is acquired at a cost of Tshs100 million, valid for 5 years. If everything goes well for the full period of 5 years, there is no need to check impairment, since there is no indication that the value of the licence may have been reduced.

However, if it is known at the end of 2 years that the route on which the transport vehicle was running is no longer available for operating the vehicles, this is an indication that the value of the licence as an asset is doubtful. The transport company has to check how much money it can get back from the government and compare this recoverable amount with the carrying amount of the licence. If the recoverable amount is lower, the resulting impairment loss will be written off.

2. Indefinite useful life

- (a) If the useful life of an intangible asset cannot be determined, it is known as an asset with indefinite useful life.
- (b) An intangible asset with an indefinite useful life **is not amortised**.
- (c) **Impairment test:** in accordance with **IAS 36 Impairment of Assets**, an intangible asset with an indefinite useful life should be tested for impairment by comparing its recoverable amount with its carrying value. **This is to be done annually or when there is an indication that the asset may be impaired.**



Example

Johnson Publishing Co owns a copyright purchased for Tshs90 million. Its life is indefinite. Johnson reviews impairment at the end of each reporting period date. Between the ends of the reporting periods, if there is an indication that the copyright is impaired, Johnson checks it for impairment.

- (d) The useful life will be reviewed each period, to determine whether it is still appropriate to assess the asset's useful life as indefinite. If the assessment does not support the indefinite life of an intangible asset it shall be accounted for as change in accounting estimate in accordance with IAS 8.



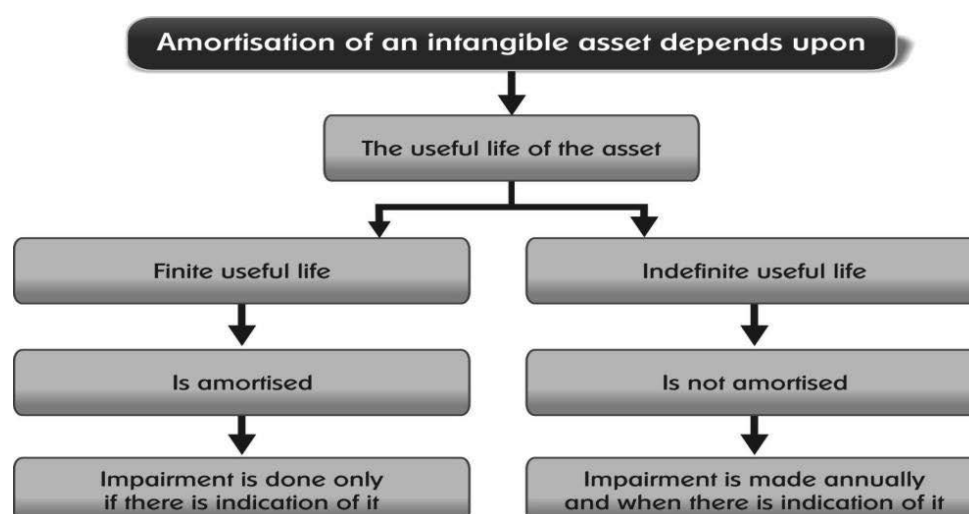
Example

Jess & Tess Ltd holds a trademark with a carrying value of Tshs1.7 million, which it uses to produce consumer goods. It is expected that the products will continue to be in demand for the foreseeable future, and the trademark has an indefinite life. At 31 December 20X6, based on a report by an independent expert, it is estimated that the recoverable amount of the trademark is only Tshs1.6 million.

Discuss the amortisation and impairment of the trademark.

The value of the trademark will not be amortised since its useful life is indefinite. However, it will be tested for impairment annually. The recoverable amount is Tshs1.6 million (Tshs0.1 million less than the carrying value of Tshs1.7 million). Therefore, there is an impairment loss of Tshs0.1 million. This amount will be deducted from the carrying value and recognised in the profit or loss part of the statement of profit or loss and other comprehensive income.

Diagram 4: Amortisation of an intangible asset



3.5 Retirements and disposals: Derecognition

Derecognition means removing an asset from the statement of financial position. An intangible asset is **derecognised when**

1. it is disposed of; or
2. no future economic benefits are expected from its use or disposal.

The gain or loss arising on derecognition is determined as the difference between the net proceeds, if any, and the carrying amount of the asset. The gain or loss is recognised immediately in the profit or loss part of the statement of profit or loss and other comprehensive income. The gain is not classified as revenue, but shown as other income.



Example

Continuing from the previous example of Jess & Tess

If the trademark held by J & T is sold on 15 Jan 20X7, for Tshs1.4 million, the loss on derecognition will be Tshs0.2 million (Tshs1.6m – Tshs1.4m). If there was no sale value, then the loss on derecognition would be the entire carrying amount of Tshs1.6 million.

Accounting entries:

Dr	Cash / bank	Tshs1.4m
Dr	Loss on disposal of trademark (Profit or loss part)	Tshs0.2m
	Cr Trademark (SOFP)	Tshs1.6m

Being loss on sale of trademark accounted for.

If there was no sales value:

Dr	Loss on retirement of trademark (Profit or loss part)	Tshs1.6m
	Cr Trademark	Tshs1.6m

Being trademark written off

4. Explain the accounting for research and development expenditure.

[Learning Outcome d]

4.1 Research and development

People are always on a lookout for a new and more efficient way of doing things, i.e. whether in a better manner or at a lesser cost or both. This requires research and development (universally abbreviated to 'R&D'), and business entities routinely spend money on such activities.

For industries such as pharmaceuticals, R&D is an essential activity. They not only look for better ways of doing the things, but also try and develop new medicines which never existed before. These companies spend large amounts on R&D.



Example

R&D expenditure incurred to develop medicines for curing cancer.

What would happen if there were no rules to recognise the intangible assets developed out of the R&D process? Companies would build up an intangible asset which does not have a substance and does not meet the definition of an asset.



Example

A company spent Tshs5 million on the R&D related to cancer. The product developed did not work, but the company still capitalised the expense and recognised an intangible asset.

This asset is a fictitious asset, which should not be capitalised.

4.2 Regulation by IAS 38 Intangible Assets

In view of the risks mentioned above, it is necessary to lay down strict conditions to be satisfied before the assets generated by R&D are recognised.

IAS 38 Intangible Assets lays down the required rules:



Definition

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

IAS 38 Para 8



Definition

Development is the **application of research findings or other knowledge** to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services **before the start of commercial production or use.**

IAS 38 Para 8

The activity related to internal generation of an intangible asset is divided between the research phase and the development phase. **If an entity finds it difficult to distinguish between the activities, then the entire expenditure is treated as being on the research phase.**

4.3 Expenditure on the research phase

1. Research means trying out different possibilities and checking their outcomes. It has an element of trial and error. People expect a particular outcome but are **not certain** about it. Examples of research expenditure are activities aimed at obtaining new knowledge, and the search for new materials, devices, products and processes.
2. Expenditure on research should be recognised as an expense and not as an intangible asset. The reason is that, normally, at this stage an entity cannot demonstrate that an asset exists and that future economic benefits will flow from it. The expenditure therefore does not satisfy the definition of an asset.



Example

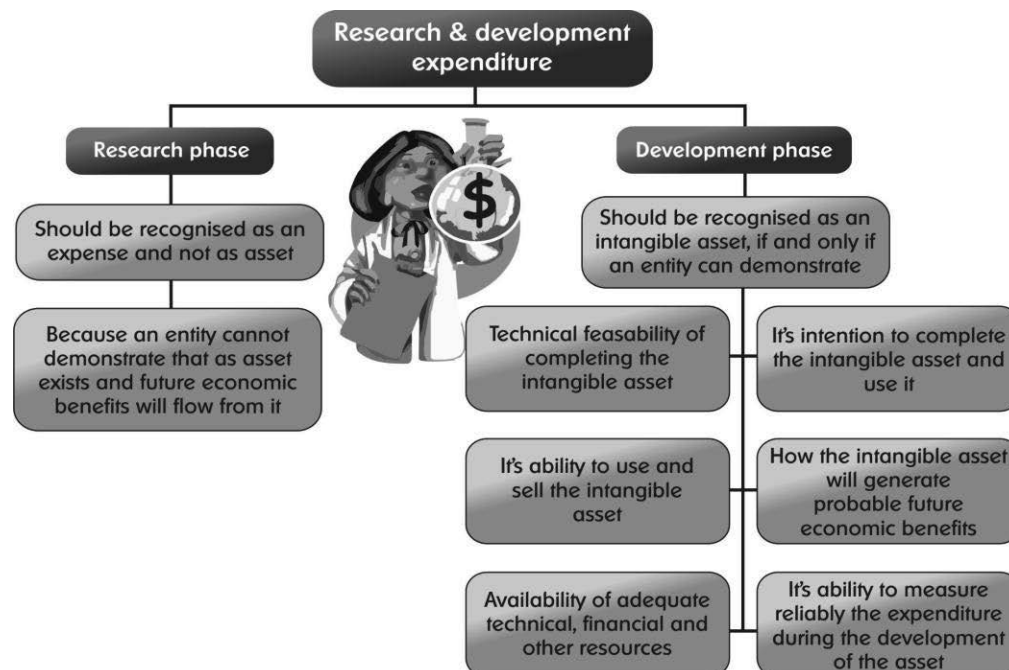
Research activities

- (i) activities aimed at obtaining new knowledge;
- (ii) the search for, evaluation and final selection of, applications of research findings or other knowledge;
- (iii) the search for alternatives for materials, devices, products, processes, systems or services; and
- (iv) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

4.4 Expenditure on the development phase

Expenditure incurred for research and development can be treated as development cost only if it satisfies the conditions mentioned in the following diagram. Therefore, the expenses which do not meet the criteria of development costs are treated as research.

Diagram 5: Expenditure during the research and development phase



Tip

The above points can be remembered with the help of the following mnemonic:

- P** Probability
I Intention
R Resources
A Ability
T Technical feasibility **Expenditure**



Example

Jontex Pharmaceuticals undertook a project to develop a cheaper but more effective drug to fight the malaria. It employed a team of scientists to obtain new knowledge, materials and processes. The team tried different alternatives, many of which failed. **This is a research phase. The expenditure of Tshs1.77 million on this phase is written off.**

The company later arrived at a unique proven formula. It narrowed down on certain materials and processes. It decided to test the formula on a wider scale and obtain patents and licences worldwide. It is confident that it has the resources to complete the project and exploit it commercially, and that the improved cost-effective formula will generate substantial sales.

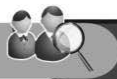
The recognition criteria are met. This is a development phase. Expenditure on this phase amounted to Tshs2.5 million. **Jontex can capitalise the expenditure and recognise an intangible asset because it meets the criteria laid down by IAS 38, i.e.:**

1. It is now technically feasible to complete the asset.
2. Management has demonstrated its intention to complete the asset and use it.
3. The company has the ability to use the new formula and produce the drug.
4. Future sales of the drug will bring economic benefits
5. The company has the resources to complete the development and use the asset.
6. It has an accounts department that will measure and record the expenditure during the development of the asset.

Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets. The reason is that expenditure on these items cannot be distinguished from the cost of developing the business as a whole.

4.5 Cost of an internally generated intangible asset

1. The cost is the sum of expenditure incurred **from the date when the intangible asset first meets the recognition criteria.**
2. All directly attributable costs are added e.g. costs of materials and services, professional fees, employee costs, amortisation of patents and licences used to generate an asset.
3. IAS 38 **prohibits reinstatement of expenditure** previously recognised as expenses.



Example

Continuing from the example of Jontex

Once the project meets the recognition criteria, the company can start to capitalise the costs as an intangible asset. However, it cannot reinstate as an asset the research expenditure incurred in the earlier stage and expensed. Therefore it can recognise only Tshs2.5 million as an intangible asset. It cannot reinstate the earlier expenditure of Tshs1.77 million.



Test Yourself 6

Gottaire Plc's management wanted an improved design for one of its machines. It employed qualified engineers to do the task.

The team did research into the available technology worldwide. They visited the existing manufacturers, decided on possible options, purchased materials and tried different designs of machines. They then put forward 2 alternative designs (A and B) to management. They had spent Tshs0.8 million up to this stage.

Management, convinced of the commercial prospects and approved alternative B, authorised the team to design and construct a pilot plant and operate it on a trial basis. It also authorised the required funds. The team spent Tshs1.7 million on this phase.

Required:

Advise Gottaire on the accounting treatment.

Answers to Test Yourself

Answer to TY 1

- (a) Whilst the antivirus software is identifiable, the criteria of control over the asset are not met in the case of Finux, as it is considered 'open', so anyone can make changes to it; and hence the software, though a valuable resource is not an intangible asset of Finux.
- (b) The criterion of 'control' is the most important one in the context of Reka. According to the contract Reka will sign, there is a chance that she will not be able to leave (except in exceptional circumstances). However, her lawyers state that the contract can be broken. At present it is therefore difficult to state whether TSC has control over Reka. Until she signs the contract, she cannot be treated as an intangible asset. After she signs the contract, on balance it is probable that she can leave, so she would still not be treated as an intangible asset.
- (c) The product of Jesta is identifiable. Jesta also controls the asset. The question here is whether future economic benefits will flow to Jesta. In this case, it will not be enough to accept Jesta's word that it will be able to sell this product technique. If Jesta can show some contracts proving the sale of this technique to animation houses, then the product could be treated as an intangible asset.

Answer to TY 2

- (a) As the expenditure does not relate to the future, the rights should be recognised as an expense (not intangible asset) and recognised in the statement of profit or loss and other comprehensive income.
- (b) If the fair values of the intangible assets can be measured reliably, IFRS 3 requires that they shall be recognised separately. Thus the fair value of the net assets is Tshs5.6m (Tshs5.3m + Tshs0.3m). The consideration being Tshs6m, goodwill shall be recognised at Tshs0.4m and not at Tshs0.7m.
- (c) The transport licence meets the condition of identifiability. Since the licence expires on the day after the end of the reporting period, apparently it does not meet the conditions of control and existence of future economic benefits. However, according to the rules, it did not have to pay the Tshs50 million premium. It gets the benefit of the licence for another 3 years. Therefore, Tshs40 million can be treated as the cost of a licence which will be valid for another 3 years, and recognised as an intangible asset.

Answer to TY 3

- (a) For the licence, either the cost model or the revaluation model can be selected, provided that all the assets of its class are valued similarly. However, for the patent, the cost model is suitable, since there is no active market.
- (b) IAS 38 requires that once the revaluation model is selected, revaluations should be done regularly, so that the values carried in the statement of financial position do not differ materially from the fair values. Therefore, management should arrange for regular revaluations.

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Answer to TY 4

The revaluation increase for licence X is Tshs15 million (Tshs75 million – Tshs60 million). The credit balance in the revaluation surplus against this asset is Tshs4 million. The following entry should be made:

Dr	Licence	Tshs15m	
	Cr	Revaluation Surplus - OCI	Tshs15m
		(Revaluation surplus)	

Being the increase in the value of licence accounted for.

The decrease in value of licence Y is Tshs5 million (Tshs30 million – Tshs25 million). The previous reduction was Tshs3 million. This must have been recognised in the profit or loss part of the statement of profit or loss and other comprehensive income, according to IAS 16.

The following entry should be made:

Dr	Profit / Loss on revaluations (Profit or loss part)	Tshs5m	
	Cr	Licence	Tshs5m

Being the decrease in the value of licence accounted for.

Since there is no balance of revaluation surplus related to this asset, the entire reduction in value is transferred to the profit or loss part of the statement of profit or loss and other comprehensive income.

Answer to TY 5

The intention behind bringing the values of the assets to the fair values is to bring them into line with their current values. By the same logic, the amortisation charge in the profit and loss also needs to be brought into line with the current fair values.

This is possible only if the charge to profit and loss is based on the revalued amounts rather than on cost. This is the reason why the IAS lays down that the transfer from the revaluation surplus to retained earnings should not be routed through the profit or loss.

Answer to TY 6

The expenditure up to the stage where two alternative designs were prepared is a research stage, since generation of probable future economic benefits could not be demonstrated. So, according to IAS 38, Tshs0.8 million should be expensed.

After management approved design B and authorised the team on the specific plans, the criteria of IAS 38 for capitalising expenditure were met, namely:

- technical feasibility was established;
- management had declared its intentions to use the asset;
- the company had the ability to use the machinery;
- future economic benefits were evident; the company would use the machine to produce the goods to be sold;
- management made available adequate resources; and
- it had the ability to measure the expenditure on the development.

The Tshs1.7 million spent during this phase is development expenditure. It can be recognised as an intangible asset.

Quick Quiz

1. Identify whether the following are intangible assets and explain why: fishing licences, import quotas, franchises, copyrights.
2. Is it correct to say that goodwill is not an individually identified asset?

3. Is internally generated goodwill recognised?
4. Can an intangible asset be measured initially at fair value?
5. "Those assets accounted for using the cost model are amortised and those accounted for using revaluation are not amortised." True or false?
6. Are all intangible assets tested for impairment at the end of each period?

Answer to Quick Quiz

1. These are all intangible assets because they are all identifiable non-monetary assets without physical substance. Similarly; these assets are likely to bring future economic benefits.
2. Yes, because it lacks features essential to make an asset identifiable i.e. it is not separable; similarly, it does not arise from a contractual or legal rights.
3. No, because it does not satisfy the requirement of identifiability. Its reliable measurement is also not possible.
4. No, its initial measurement has to be at cost, as required by IAS 38.
5. False. Amortisation does not depend upon the model of accounting chosen. If an asset has a finite useful life, its cost shall be amortised over its useful life, whichever model is used.
6. No, assets with a finite useful life are not tested for impairment, unless there is an indication of impairment. Those with an indefinite useful life are tested for impairment each period.

Self-Examination Questions

Question 1

Hempel Foods Plc acquired a licence for Tshs10 million. The lifecycle of the related product is expected to be 5 years. Net operating cash flows are expected to be as follows:

Year 1: Tshs15m Year 2: Tshs15m Year 3: Tshs15m Year 4: Tshs10m
Year 5: Tshs5m.

Required:

Advise on the amortisation policy that will comply with the requirements of IAS 38.

Question 2

Zest Ltd acquired a patent right for Tshs50 million for a period of 20 years. It decided to amortise the value using the straight-line method of calculation. It opted for the revaluation method of accounting.

The market prices of these patents at the end of years are:

Year 1: Tshs48 million Year 2: Tshs46 million Year 3: Tshs42 million

Thereafter, market prices are not available.

Required:

Explain the accounting treatment for the first 4 years so as to comply with the requirements of IAS 38.

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Question 3

Moonlight Airlines has landing rights with a gross cost of Tshs6.8 million. The related revaluation surplus is Tshs2 million and accumulated amortisation is Tshs4 million. The company sold the landing rights for Tshs3 million.

Required:

Show the accounting entries.

Answers to Self-Examination Questions

Answer to SEQ 1

An intangible asset is to be amortised in the ratio of consumption and future economic benefit.

Assuming that the future economic benefits are consumed in proportion to net operating cash flows, amortisation amount can be calculated as below:

Year	Net operating cash flow	Amortisation fraction	Amortisation amount
	Tshs million	Tshs million	Tshs million
1	15	0.25	2.5
2	15	0.25	2.5
3	15	0.25	2.5
4	10	0.17	1.7
5	5	0.08	0.8
	60	1.00	10.0

Answer to SEQ 2

(Tutorial note: until now, we have considered the questions with either only amortisation or only revaluations. This is a question combining amortisation with the revaluation model.)

The following steps are needed:

- Calculate the initial annual amortisation and charge this amount.
- Determine fair values. If they differ from carrying values, do the revaluation accounting.
- Revise the annual amortisation by dividing the revalued amount by the remaining useful life (since we are using the straight-line method).

Year	Balance of life at beginning	Opening carrying amount	Annual amortisation	Closing net value	Fair value	Revaluation increase	Revaluation decrease
		Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
				(Note 1)			
1	20	50,000	2,500	47,500	48,000	500	-
2	19	48,000	2,526	45,474	46,000	526	-
3	18	46,000	2,556	43,444	42,000	-	1,444
4	17	42,000	2,471	39,529	-	-	-

Accounting entries:

Amortisation

Each year, the amount in the 'annual amortisation' column shall be debited to the 'amortisation of patent' account and credited to the 'accumulated amortisation' account.

Revaluations (Amounts in Tshs'000)**Year 1**

Dr Patent account	Tshs500	
Cr Revaluation surplus OCI		Tshs500
(Being revaluation surplus credited)		

Being increase in revaluation accounted for

Year 2

Dr Patent account	Tshs526	
Cr Revaluation surplus – OCI		Tshs526

Being increase in revaluation accounted for

Up to this stage, the total balance in revaluation surplus is Tshs1,026. Third year, there is a decrease in the value of Tshs1,444. According to IAS 38, to the extent of revaluation surplus available, the decrease shall be debited to revaluation surplus.

The excess of Tshs418 shall be recognised in the profit or loss part of the statement of profit or loss and other comprehensive income. Thus the entry shall be:

Year 3

Dr Revaluation Surplus - OCI	Tshs1,026	
Dr Loss on revaluation of patent –	Tshs418 (Profit or loss part)	
Cr Patent account		Tshs1,444

Being decrease in value of patent in excess of revaluation surplus recognised in the profit or loss part of the statement of profit or loss and other comprehensive income

Note - For the fourth year there is no revaluation. Therefore, the accumulated amortisation figure for the next year would be total of the depreciation for two years i.e. amortisation subsequent to the previous revaluations.

Answer to SEQ 3**(All amounts in Tshs million)**

1. Landing rights and the accumulated amortisation shall be transferred to a disposal account, as follows:

(a)

Dr Disposal of landing rights account	Tshs6.80	
Cr Landing rights account		Tshs6.80

Being the balance in landing rights account transferred to disposal account

(b)

Dr Accumulated amortisation account	Tshs4.0	
Cr Disposal of landing rights account		Tshs4.0

Being the balance in accumulated amortisation account transferred to disposal account

2. Sale consideration shall be recorded

Dr Bank / Cash / Receivables account	Tshs3.0	
Cr Disposal of landing rights account		Tshs3.0

Being receipt of sale consideration

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3. Profit on disposal shall be recorded

Dr	Disposal of landing rights account	Tshs0.2	
	Cr	Profit on disposal of landing rights	Tshs0.2

Being the profit on sale of landing rights recorded

4. Since the revaluation surplus is realised, it shall be transferred to retained earnings

Dr	Revaluation surplus account	Tshs0.2	
	Cr	Retained earnings	Tshs0.2

Being the transfer of revaluation surplus realised to retained earning

The net effect of these entries is thus as follows:

Dr	Accumulated amortisation account	Tshs4.0	
Dr	Bank / Cash / Receivables account	Tshs3.0	
Dr	Revaluation surplus account	Tshs2.0	
	Cr	Landing rights account	Tshs6.8
	Cr	Profit on disposal of landing rights	Tshs0.2
	Cr	Retained earnings	Tshs2.0

Being landing right sold

STUDY GUIDE B4: LEASES

Get Through Intro

Acquiring non-current assets under a lease arrangement is a lifeline available to cash-starved companies. Cash-rich companies may also opt for lease arrangements after conducting a cash outflow-benefit analysis, where they may decide to lease because they can invest their money in something that gives a higher return than the interest they need to pay on the lease payments.

Imagine that Cash Co 'sells' a building to Carry Co for Tshs100 million but in the contract it states that Cash Co will buy the building back within 1 year for Tshs150 million.

You need to look at the 'substance' of the transaction, rather than its strict 'legal form'. That means that instead of looking at the legal document, think about whether it really looks like a sale. Here, it does not look like a sale - why would a company agree to sell something at a low value and then agree to buy it back at a higher value?

In substance, Carry Co has given Cash loan of Tshs100 million and Cash Co has given Carry Co the building as security. When Cash Co buys back the building, it pays Tshs150 million, which in effect is Tshs100 million for the building, with Tshs50 million paid as interest.

Does it seem fair to derecognise the building in Cash Co's accounts? No, it does not, as effectively the asset was just pledged as security just like if a bank requires the deeds of a building as security against a bank loan.

This Study Guide will help you acquire the knowledge required in order to answer examination questions as well as account for leases with ease. It will also teach you how to spot if there is a substance over form issue!

Learning Outcomes

- a) Describe the essential characteristics of a lease arrangement along with important terms and definitions in accordance with International Accounting Standards on leases.
- b) Classify a lease arrangement into an operating or finance lease in accordance with International Accounting Standard on leases.
- c) Present the accounting treatment of operating leases in the books of the lessor and the lessee.
- d) Present the accounting treatment of finance lease in the books of the lessor and the lessee.

1. Describe the essential characteristics of a lease arrangement along with important terms and definitions in accordance with International Accounting Standards on leases.
[Learning Outcome a]

 **Definition**

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

IAS 17 Para 4

In simple terms, a lease is an arrangement by which a person / entity (the lessee) can acquire the right to use an asset from **another person / entity** (the lessor), without making a full payment for the asset when **the arrangement** (the lease) commences.

The lessee pays for the asset in instalments, over the period of the lease.

As full payment **for the use of the assets is** not made **by the lessee**, the title of ownership of the asset remains with the lessor.

The essential characteristics of a lease are

1. The existence of a **lessor**: the lessor is the **person who transfers the right** to use the asset for an agreed period of time to another person.
2. The existence of a **lessee**: the lessee is the **person who acquires the right** to use the asset for an agreed period of time from another person.
3. **Transfer of the right to use an asset**: the lessor transfers the right to use an asset to the lessee. Normally the possession of the leased asset is handed over to the lessee. However, handing over the asset **physically is not compulsory**, what is handed over **is the right to use an asset**.

 **Example**

Plain Co enters into an agreement with Jane Co to use a machine which remains within the factory premises of Jane Co as the cost of dismantling and reinstalling the machine is high.

The cost of the machine is Tshs25 million.

Plain Co agrees to pay the full amount to Jane Co over 10 years, by paying Tshs3 million each year. The ownership or title of the machine remains with Jane Co.

The agreement mentioned above is a lease agreement where:

Plain Co has the right to use the asset **the lessee**.
Jane Co is the lender of the asset **the lessor**.

The **right to use the asset** is with **the lessee (Plain Co)**.
 The **physical possession** of the machine is with **the lessor (Jane Co)**.
 The **ownership** of the machine is with **the lessor (Jane Co)**.

4. **Lease payments** are the **instalments** which the lessee pays to the lessor in return for the right to use an asset.

5. Minimum lease payments

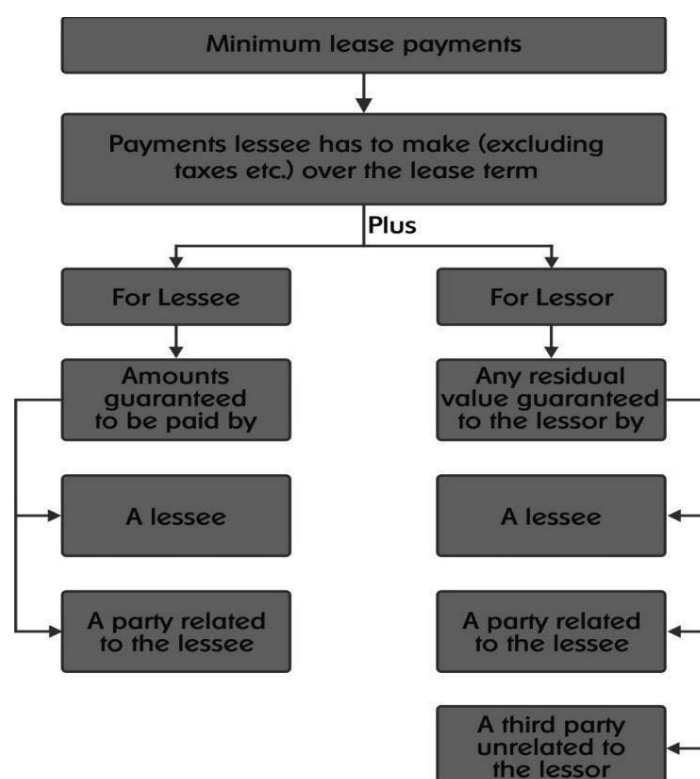


Definition

Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

1. for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or
2. for a lessor, any residual value guaranteed to the lessor by:
 - (a) the lessee;
 - (b) a party related to the lessee; or
 - (c) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Diagram 1: Minimum lease payments for a lessee and a lessor



Other important related terms

1. The **economic life** of an asset



Definition

Economic life is either:

- (a) the period over which an asset is expected to be economically usable by one or more users; or
- (b) the number of production or similar units expected to be obtained from the asset by one or more users.

2. The **degree / extent of transfer of risks and rewards which are incidental to the ownership** of leased asset by the lessor to the lessee.

(a) **Risks incidental to ownership include**

- (i) the possibilities of losses from idle capacity or technological obsolescence
- (ii) variations in return because of changing economic conditions

(b) **Rewards** incidental to ownership include:

- (i) the expectation of profitable operation over the asset's economic life
- (ii) gain from appreciation in value
- (iii) realisation of residual value

When the indicators are mixed the management of the reporting company has to use its discretion in deciding the **degree / extent of transfer of risks and rewards which are incidental to the ownership** of leased asset by the lessor to the lessee.

3. The lease term



Definition

The **lease term** is the **non-cancellable period for which the lessee has contracted to lease the asset**, together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

This basically means that when the lease term is calculated, if the lessee has the option to use the asset for a further period for a very low payment, this extra term should be included in the lease term.



Test Yourself 1

Tom took a vehicle on lease from Jerry. Tom agreed to pay Tshs12 million every year for the next 4 years. Tweety who is related to Tom has agreed to pay the lease rental to Jerry if Tom is unable to pay any lease rent.

Tweety has also agreed to pay Tshs1.25 million for the residual value of the vehicle at the end of the lease term. Tom had to pay Tshs250,000 for registering the lease agreement.

Required:

Determine the minimum lease payments in this transaction.

2. Classify a lease arrangement into an operating or finance lease in accordance with International Accounting Standard on leases.

[Learning Outcome b]

2.1 Finance lease



Definition

A **finance lease** is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

IAS 17 Para 4

If the risks and rewards incidental to ownership are transferred to the lessee, then the lease is a finance lease regardless of whether the ownership is transferred to the lessee or not.

2.2 Operating lease

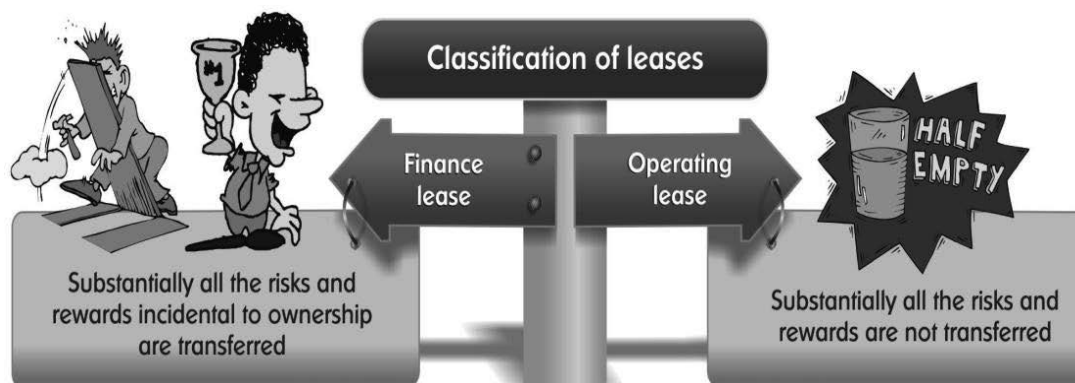


Definition

An **operating lease** is a lease other than a finance lease.

IAS 17 Para 4

Diagram 2: Classification of leases



2.3 Determining a lease type

The **lease type** has to be determined on **inception of the lease** because the **accounting treatment** for assets acquired under the two lease types **is different**.

The **inception of the lease** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease.

It is this date on which a lease is classified as either an operating or a finance lease; and in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

Determining a lease type requires determining whether the **risks and rewards incidental to ownership** of the leased asset **remain with the lessor** or are **transferred to the lessee**.

While determining a lease type, it becomes essential to consider the **substance of the transaction rather than the form of the contract**. A similar-sounding lease gets **classified differently** when we **consider the substance of the transaction rather than the strict legal form of the contract**.

A lease is normally **classified as a finance lease when any one or all of the following situations** arise:

1. The lease **transfers ownership of the asset to the lessee** by the end of the **lease term**.
2. The **lessee has the option to purchase the asset at a price** that is expected to be sufficiently **lower than the fair value of the asset**, at the **date the option becomes exercisable**. It has to be **reasonably certain** at the inception of the lease that the option will be exercised.
3. The lease term is for the major part of **the economic life of the asset**, even if the title is not transferred.
4. At the inception of the lease the present value of the **minimum lease payments** amounts to at least **substantially all of the fair value of the leased asset**. The standard does not define the term 'substantial'. However, if the minimum lease payment is more than 90% of the fair value of the leased asset, it can be said to be substantial.

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IAS 17 does not specify the quantitative threshold for determining ‘Substantially all’ In contrast to this US GAAP, states “the present value of minimum lease payments equaling at least 90% of leased asset fair value,” while the corresponding language, “substantially all of the fair value of the leased asset,” is used in IAS 17. Again, there is scope for debate as to whether “substantially all” implies a threshold lower than 90% or, less likely, an even higher one. However the decision rests on management to determine this threshold.

- 5.
6. The leased assets are of such a **specialised nature** that only **the lessee can use them without major modifications**.
7. If the lessee can cancel the lease, then the **lessor’s losses associated with the cancellation are borne by the lessee**.
8. **Gains or losses** from the fluctuation in the fair value of the **residual accrue to the lessee**.
9. **The lessee** has the ability to **continue the lease for a secondary period at a rent that is substantially lower than market rent**.



Tip

If **none** of the above **conditions** are fulfilled then it is an **operating lease**.

It is important to remember that **all the situations mentioned above are not conclusive** in the classification of the lease type. Each lease agreement has to be considered individually, keeping in mind that the most important feature for classification is **whether the risks and rewards incidental to ownership of the leased asset lie with the lessor or the lessee**.



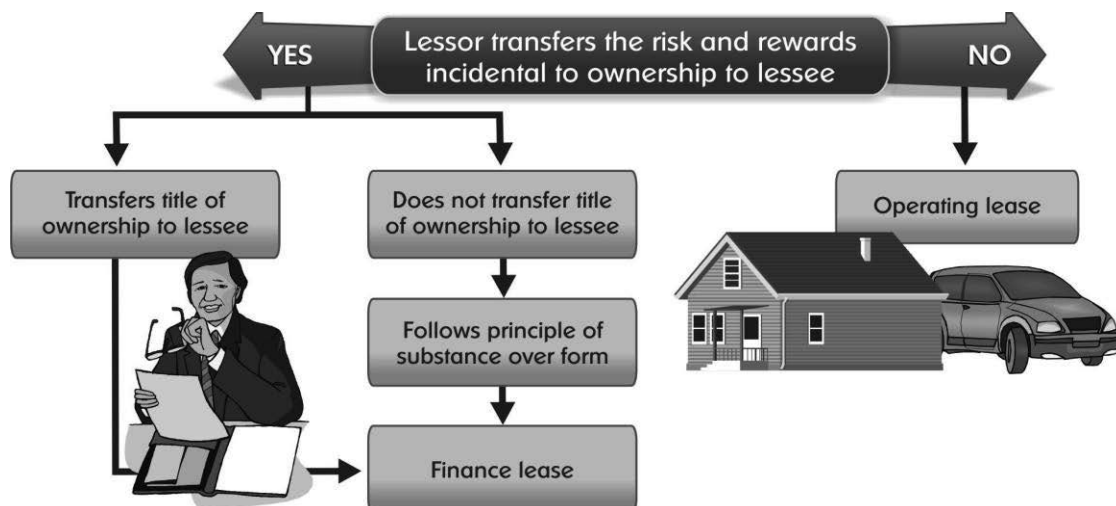
Test Yourself 2

1. Alpha Co takes on lease a special camera from Beta Co at an annual lease rent of Tshs6 million. Alpha Co is to make minimum lease payments for 5 years. The present value of annual lease rents is Tshs23.956 million. The fair value of the camera is Tshs25 million.
2. Fair Co acquired a building from Deal Co on lease for 20 years. In the lease agreement itself, it is decided that the sale proceeds of the building at the end of the lease period will remain with Deal Co.

Required:

Determine whether this lease is a finance lease or an operating lease.

Diagram 3: Determining a lease type



2.4 Method of classifying leases of land and buildings

One unique feature of land is that it cannot have an estimated economic life. Prior to the amendment to IAS 17 (2009), if the title of ownership of land was not going to be transferred to the lessee at the end of the lease term, then the risks and rewards of owning land cannot be said to be transferred and therefore the land was classified as an operating lease.

For classifying a lease involving land and buildings, land and buildings elements are required to be separated. The minimum lease payments are allocated between the land and buildings elements in proportion to their relative fair values. The land element of lease is normally classified as an operating lease however, when the title of land passes to the lessee at the end of the lease term it is classified as finance lease. However, according to the amendment made to IAS 17 in April 2009, a long term lease of land should be classified on the basis of its substance and not only based on its legal form. In the case of long term land agreements, the risks and rewards would be automatically transferred to the lessee, even though the title is not transferred. In such a case, the lease for the land should be treated as a finance lease. The buildings element is classified as an operating or finance lease by applying the classification criteria in IAS 17.

However, if the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted separate measurement of the land and buildings elements is not required.



Example

Juke Co acquired land on lease from Buke Co. for the period of 999 years. The title is not expected to pass to Juke Co.

However, due to the long duration of the lease, significant risks and rewards associated with the land during the lease term are to be transferred to the lessee despite there being no transfer of title.

In this situation, the lease should be treated as a finance lease and not as an operating lease.

3. Present the accounting treatment of operating leases in the books of the lessor and the lessee.

[Learning Outcome c]

3.1 In the books of the lessee

IAS 17 states that **lease rental payments** under an **operating lease** shall be **recognised as an expense on a straight line basis over the lease term** unless another systematic basis is more representative of the time pattern of the user's benefit. **An asset acquired under a lease agreement is not recognised as an asset in the books of the lessee.**



Test Yourself 3

Why are assets acquired under an operating lease not recognised as an asset purchased on credit?

This means that the **lease rentals** which the **lessee pays** periodically, when he acquires an asset under an **operating lease**, are **debited to the statement of profit or loss as an expense.**

Journal entry:

Dr	Lease rents paid		X	
	Cr	Bank		X
	Being lease rental paid			



Example

On 1 January 20X5, Earthmovers Ltd acquired on lease a bulldozer from Power Plant Ltd by paying an annual lease rental of Tshs5 million for the next five years. The repairs and maintenance of the bulldozer are to be undertaken by Power Plant Ltd. At the end of five years, if Earthmovers Ltd wishes to renew the lease, then it would have to re-negotiate the terms of the lease.

Required:

State with reasons, the type of the lease and show the accounting treatment and the relevant extracts of its financial statements in the books of Earthmovers Ltd assuming the calendar year to be the accounting year.

Answer

According to the terms of this lease agreement:

1. the **risks incidental to ownership** of the leased asset remain with Power Plant Ltd (**lessor**) has to undertake the repairs and maintenance of the leased asset.
2. the **rewards incidental to ownership** of the leased asset remains with Power Plant Ltd (**lessor**) if the lease is to be renewed at the end of the lease term, and then there are to be re-negotiations.
3. The title of ownership is going to remain with Power Plant Ltd (**lessor**).

Hence, this is an **operating lease** and will be accounted for in the following manner in the books of Earthmovers Ltd.

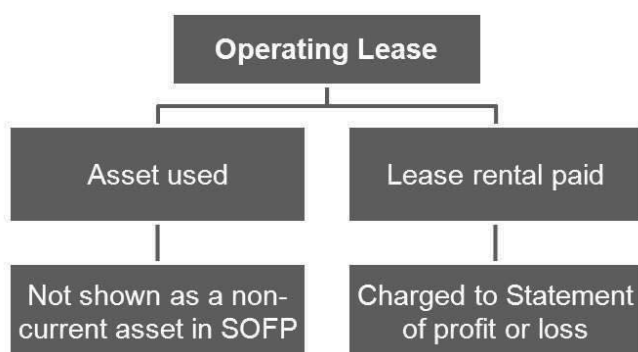
Lease rent paid					
Date		Tshs'000	Date		Tshs'000
31/12/20X5	Bank	5,000	31/12/20X5	Statement of profit or loss	5,000
31/12/20X6	Bank	5,000	31/12/20X6	Statement of profit or loss	5,000
31/12/20X7	Bank	5,000	31/12/20X7	Statement of profit or loss	5,000
31/12/20X8	Bank	5,000	31/12/20X8	Statement of profit or loss	5,000
31/12/20X9	Bank	5,000	31/12/20X9	Statement of profit or loss	5,000
31/12/20Y0	Bank	5,000	31/12/20Y0	Statement of profit or loss	5,000

Statement of profit or loss and OCI (extracts) for the year to 31 December (Amount in Tshs'000)

	20X5	20X6	20X7	20X8	20X9	20Y0
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Lease rent paid	5,000	5,000	5,000	5,000	5,000	5,000

The statement of financial position will not reflect any item for the bulldozer acquired under an operating lease.

Diagram 4: Accounting treatment in the books of the lessee for assets leased out under an operating lease



3.2 In the books of the lessor

The leased asset continues to be reflected as a non-current asset in the financial statements of the lessor and is depreciated in the normal manner. The lease rentals received are credited in the statement of profit or loss of the lessor.



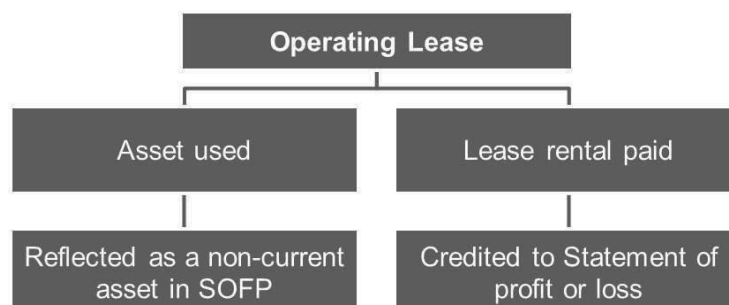
Test Yourself 4

Using the information given in the example of Earthmovers Ltd above and the additional information given here **show the relevant extracts in the financial statements of Power Plant Ltd.**

Additional information

The carrying amount of the bulldozer on 1 January 20X5 was Tshs200 million and the rate of depreciation was 10% on a reducing balance method.

Diagram 5: Accounting treatment in the books of the lessor for assets acquired under an operating lease



4. Present the accounting treatment of finance lease in the books of the lessor and the lessee.

[Learning Outcome d]

4.1 Accounting treatment for finance lease in the books of the lessee

IAS 17 states that assets acquired by way of finance leases are to be accounted for in **the books of the lessee** in the **same manner as credit purchases are recorded.**

1. Recognition of an asset and a liability

The journal entry to capitalise the asset is:

Dr	Asset		X	
	Cr	Lessor		X

Being asset acquired by a finance lease

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The amount to be recorded is the **lower** of the **fair value of the asset** and the **present value** of the **minimum lease payments**.



Example

Alpha Ltd acquired a machine on lease from Beta Ltd. Alpha Ltd has to bear the repairs and maintenance charges of the machine and can also realise the residual value at the end of its economic life. The fair value of the machine is Tshs50 million and the present value of the minimum lease payments is Tshs48.5.

In this example:

The lease is a finance lease as both the risks (repairs and maintenance charges of the machine) and the rewards (realisation of the residual value at the end of the economic life) of ownership of the machine lie with Alpha Ltd (the lessee).

The journal entry in the books of Alpha Ltd (the lessee) is:

Dr	Machine	Tshs48.50
	Cr Lessor	Tshs48.50
Being machine acquired by a finance lease		

2. Depreciating an asset

The **depreciation policy** for depreciable leased assets should be **consistent with the normal depreciation policy of the lessee for similar assets** (according to the requirements of IAS 16 and IAS 38).

If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset shall be fully depreciated over the shorter of:

- the **life of the lease**; and the **useful life of the asset**.



Example

Laurel acquired a film projector from Hardy on a 5-year finance lease. The fair value of the projector is Tshs75 million and the present value of the minimum lease payments is Tshs76 million. The useful life of the projector is 10 years and the estimated residual value is Tshs2.5 million.

In this example:

- Laurel will capitalise the projector in his books for Tshs75 million (the **lower** of the **fair value of the asset** and the **present value** of the **minimum lease payments**).
- The projector will be depreciated over 5 years [the shorter of the life of the lease and the useful life of the asset].
- The amount of depreciation charged each year will be Tshs14.5 million ((Tshs75 million – Tshs2.5 million) / 5 years).

Estimated residual value



Test Yourself 5

Why is an asset acquired by a finance lease recorded as a credit purchase in the books of the lessee?

3. Accounting for repayment

The journal entries to record the lease rental payment are

For the lease rental repayment (inclusive of both the interest and capital repayment portion):

Dr	Lessor		X	
	Cr	Cash/bank		X

Being the total rental payment paid to the lessor

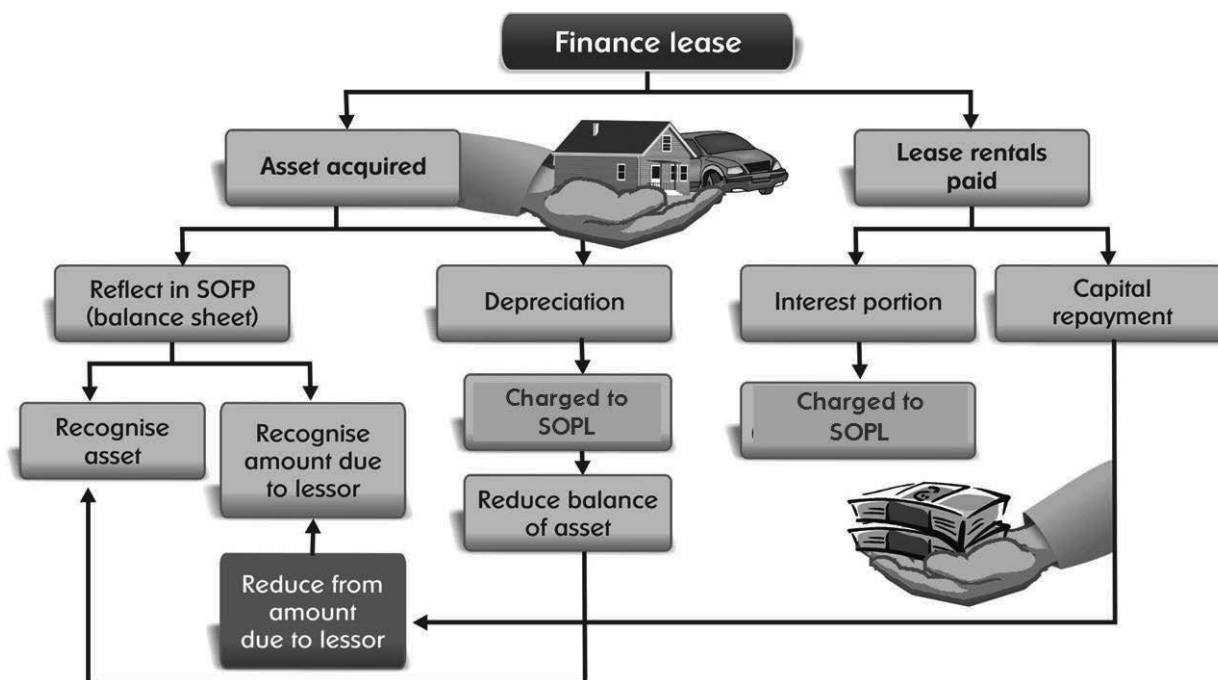
For recording the interest

Dr	Lease interest		X	
	Cr	Lessor		X

Being the interest accrued outstanding on the total lease amount

(The lease rental payment is split into the capital portion and the interest portion by using one of the two methods mentioned above).

Diagram 6: Treatment in the books of the lessee for assets acquired under a finance lease



SOPL – Statement of profit or loss

4.2 Accounting treatment in the books of the lessor

IAS 17 requires the leased asset to be recognised in the lessor's statement of financial position as a receivable and not as a non-current asset. The lessor will recognise receivables and derecognise the leased asset.

The journal entry for recording this transaction is:

Dr	Receivable (lessee)		X	
	Cr	Non-current asset		X

Being asset transferred by a finance lease

The amount to be recognised is the **present value** of **minimum lease payments**.

The journal entries to record the lease instalments received are:

For the lease instalment received (inclusive of both the interest and capital repayment portion)

Dr	Cash/bank		X	
	Cr	Lessee		X

Being the total lease instalment received from the lessee

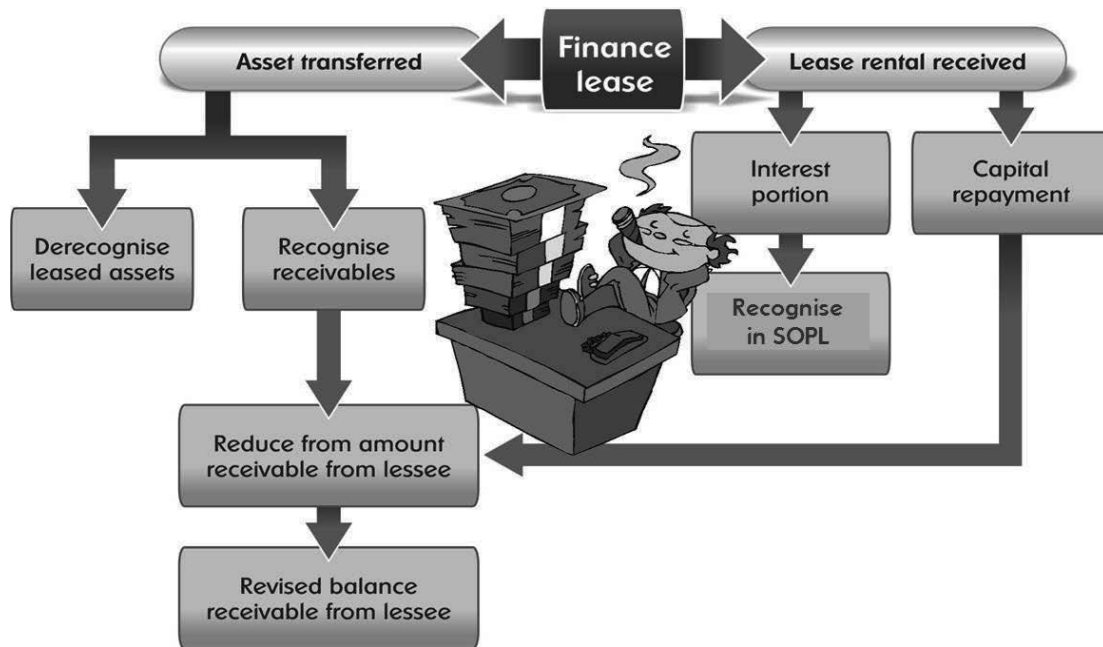
For recording the interest

Dr	Lessee		X	
	Cr	Lease interests received		X

Being the interest received on the total lease amount outstanding

(The lease rental payment is split into the capital portion and the interest portion by using one of the two methods mentioned above).

Diagram 7: Treatment in the books of the lessor for assets leased out under a finance lease



SOPL – Statement of profit or loss

Treatment of initial direct costs incurred by the lessor

Lessors often incur initial direct costs like commissions, legal charges, professional fees etc. In the case of lessors other than manufacturer or dealer lessors, the initial direct costs incurred are to be capitalised and recognised over the lease term. The interest rate implicit in the lease is defined in such a manner that initial direct costs are automatically included in finance lease receivables. Thus, there is no need to add these costs separately.

However in case of manufacturer or dealer lessors the initial direct costs are recognised as expenses as and when the selling profits are recognised.

4.3 Determination of the interest portion and the capital portion of the lease instalment

In order to account for the finance lease the lease rental has to be split into

-
- The **interest** portion; and
- The **capital** portion

The two methods which can be used for apportioning **the lease rental payments** are:

- The **actuarial** method; and
- The **sum-of-digits** method



Tip

It should be noted that, whichever method is followed, the total interest paid remains the same.

4.4 The actuarial method

- (1) At the inception of the lease (when the lease starts), the lessor is credited with an amount equal to the fair value of the asset.
- (2) Any deposit paid to the lessor is then deducted from this amount.
- (3) The amount of capital repaid is deducted from the credit balance of the lessor's account every time a lease rental is paid.
- (4) The interest portion is calculated by applying the rate of interest to the balance in lessor's account each year (reducing balance method).

The interest rate used is called the **interest rate implicit in the lease**. This rate spreads income derived from the lease over the period of the lease. This interest rate will be mentioned in the question.

As the reducing balance method is followed to calculate the amount of interest, the interest is highest in the early part of the lease term, and gradually reduces as capital is repaid.



Test Yourself 6

Right Ltd leases an item of a plant from Left Ltd on 1 January 20X5. Tshs12.5 million is payable immediately, followed by four annual payments starting on 1 January 20X6. The agreed fair value of the plant is Tshs44.868 million and the interest rate implicit in the lease is 20% per annum.

Right Ltd has the right to continue to use the plant after the end of the five-year period for as long as it wishes to without further payment. The expected useful life of the plant is ten years, at the end of which the residual value is estimated to be nil.

Required:

Split the lease rental payments into the interest and capital portions by using the actuarial method.

4.5 The sum-of-digits method

1. A digit is assigned to each interest bearing instalment.

If there is a down payment followed by 3 instalments then the number of interest bearing instalments is 3. The number of interest bearing instalments is not 4 - there is no interest inherent in a down payment.

2. The last instalment is assigned the digit 1, the second last one 2, and so on.

3. Add all the digits, using the formula:

Sum of digits = $n(n+1) / 2$, where **n** is the number assigned to the interest bearing instalments

4. Calculate the interest portion included in each interest bearing instalment by using the formula:

Interest portion = Total interest (to be paid or received) over lease term x digit applicable to the instalment / sum of digits

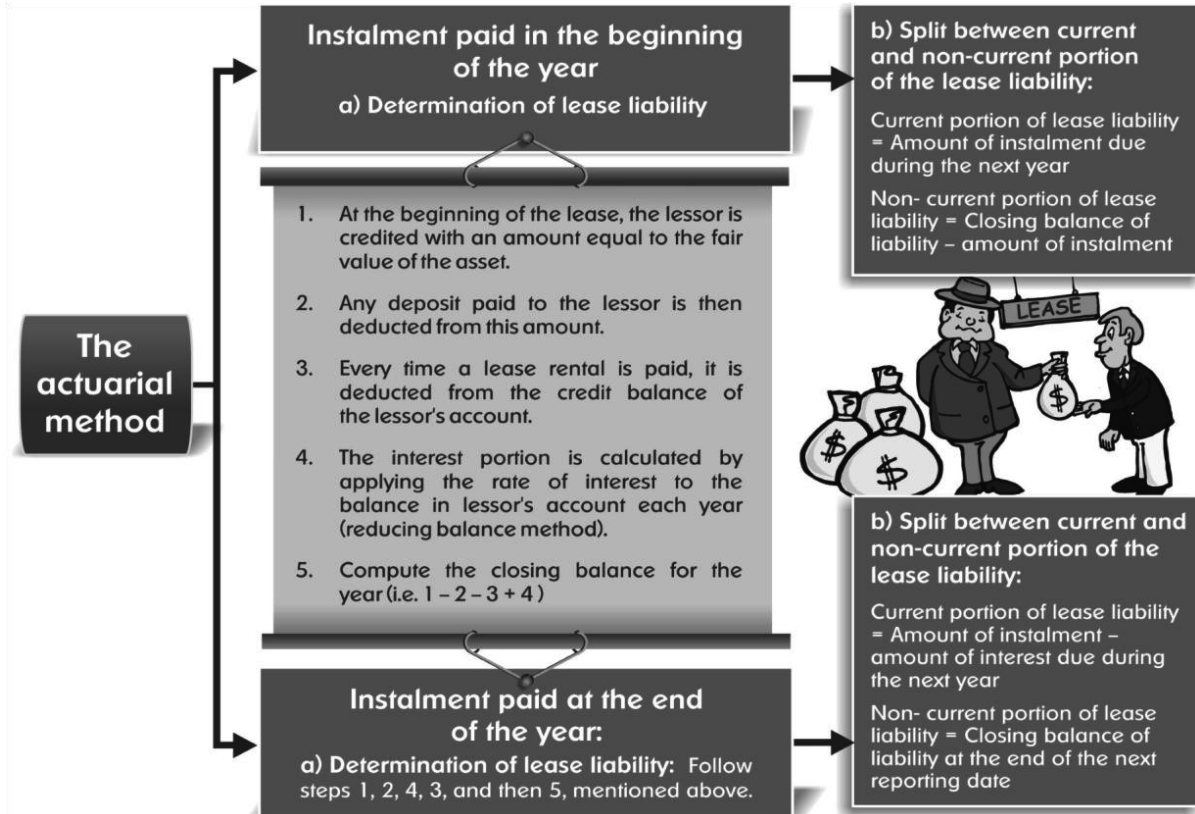
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In this method also, the interest is highest in the early part of the lease term, and gradually reduces as capital is repaid. This is consistent with what happens in reality, where the first instalments have a higher interest element as there is more capital outstanding at that point.

Test Yourself 7

Using data and figures from Test Yourself 6 - Right Ltd, calculate interest under the sum-of-digits method.

Diagram 8: Treatment of interest using the actuarial method



Test Yourself 8

Using information given in Test Yourself 6, show the relevant extracts of the financial statements (interest apportionment using the actuarial method) of Right Ltd, the lessee, for the years 20X5 to 20Y0.

Test Yourself 9

For Test Yourself 6 show the relevant extracts of the financial statements of Left Ltd

Answers to Test Yourself

Answer to TY 1

In this case minimum lease payments for both Tom (lessee) and Jerry (lessor) are:

	Tshs'000
Lease rent (Tshs12,000 x 4)	48,000
Plus amount guaranteed to be paid by Tweety	1,250
Minimum lease payments	49,250

Tshs250,000 paid for registering the lease agreement does not become a part of the minimum lease payments.

Answer to TY 2

- (a) A lease is classified as a finance lease if the present value of the **minimum lease payments** amounts to at least **substantially all of the fair value of the leased asset**.

In this lease

the present value of the minimum lease payments is Tshs23.956 million
the fair value of the camera is Tshs25 million.

As the present value of the **minimum lease payments** amounts to **substantially all of the fair value of the leased camera**, this lease is classified as a **finance lease**.

- (b) As gains or losses arising from the fluctuation in the fair value of the leased building remain with the lessor this is an operating lease.

Answer to TY 3

The **risks and rewards incidental to ownership** of the leased asset remain with the lessor under an **operating lease**.

They are **not transferred to the lessee**.

This means that the **lessee does not acquire a non-current asset**, even after making the minimum lease payments under the lease agreement: he is **only paying rent for operating the asset**.

Hence, assets acquired under an operating lease are treated not as a credit purchase of asset but as a lease (rental) expense in the statement of profit or loss.

Answer to TY 4

Statement of profit or loss and OCI (extracts) of Power Plant Ltd for the year to 31 December (Amounts in Tshs'000)

Income	20X5	20X6	20X7	20X8	20X9	20Y0
Lease rent received	5,000	5,000	5,000	5,000	5,000	5,000

Expenses	20X5	20X6	20X7	20X8	20X9	20Y0
Depreciation (W1)	20,000	18,000	16,200	14,580	13,122	11,810

Statement of financial position (extracts) of Power Plant Ltd as on 31 December (Amounts in Tshs'000)

Assets	20X5	20X6	20X7	20X8	20X9	20Y0
Non-current assets (W1)	180,000	162,000	145,800	131,220	118,098	106,288

Workings

W1 Carrying amount of non-current assets and depreciation (Amounts in Tshs'000)

	20X5	20X6	20X7	20X8	20X9	20Y0
Carrying amount on 1 January	200,000	180,000	162,000	145,800	131,220	118,098
Depreciation @ 10% (RBM)	(20,000)	(18,000)	(16,200)	(14,580)	(13,122)	(11,810)
Carrying amount on 31 December	180,000	162,000	145,800	131,220	118,098	106,288

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Answer to TY 5

The risks and rewards incidental to ownership of the leased asset are transferred to the lessee in a finance lease. This means that the lessee has acquired a non-current asset, regardless of whether the title of ownership eventually passes over to him or not.

In order to **apply the principle of economic substance** an asset acquired by a finance lease is recorded as a credit purchase in the books of the lessee.

The substance of the transaction is: the asset is being used and benefits are being received by the lessee. The legal form of the transaction is: the ownership documents are owned by the lessor.

Answer to TY 6

The **lease rental payments** are split into the **interest** and **capital** portions, by using the **actuarial method** in the following manner:

	Left Ltd	Lease Rental	Left Ltd.'s'	Interest	Balance on Left Ltd
Year	Balance on 1 January Tshs'000	Paid on 1 January Tshs'000	Reducing Balance Tshs'000	Portion Tshs'000	31 December Tshs'000
20X5	44,868	(12,500)	32,368	6,474	38,842
20X6	38,842	(12,500)	26,342	5,268	31,610
20X7	31,610	(12,500)	19,110	3,822	22,932
20X8	22,932	(12,500)	10,432	2,068	12,500
20X9	12,500	(12,500)		17,632	-

Answer to TY7

The following calculation shows the allocation of the lease rental payments into the **interest** and **capital** portions by using the **sum of digits** method:

Year	Formula	Interest portion Tshs'000
20X5	4/10 x 17,632	7,053
20X6	3/10 x 17,632	5,290
20X7	2/10 x 17,632	3,526
20X8	1/10 x 17,632	1,763
	Total interest	17,632

Workings (Amounts in Tshs'000)

W1 Sum of digits

$$\begin{aligned}
 \text{Sum of digits} &= n(n+1)/2 \\
 &= 4(4+1)/2 \\
 &= 4 \times 5/2 \\
 &= 10
 \end{aligned}$$

n = number of interest bearing instalments - 4

W2 Total interest

$$\begin{aligned}
 \text{Total interest} &= \text{Total of instalments} - \text{fair value of asset} \\
 &= (12,500 \times 5) - 44,868 \\
 &= 62,500 - 44,868 \\
 &= 17,632
 \end{aligned}$$

Answer to TY 8

Right Ltd has the right to continue to use the plant after the end of the five year period for as long as it wishes without further payment. This shows that Right Ltd has acquired the plant under a finance lease because the risks and rewards of ownership have been transferred from the lessor (Left Ltd) to the lessee (Right Ltd).

It is assumed that Right Ltd charges depreciation at 10% on a straight-line basis as the estimated useful life of the machine is estimated to be 10 years.

Statement of profit or loss and OCI (extracts)

	20X5	20X6	20X7	20X8	20X9
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Lease interest (W1)	6,474	5,268	3,822	2,068	
Depreciation - plant (W2)	4,487	4,487	4,487	4,487	4,487

Statement of financial position (extracts)

	20X5	20X6	20X7	20X8	20X9
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets					
Plant: at cost	44,868	44,868	44,868	44,868	44,868
Depreciation (W3)	(4,487)	(8,974)	(13,461)	(17,948)	(22,435)
	40,381	35,894	31,407	26,920	22,433
Current Liabilities					
Left Ltd (Instalment - interest portion) (W4)	12,500	12,500	12,500	12,500	
Non-current liabilities					
Left Ltd (closing balance - current liability) (W4)	26,342	19,110	10,432		

Note

The asset will be depreciated for a further period of 5 years, hence the WDV at the end of the 5 year is not nil. However, the lease payment is to be made only for 5 years, so the liability to the lessor will be nil.

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Workings

W1 Lease interest

Year	Left Ltd Balance on 1 January	Lease Rental Paid on 1 January	Left Ltd Reducing Balance	Interest Portion	Left Ltd Balance on 31 December
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
20X5	44,868	(12,500)	32,368	6,474	38,842
20X6	↓ 38,842	(12,500)	26,342	5,268	31,610
20X7	↓ 31,610	(12,500)	19,110	3,822	22,932
20X8	↓ 22,932	(12,500)	10,432	2,068	12,500
20X9	↓ 12,500	(12,500)	-	-	-
		62,500		17,632	

W2 Depreciation on plant (Amounts in Tshs'000)

Plant at cost	Tshs44,868
Depreciation at 10% on straight line basis (Tshs44,868 x 10%)	Tshs4,487

W3 Provision for depreciation

	20X5	20X6	20X7	20X8	20X9
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Opening balance	-	4,487	8,974	13,461	17,948
Depreciation for the year	(4,487)	(4,487)	(4,487)	(4,487)	(4,487)
Closing balance	4,487	8,974	13,461	17,948	22,435

W4 Non-current liabilities

Non-current liability portion = Amount payable to Left Ltd – Current liability portion

As at 31 December	20X5	20X6	20X7	20X8	20X9
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Amount payable to Left	38,842	31,610	22,932	12,500	-
Less: Current portion Non-current portion	(12,500)	(12,500)	(12,500)	(12,500)	-
	(26,342)	(19,110)	(10,432)		-

Answer to TY 9

Statement of profit or loss and OCI (EXTRACTS) (amounts in Tshs'000)

	20X5	20X6	20X7	20X8	20X9	20Y0
Lease interest received (W1)	6,474	5,268	3,822	2,068		

Statement of financial position (EXTRACTS) (amounts in Tshs'000)

	20X5	20X6	20X7	20X8	20X9	20Y0
Receivable from Right Ltd	38,842	31,610	22,932	12,500		-

Workings

W1 Lease interest received and receivable from Right Ltd

Year	Right Ltd Balance on 1 January Tshs'000	Lease instalment received on 1 January Tshs'000	Right Ltd Reducing Balance Tshs'000	Interest Portion Tshs'000	Right Ltd Balance on 31 December Tshs'000
20X5	44,868	(12,500)	32,368	6,474	38,842
20X6	↓ 38,842	(12,500)	26,342	5,268	31,610
20X7	↓ 31,610	(12,500)	19,110	3,822	22,932
20X8	↓ 22,932	(12,500)	10,432	2,068	12,500
20X9	↓ 12,500	(12,500)	-	-	-
				17,632	

Quick Quiz

- (1) Name the two different types of leases.
- (2) What are the two components of a lease rental and which are the two methods by which these components are identified?
- (3) Is an asset acquired under an operating lease capitalised and brought into the books of accounts of the lessee?
- (4) What is the principle of substance over form?

Answers to Quick Quiz

- (1) The two different types of leases are:
 - Finance lease
 - Operating lease
- (2) The lease rental comprises of two portions:
 - The interest portion
 - The capital portion

The two methods by which these components can be identified are:

 - The actuarial method
 - The sum of digits method
- (3) An asset acquired under an operating lease is not brought into the books of accounts of the lessee at all. Only the lease rental payments made are debited to the statement of profit or loss.
- (4) Substance over form is the principle that transactions and events are accounted for and presented in accordance with their substance and economic reality, and not just their legal form.

Self Examination Questions

Question 1

Play Inc has leased land and buildings to Clay Inc. The terms of the lease say that:

- The title of land will not be transferred to Clay Inc.
- Clay Inc has to pay an annual lease rent of Tshs50 million for a minimum number of 10 years. The fair value of the building is Tshs480 million.

Required:

Determine the lease type.

Question 2

Fox Enterprises bought four helicopters at a price of Tshs20 million each as a part of business expansion. Fox Enterprises entered into a finance lease agreement with Monk Flights Co for the same on 1 January 20X5. The agreement stated that Fox Enterprises would pay a deposit of Tshs10 million on 1 January 20X5, annual instalments on 31 December 20X5 and 31 December 20X6 of Tshs25 million each and a final instalment on 31 December 20X7 of Tshs79.04 million.

Interest was charged at 30% on the outstanding balance at 1 January and paid on 31 December each year. Fox Enterprises writes off its vehicles over a period of three years using the straight-line method. The value of scrap of the vehicle is assumed to be Tshs1.5 million each.

Required:

Prepare

- (i) The relevant accounts to show how the above transactions would be recorded in the books of Fox Enterprises and;
- (ii) Extracts from the statement of profit or loss and statement of financial position for the years ending 31 December 20X5, 20X6, 20X7.

Question 3

On 1 October, 20X5 Red Inc leased one of its machines to White Inc for 3 years, at an annual lease rental of Tshs4 million. The estimated economic life of the machine was 10 years. Show the accounting entries in the books of White Inc for these transactions.

Answers to Self-Examination Questions

Answer to SEQ 1

The land portion of the lease: This portion is an operating lease because the title of land will not be transferred to Clay Inc and the estimated economic life of land cannot be ascertained.

Furthermore, this is not the long term lease agreement where the significant risks and rewards associated with the land during the lease term would be transferred to the lessee, despite there being no transfer of title. Therefore this will be an operating lease.

The building portion of the lease:

The minimum lease payments amount to Tshs500 million (Tshs50 million x 10).
The fair value of the building is Tshs480 million.

This portion of the lease is a finance lease, because at the inception of the lease the present value of the minimum lease payments seems to cover substantially all of the fair value of the leased asset.

Answer to SEQ 2

Books of Fox Enterprises

Helicopter Account

Date		Tshs'000	Date		Tshs'000
01/01/20X5	Monk Flights (Tshs20,000 x 4)	80,000	31/12/20X5	Balance c/d	80,000
01/01/20X6	Balance b/d	80,000	31/12/20X6	Balance c/d	80,000
01/01/20X7	Balance b/d	80,000	31/12/20X7	Balance c/d	80,000

Accumulated depreciation on helicopter

Date		Tshs'000	Date		Tshs'000
31/12/20X5	Balance c/d	24,667	31/12/20X5	Statement of profit or loss 33.33% x (Tshs80,000- (4 x Tshs1,500))	24,667
31/12/20X6	Balance c/d	49,334	01/01/20X6	Balance b/d	24,667
		49,334	31/12/20X6	Statement of profit or loss	24,667
31/12/20X7	Balance c/d	74,000	01/01/20X7	Balance b/d	49,334
		74,000	31/12/20X7	Statement of profit or loss	24,666
					74,000

Lease interest

Year		Tshs'000	Date		Tshs'000
31/12/20X5	Monk Flight Co	*21,000	31/12/20X5	Statement of profit or loss	21,000
31/12/20X6	Monk Flight Co	*19,800	31/12/20X6	Statement of profit or loss	19,800
31/12/20X7	Monk Flight Co	*18,240	31/12/20X7	Statement of profit or loss	18,240

Workings (Amounts in Tshs'000)

*(Tshs20,000 x 4 helicopters) = total Tshs80,000 – deposit Tshs10,000 = cost Tshs70,000 x interest 30% = 21,000

*(cost Tshs70,000 + lease interest 21,000 – 1st instalment Tshs25,000) = Tshs66,000 x interest 30% = 19,800

*(cost Tshs66,000 + lease interest 19,800 – 2nd instalment Tshs25,000) = Tshs60,800 x interest 30% = 18,240

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Statement of profit or loss and OCI (extracts) for the year to 31 December

Expenses	Amounts in Tshs'000		
	20X5	20X6	20X7
Lease interest	21,000	19,800	18,240
Depreciation on helicopters	24,667	24,667	24,666

Statement of financial position (extracts) as at 31 December

	20X5	20X6	20X7
	Tshs'000	Tshs'000	Tshs'000
Non-current assets			
Helicopters: at cost	80,000	80,000	80,000
	(24,667)	(49,334)	(74,000)
Less: Depreciation	55,333	30,666	6,000
Non-current liabilities			
Finance lease obligations (Closing balance – Current liability)	66,000	60,800	-
Current liabilities			
Finance lease obligations (Instalment – Interest portion)	-	-	-

Monk Flight Co

Year		Tshs'000	Year		Tshs'000
01/01/20X5	Bank- deposit	10,000	01/01/20X5	Helicopter	80,000
31/12/20X5	Bank	25,000	31/12/20X5	Interest	21,000
	Balance c/d	66,000			
31/12/20X6		101,000	01/01/20X6	Balance b/d	101,000
	Bank	25,000			66,000
	Balance c/d	60,800	31/12/20X6	Interest	19,800
31/12/20X7		85,800			85,800
	Bank	79,040	01/01/20X7	Balance b/d	60,800
			31/12/20X7	Interest	18,240
		79,040			79,040

Answer to SEQ 3

According to the **terms** of this **lease agreement**:

The **rewards incidental to ownership** of the **leased asset remains with Red Inc (lessor)**: the asset has been leased for only 3 years out of its estimated economic life of 10 years.

The title of ownership is going to remain with Red Inc (**lessor**).

Hence, this is an **operating lease** and will be accounted for in the following manner, in the books of White Inc.

Lease interest

Year		Tshs'000	Date		Tshs'000
31/12/20X5	Bank	1,000	31/12/20X5	Statement of profit or loss	1,000
31/12/20X6	Bank	4,000	31/12/20X6	Statement of profit or loss	4,000
31/12/20X7	Bank	4,000	31/12/20X7	Statement of profit or loss	4,000
31/12/20X8	Bank	3,000	31/12/20X8	Statement of profit or loss	3,000

Statement of profit or loss (extracts)

	(Amount in Tshs'000)			
	20X5	20X6	20X7	20X8
Lease rent	1,000	4,000	4,000	3,000

STUDY GUIDE B5: REVENUE AND CONSTRUCTION CONTRACTS

Get Through Intro

Revenue is something that most of us would like to have more and more of. It is often a sign that the business is growing. However, in the past, there have been a number of instances where revenue has been recorded earlier than it should have been in the financial statements.

For example, imagine that you are selling tables and chairs. You receive an order on 28 December 20X7 to supply 200 tables and 1,200 chairs to a new restaurant that is opening up. They would like delivery by the end of January 20X8. Your year end is 31st December. Without the proper guidance, you may be tempted to book the revenue in 20X7 as it is going to show a higher revenue figure and therefore make your business look better. However, in reality, as the tables and chairs will be delivered in January, the invoice should not be raised until January 20X8, when the tables and chairs are actually delivered.

IAS 18 gives specific guidelines about the timing of revenue recognition. The principles of timing of revenue recognition need to be carefully understood as an incorrect interpretation will lead to errors in the financial statements.

Further, the construction industry is one of the most important industries. The date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Sometimes, the contracts run into several accounting periods. IAS 11 gives specific guidance to account for revenue in the construction industry

Understanding this Study Guide will ensure that you never face problems recognising when revenue should be accounted for!

Learning Outcomes

- a) Describe the criteria for revenue recognition.
- b) Discuss revenue recognition issues during the production and sales cycle.
- c) Illustrate issues relating to sales of multiple arrangement and extended credit terms in revenue recognition of goods and services.
- d) Apply the revenue recognition principles in sale and repurchase agreements.
- e) Describe various types of a construction contract, including the need for a standard on construction contract.
- f) Recognise contract revenue, costs and profit as the contract progresses.
- g) Account for expected losses on a contract.

1. Describe the criteria for revenue recognition. [Learning Outcome a]

 **Definition**

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

IAS 18 Para 7

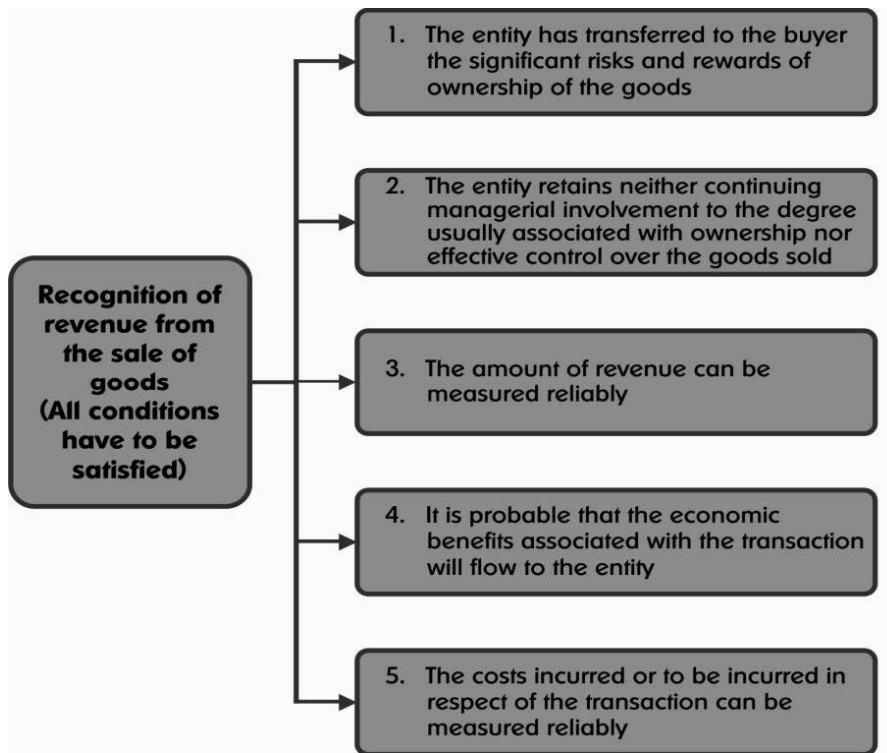
Sales revenue includes revenue arising from the following transactions and events:

- The sale of goods;
- The rendering of services; or
- The use by others of entity assets yielding interest, royalties and dividends.

The amounts collected on behalf of others (such as sales taxes, value added tax and money collected on behalf of a principal, in an agency relationship) are excluded from revenue.

1.1 Revenue from the sale of goods shall be **recognised** when **all** the following conditions have been satisfied:

Diagram 1: Recognition of revenue from the sale of goods



Going through each of these conditions in turn

1. The entity has **transferred** to the buyer the significant **risks and rewards of ownership of the goods**.

In most cases an entity transfers the significant risks and rewards of ownership when it transfers the legal title or the possession of the goods to the buyer.

Risks of ownership include obsolescence, damage and inability of an asset to operate at its optimum level among others. On the other hand, rewards of ownership include future economic benefits from the use of the asset or increases in the value of the asset.



Example

Perfect Traders, a dealer of cars sells a car worth Tshs50 million to Tom.

In this case the risks and rewards of owning the car are transferred to Tom as soon as Perfect Traders transfers the legal title of the car and hands over the possession of the car. What do we mean by risks and rewards? In the context of selling the car to Tom:

Risks

- (a) Tom is responsible for the car once he takes delivery. This means that should he crash the car after signing the delivery form, he will have to pay for any repairs.
- (b) If a fault develops in the car, which is not covered by the warranty, Tom will have to pay for it.
- (c) Perfect Traders are no longer responsible for any aspect of the car; unless it can be proved that there was faulty workmanship **before** the car was given to Tom.

Rewards

- (a) Tom can drive the car wherever he likes.
- (b) Tom is free to re-sell the car, hire it out or do whatever he wants with the car. (c) Perfect Traders have no rights over the car whatsoever.



Example

Motion Pictures Ltd sold DVD rights for its new movie to Famous Distributors. The agreed price of Tshs23 million was collected immediately. However, Motion Pictures impose a condition that the DVD rights can be exploited after 6 months of theatre release of the film.

When should the sale of DVD rights be accounted for?

In this case, revenues from sale of DVD rights should be recognised only after the end of 6 months of the theatre release of the film. This is because the significant risks and rewards of ownership are transferred only at the end of 6 months, when the right to exploit those rights by the buyer commences.

However, an entity may retain the significant risks and rewards of ownership in the following circumstances:

- When the entity retains an **obligation for unsatisfactory performance** not covered by normal warranty provisions



Example

Perfect Co is a manufacturer of stereos and offers a warranty of a 'six months free repair period' for all its models. However a manufacturing defect is revealed in the model 234 and Perfect Co has declared that it will refund the money for the model even after the warranty period is over, but before one year from sale.

In this case, for model 234, the risk of ownership remains with Perfect Co till the end of one year from the date of sale. This is because the customers have an option to return the product within one year from the date of sale. Therefore Perfect Co should not recognise revenue from the sale of Model 234. The revenue will be recognised only after one year from the date of sale, if the goods are not returned by the customers.

- When the **receipt of revenue from a particular sale is contingent** on the receiving of revenue by the buyer from its sale further on of the goods;



Example

Generally, in the case of car dealerships, the dealer takes cars from the manufacturer on consignment. In some agreements, payment is not made from the dealership (consignee) to the manufacturer (consignor) until the

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dealer sells the car on to a third party. The dealer often has the right to return cars to the manufacturer if they are not sold within a specified period of time.

- When the goods are shipped subject to installation and the installation is a **significant part of the contract which has not yet been completed** by the entity;



Example

Heavy Machines Ltd sells a machine worth Tshs25 million to Superfine Polyesters. This machine has to be embedded into the ground before it can start manufacturing goods.

Heavy Machines Ltd cannot recognise this sale as revenue until it completes the installation of this machine in the premises of Superfine Polyesters.

- When the buyer **has the right to cancel the purchase** for a reason specified in the sales contract and the entity is uncertain about the probability of return.



Example

Goods sold on approval basis cannot be recognised until the persons taking the goods have agreed that they want them.

No recognition of revenue in spite of outflow of inventory

Any replacement of the damaged goods during the warranty period by the company is not recognised as revenue because of the following reasons:

- (a) revenue was already recognised during the sale of the original stock of goods
- (b) there is no consideration received by the entity for the damaged goods



Example

Tabitha purchased plastic containers from Solomon worth Tshs6 million. The terms of the sales contract stipulated that in the event of damage to the containers, Solomon would replace the containers free of cost to Tabitha.

On their arrival at Tabitha's 50% of the consignment was damaged. Though Solomon would replace the damaged goods, he could not recognise this outflow of his inventory as revenue.

2. The entity **retains neither continuing managerial involvement** to the degree usually associated with ownership **nor effective control** over the goods sold.



Example

Zodiac Plc is a manufacturer of electronic products. It enters into a distribution agreement with Pinnacle stores.

The terms and conditions of the agreement provide that:

- (a) Pinnacle will obtain title to the goods and will sell them to retailers.
- (b) Pinnacle will earn a fixed margin on the products sold to retailers, but will have no authority in establishing the sale price of the goods for retailers.
- (c) Pinnacle has the right to return the goods to Zodiac if they remain unsold for 2 years.

Accordingly Zodiac sold goods worth £10,000 to Pinnacle. When should the sale be accounted for?

In this case, the sale to Pinnacle Stores cannot be recognised as a sale as Zodiac Plc retains continuing managerial involvement with the goods by being able to set the sales price. Also, Pinnacle has the option to return the goods so risks and returns are not fully transferred. Therefore, Zodiac Plc should continue recognising the

inventory on its statement of financial position. Zodiac should recognise the revenue only when substantially all the risks and rewards of ownership have been transferred, which will be when Pinnacle sells the goods to a third party.

3. The amount of revenue can be **measured reliably**.



Example

Pleasant Inc sells 10,000 mobile phones to Smart Co. However they are still negotiating the value of the mobile phones which have been sold.

In this case Pleasant Inc cannot recognise any sales revenue until the value of the 10,000 mobile phones is determined.

4. It is probable that the **economic benefits associated with the transaction will flow to the entity**.



Example

Farland Inc, operating in currency F, has made sales to Awayland Plc which operates in currency A. Due to political reasons it is uncertain whether the government of the country in which Awayland Plc operates will permit to transact with Farland Inc and will remit any consideration from this transaction. In this case Farland Inc cannot recognise the revenue, since the economic benefits associated with the transaction may not flow to the entity.

At times this may not be probable until an uncertainty is removed. In this case, revenue is recognised only after the uncertainty is removed.



Example

Continuing with the above example of Farland Inc

As subsequently the political relations amongst the countries in which these entities operate have been stabilised. The government authorities of the country in which Awayland Plc operates have granted the permission for trading with the Farland Inc. Hence the uncertainty no longer exists and Farland Inc can recognise the revenue from that sales transaction.

5. The **costs incurred or to be incurred** in respect of the transaction **can be measured reliably**.

If it is not possible to measure expenses reliably, then any consideration received for sale of goods is recognised as a liability.



Example

Machine Tools Ltd has sold a plant worth Tshs25 million to Significant Co and has received the amount. The sales contract requires Machines Tools to bear the installation expenses, which are expected to be of considerable value. However as on the statement of financial position date neither has the plant been installed, nor is it possible to reliably estimate these expenses. In this case the amount received (Tshs25 million) will be not be reflected as revenue but as a current liability - advance received from Significant Co.



Test Yourself 1

Grace International Tours and Travels purchases two luxury buses from Comfort Drive Pvt Ltd for Tshs62 million on 17 December 20X6. Comfort Drive has received the full payment, but has not been able to complete the buses

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according to the specifications given by Grace International Tours and Travels. It is not in a position to reliably estimate the expenses for completion of work as on the statement of financial position date.

Required:

State with reasons, whether Comfort Drive Pvt. Ltd can recognise the amount of Tshs62 million as revenue in the financial statements of 20X6.

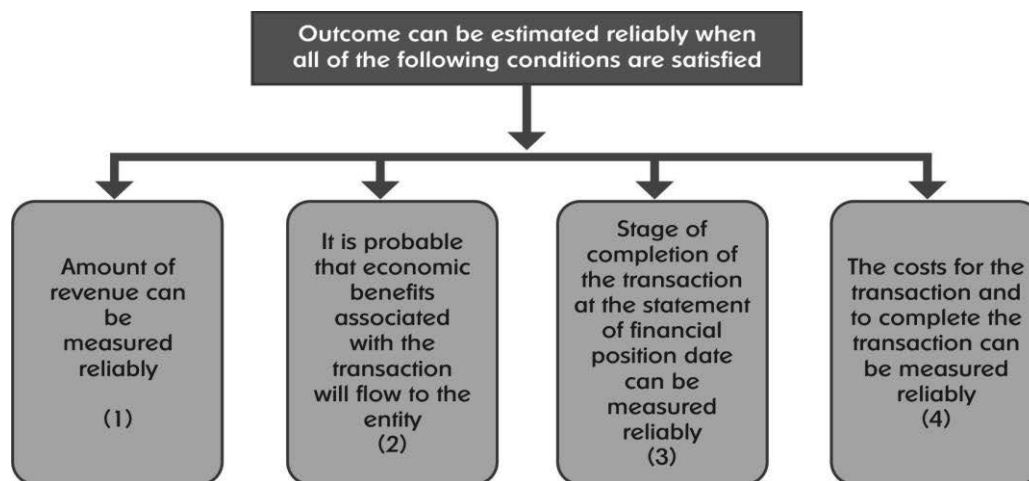
1.2 Revenue from services

Recognition of revenue depends upon whether the outcome of a transaction involving the rendering of services can be estimated reliably:

1. If outcome can be estimated reliably, revenue from services rendered is recognised using the stage of completion method.
2. If outcome cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.

In order to estimate the outcome reliably, all of the necessary conditions outlined in the following diagram must be satisfied.

Diagram 2: Criteria to decide whether outcome can be reliably estimated



1. Reliable estimates of revenue can be made when both the parties to the contract agree about:
 - (a) Each party's enforceable rights about the services to be provided / received.
 - (b) The consideration to be exchanged.
 - (c) The manner and the terms of settlement.
2. It is probable that the **economic benefits associated with the transaction will flow to the entity.**

If after the revenue is recognised, there is uncertainty about the probability of receiving the monies, then it is simply accounted for as a bad debt.

3. The **stage of completion of the transaction** at the statement of financial position date can be **measured reliably.**

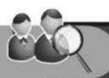
Generally, the seller's performance under service contracts is not immediate and often takes place over several reporting periods. Therefore, revenue is recognised depending on the stage of completion of a transaction.

**Tip**

Revenue recognition with reference to the stage of completion of a transaction is called the **percentage of completion method**. The stage of completion of a transaction can be determined in a number of ways e.g. based on past experience, percentage of work completed, surveys of work performed etc.

If services are performed continuously over a period of time, revenue is recognised on a straight line basis over the period.

If a specific act is extremely important for completing any service then the revenue is recognised only after that specific act is performed.

**Example**

Dr. Rao who is a cardiac surgeon charges Tshs20 million for an operation. The pre-operative checks cost Tshs5 million. A patient has to pay Tshs12.5 million before the operation and Tshs12.5 million after the operation.

In this case, Dr Rao can recognise the revenue only **after** he has conducted the operation, as the **operation** is the **significant act** in this service. The amount received before the operation will be recognised as a liability (Advance received from the patient) until the operation is performed.

4. The **costs incurred** for the transaction and the costs to complete the transaction **can be measured reliably**.

**Test Yourself 2**

Perfect Interiors is a firm of interior decorators. It has taken up a project where the fees are to be received in the following stages:

On completion of architectural changes: Tshs25 million
On completion of interior work: Tshs25 million

As at the statement of financial position date (31 December, 20X6), Perfect Interiors has received Tshs15 million. However, it has not started any work on this project.

Required:

Explain how much should be recognised on 31 December 20X6 and why?

In the early stages of rendering services when the **outcome of a transaction is not certain, revenue will be recognised only to the extent of costs incurred**. This is because it is assumed that at a minimum, these costs will be recovered from the client.

**Example**

Jay Co has asked Zara Co to write a computer programme to help Jay Co track sales and margins on individual customers. They have agreed to a timetable, whereby Zara Co starts writing the programme in November 2006, while the majority of the programme will be written in December 20X6 and January 20X6. Zara's year end is 30 November 20X6.

In the accounts ending November 20X6, Zara Co will recognise any expenses incurred for rendering this service as revenue e.g. petrol expenses for coming to Jay Co's offices, any administrative costs incurred on the project etc.

This is because Zara Co can assume that Jay Co will definitely pay for the expenses Zara Co incurs for rendering its services.

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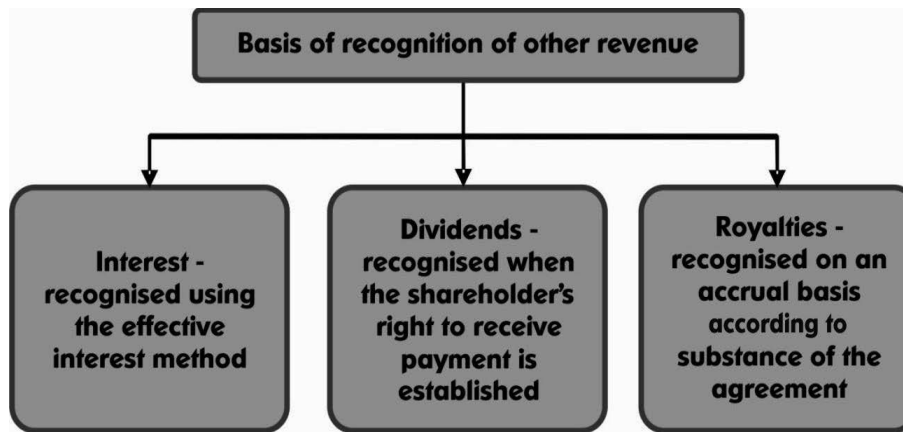
If it is not probable that the costs will be recovered, no revenue is recognised and all costs are immediately expensed.

As soon as the uncertainty of the outcome is removed, revenue will be recognised according to the procedure explained above.

1.3 Revenue received on account of **use by others of entity assets** (yielding **interest royalties and dividends**) are **recognised** when **all** the following conditions are satisfied:

- it is probable that the **economic benefits associated with the transaction will flow to the entity**; and
- the amount of the revenue can be **measured reliably**.

Diagram 3: Basis of recognition of revenue



1. Interest

Interest shall be recognised using the effective interest method.



Example

On 1 January 20X1, M-dok Co purchased a bond worth Tshs10 million. The bond attracts interest of 5% every year. On 31 December 20X3, it will be redeemed for Tshs11.66 million. The effective interest rate is 10%.

In this case, the total revenue is not only interest but also the premium on redemption. Total amount receivable as interest and premium on this bond is:

	Tshs'000
On account of interest (Tshs10,000 x 5%) x 3 years)	1,500
On account of premium on redemption (Tshs11,660 – Tshs10,000) Total amount receivable	1,660
	3,160

M-dok Co must allocate the amount receivable over the life of the bond at a constant rate on the carrying amount of the bond. The effective interest rate it has to apply in order to allocate the amount receivable over three years is 10%.

Year	Amortised cost at beginning of year (1)	Amount receivable at effective rate of 10% (2)	Amount actually received during year (3)	Amortised cost at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
20X1	10,000	1000	(500)	10,500
20X2	10,500	1050	(500)	11,050
20X3	11,050	*1110	(11,660 + 500)	-

* - rounding adjustment at end

Amortised cost at the end of the year = Amortised cost at the beginning of the year (1)
 + Amount receivable at effective rate of 10% (2) -
 Amount actually received during the year (3)

2. Royalty

Revenue from royalty is recognised on an accruals basis according to the substance of the agreement.

 **Example**

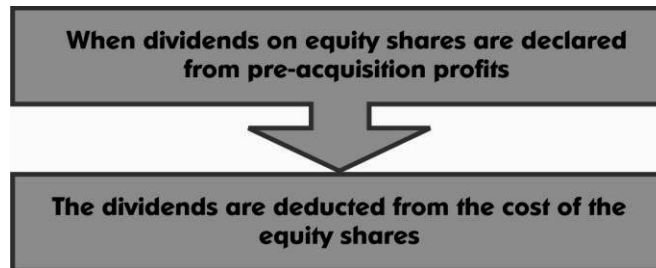
On 1 July 20X6 K.R. Jowling entered into an agreement with the publisher of his book. According to this agreement the royalty on sale of his new book will be paid in the following manner for sales made in month 1 the royalty will be payable on day 1 of month 3.

This means that for sales in November 20X6 he will receive royalty on 1 January 20X7 and for sales in December 20X6 he will receive royalty on 1 February 20X7.

In this case the financial statements for the year to 31 December 20X6 will recognise royalty only on the sales between 1 July 20X6 and 31 December 20X6. This is because the royalty has accrued even on sales made in November 20X6 and December 20X6 even if it has not been paid till the statement of financial position date.

3. Dividend

Diagram 4: Treatment of dividends in the first year after acquisition of a subsidiary



Dividends are recognised when the shareholder’s **right to receive payment is established**.

 **Test Yourself 3**

On 1 January 20X5, Wear Co purchased a bond worth Tshs5 million. The bond attracts interest of 5% every year. On 31 December 20X7, it will be redeemed for Tshs5.83 million. The effective interest rate is 10%.

Required:

How will the interest be calculated for the bond and what entries would be made in the financial statements each year?

2. Discuss revenue recognition issues during the production and sales cycle. [Learning Outcome b]

The various points in the production and sales cycle where it is more appropriate to recognise gains and losses can be best explained with the help of examples:

The law in different countries determines the point in time at which the entity transfers the significant risks and rewards of ownership.

Hence the following examples need to be read in the context of the laws of the country in which the sale transaction takes place.

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2.1 Bill and hold sales where

- The buyer takes title and accepts billing but Delivery is delayed at the buyer's request

In this case sales revenue **is recognised** when the buyer takes title only if:

- it is probable that **delivery will be made**;
- the item is on hand, identified and **ready for delivery** to the buyer at the time the sale is recognised; the buyer specifically **acknowledges the deferred delivery instructions**; and the **usual payment** terms apply.

Sales revenue is **not recognised** when there is simply an intention to acquire or manufacture the goods in time for delivery.



Test Yourself 4

Lolo has entered into an agreement to supply 10 computers worth Tshs30 million to Bebo. Bebo has made the payment but as her office is under renovation she has asked Lolo not to deliver the computers until further instructions.

Required:

How should this transaction be accounted for?

2.2 Goods shipped subject to certain conditions

Condition: installation and inspection

Revenue is recognised immediately upon the buyer's acceptance of delivery

- (a) If the installation process is simple in nature or
- (b) The inspection is performed only for purposes of final determination of contract prices



Test Yourself 5

Wheat Growers have agreed to sell 2,000 kg of wheat at a base price of Tshs2 million to All Grain Merchants. All Grain Merchants after inspection of the wheat will pay an additional amount of Tshs0.2 million if the wheat is of a certain quality.

Required:

Determine the point of time of revenue recognition.

1. Condition: on approval when the buyer has negotiated a limited right of return

In this case sales revenue is recognised when

- (a) The goods have been formally accepted by the buyer or
- (b) The goods have been delivered and the time period for rejection has elapsed

2. Consignment sales

A 'consignment sale' is a transaction where one entity (the consignor) sells goods to another entity (the consignee). The consignee has the option of returning any unsold goods at the end of time period specified in the contract.

In this case **sales revenue is recognised by the consignor** when the consignee **sells the goods to a third party**. Any unsold goods held by the consignee are reflected as an asset in the statement of financial position as inventory with consignee.



Test Yourself 6

Rain Co sells goods amounting to Tshs25 million on a consignment basis to Gain Co. During the year, Gain Co sold goods amounting to Tshs15 million to dealers.

Required:

State the accounting treatment to be given to this transaction in Rain Co's books.

3. Cash on delivery sales

In this case sales **revenue is recognised** when:

- (a) delivery is made and
- (b) cash is received by the seller or its agent.



Example

Needs is a grocery store which has a policy of delivering groceries to the consumers and collecting cash on delivery.

In this case, sales revenue is recognised when cash is received on delivery of goods.

4. Lay away sales are sales where goods are delivered only when the buyer pays the final instalment. Here the goods are paid for in a series of instalments.

In this case sales revenue is **recognised** when the **goods are delivered**.

However, if the seller through past experience knows that the buyer will pay all the instalments and that the goods will actually be delivered **then revenue is recognised when:**

- (a) A significant deposit is received and
- (b) The goods are on hand, identified and ready for delivery



Test Yourself 7

Apricot Co sells goods amounting to Tshs25 million to Perfect Industries. Perfect Industries is to pay for these goods in 5 monthly instalments of Tshs5 million each. From past experience Apricot Co knows that Perfect Industries will pay all the instalments and collect the goods.

Required:

Determine when Apricot Co can recognise this sale as revenue.

2.3 Advance payment where payment (or partial payment) is received in advance of delivery for goods and

1. These goods are still to be manufactured or
2. Not presently held in inventory or
3. To be delivered directly to the customer from a third party.

In this case sales revenue is **recognised** when the **goods are delivered**.



Example

Rutima Co has launched a new model of a car. It has received Tshs50 million from potential customers as part payment for sale of the new model. However the production of cars for commercial purposes has not commenced.

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In this case Rutima Co can recognise this revenue only after the cars are delivered, as the goods are still to be manufactured. This is because the cars for which part payment has been received are still to be manufactured.

2.4 Sale to intermediate parties: sale to distributors, dealers or others for resale

In this case sales **revenue is recognised** when the **risks and rewards of ownership** have **passed** from the seller **to the intermediate party**. If the buyer is acting as an agent then this sale is treated as a consignment sale.

The following chart shows the basis of determination of transfer of risks

Basis of determination	All risks / rewards retained by seller i.e. do NOT recognise a sale in the seller's books	All risks / rewards transferred to intermediate parties (IP) i.e. DO recognise a sale in the seller's books
Expenses for inventory Rate charged on date of sale by IP to final consumer Reason for return of goods Penalty charged for return of goods	Borne by seller Market prices prevailing on date of sale to final consumer IP can return the goods without giving a reason No penalty charged to IP	Borne by IP Rate will be price charged by seller to IP IP has to give a reason for return of goods Penalty charged to IP

The above list is not an exhaustive one.



Example

Lata Co manufactures clothing and sends the goods to Snehal Co on the following terms:

- The legal title of ownership passes to Snehal Co when it receives the clothes.
- Snehal Co stores the merchandise in its warehouse.
- Snehal Co does not have to pay for the merchandise until it receives payment from the third party.
- After three months, if the goods are not sold, Snehal Co. can either return the clothes to Lata Co or pay Lata Co for the goods and keep them.

In this case the risks and rewards of ownership are retained by Lata Co as Snehal Co has the option to return the goods within three months, if they are not sold (i.e. the risk that goods are not sold is with Lata Co).

Therefore Lata Co should recognise revenue at the earlier of: receiving payment from the third party or three months after the sale, provided that the goods are not returned.

3. Illustrate issues relating to sales of multiple arrangement and extended credit terms in revenue recognition of goods and services.

4. Apply the revenue recognition principles in sale and repurchase agreements.

[Learning Outcomes c and d]

3.1 Servicing fees included in the price of the product

These are fees which can be separately identified and received for subsequent servicing of a product which has been sold. Such fees are **recognised** as revenue **over the period during which the service is performed**.

If these fees are collected along with the sales price of the product the amount to be deferred is enough to cover the expected costs of the services under the agreement, plus a **reasonable profit** on those services.



Example

On 1 April 20X6 Swift Motors sold a car to Peter for Tshs40 million. This cost is inclusive of:

- First servicing Tshs0.1 million (after six months of sale)
- Second servicing Tshs0.15 million (after twelve months of sale)
- Third servicing Tshs0.2 million (after eighteen months of sale)

The amounts fixed for servicing are the expected costs of the services plus a reasonable profit on those services.

In this case:

The amount of revenue recognised as servicing fees (for this transaction) in the financial statements for the year to 31 December 20X6 is Tshs0.1 million.

This is because the due dates of the three services are:

- First servicing 1 October 20X6
- Second servicing 1 April 20X7
- Third servicing 1 October 20X7

Servicing fees are to be recognised as revenue over the period during which the service is performed. As only the first servicing is performed in the year to 31 December 20X6 only Tshs0.1 million can be recognised as revenue.

The amount recognised for sale of car is Tshs39.55 million (Tshs40 million – Tshs0.1 million – Tshs0.15 million – Tshs0.2 million)



Example

On 1 April 20X9, Alpha sold goods for a price of Tshs12.1 million. The terms of the sale allowed the customer extended credit and the price was payable by the customer in cash on 31 March 20X1. A discount rate that is appropriate for the risk in this transaction is 10%.

In this case, according to IAS 18, revenue should be measured at the fair value of goods or services provided. The value is usually the invoiced price, discounted to present value where material.

Therefore, revenue should be included at present value at the date of sale (Tshs12.1 million / $(1.10)^2$) = Tshs10 million.

Over the next two years, the discount is unwound and this will create an investment income in the statement of profit or loss. Alpha, therefore, needs to show finance income of Tshs1,000 (Tshs10 million x 10%) in the year ended 31 March 20X0 and 31 March 20X1.

3.2 Sales involving extended credit terms

In the case of sales involving extended credit terms, the inflows of cash or cash equivalents are deferred, therefore the fair value of the consideration will be less than its nominal value as an element of financing is involved. The fair value of consideration is calculated by discounting the future receipts at an imputed rate of interest, the fair value being recognised as revenue from sale. The difference between the fair value and the nominal value is to be recognised as interest income.

Sale with normal warranty

Warranty that only guarantees that the product will perform according to its specifications is not accounted for as a separate obligation arising from the sale of the product. The total amount of sale is recognised as revenue. However, a provision is made for the estimated future costs of honouring the warranties.

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Sale when the right to return exists

When the buyer has the right to return under defined conditions, and the seller cannot estimate the likelihood of this occurrence with reasonable confidence, future amount of returns cannot be reasonably estimated and even the transfer of risks and rewards cannot be confirmed. Therefore the amount cannot be recognised as revenue. US GAAP usefully elaborates on this situation, and may provide additional information. However, under both the standards, sale is to be recorded if the future amount of returns can reasonably be estimated. If the ability to make a reasonable estimate does not exist, the sale is not to be recorded until further information is available.

In the case of retail sales where refunds are offered - revenue is recognised immediately as the risks and rewards are transferred and the risks involved are insignificant.

However, if the risks are significant and no reliable estimates can be made, revenue recognition is deferred until the acceptance of goods is confirmed.

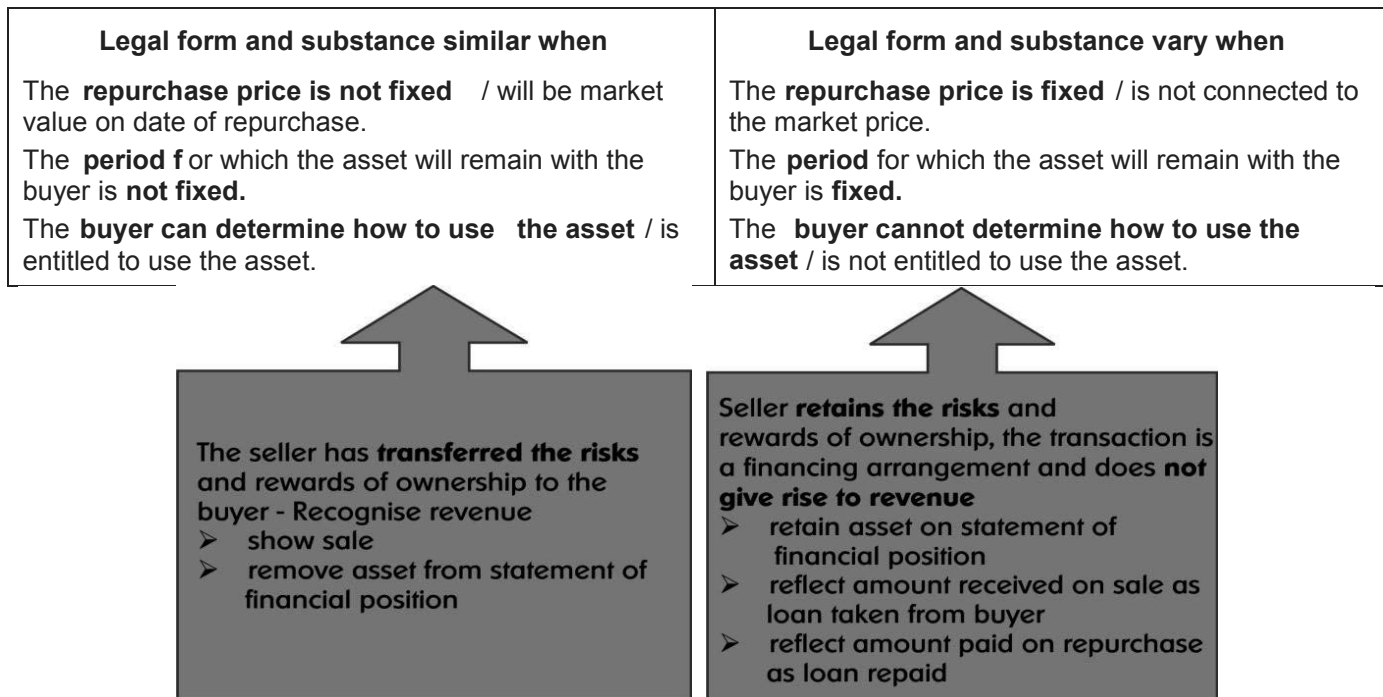
3.3 Sale and repurchase agreements

When goods / assets are sold on the condition that they will be repurchased by the seller after a specified period of time, the **legal form says that a sale has been made**, as generally title to the goods is transferred to the buyer at the time of sale. However, the **substance** of the transaction could be **different**.

The buyer could have **advanced a loan** to the original seller, with the **goods acting as security for the transaction**. The price at which the seller repurchases the goods / assets could include an element of interest on loan.

The following features decide when the legal form and substance of a transaction are similar or vary:

Legal form and substance of the transaction



Test Yourself 8

Superb Co had a plot of land which it has sold to Excellent Co for Tshs400 million (the prevailing market price of the land). It was decided at the time of the sale that Superb Co would repurchase that plot after four years. The repurchase price was fixed at Tshs500 million.

Required:

How should this transaction be accounted for?

5. Describe various types of a construction contract, including the need for a standard on construction contract.
6. Recognize contract revenue, costs and profit as the contract progresses.
7. Account for expected losses on a contract.

[Learning Outcomes e, f and g]

4.1 Definitions



Definition

A **construction contract** is a contract specifically negotiated for the **construction of an asset or a combination of assets** that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

IAS 11 Para 3

A **fixed price contract** is a construction contract in which the contractor agrees to a **fixed contract price, or a fixed rate per unit** of output, which in some cases is subject to cost escalation clauses.

IAS 11 Para 3

A **cost plus contract** is a construction contract in which the contractor is **reimbursed** for allowable or otherwise **defined costs, plus** a percentage of these costs or a fixed fee.

IAS 11 Para 3

Examples of contracts for the construction of a **single asset** are contracts for the construction of a **building or a dam**.

Similarly, an example of a contract for the construction of a **combination of assets** is a contract for the construction and commissioning of a **refinery** that may include the construction or erection of many different items of machinery working together as a refinery.

Activity under a construction contract usually begins in one accounting period but ends in another. This creates a necessity to **allocate the costs and revenues to different periods**. Also, there has to be a **matching of the revenues recognised with the relevant costs**.

4.2 Combining and segmenting construction contracts

1. Combining: a group of contracts shall be treated as a **single** construction contract when:

- (a) Many contracts are **negotiated as a single package**
- (b) The contracts are **closely interrelated** and effectively form parts of a single project with an **overall profit margin**
- (c) The contracts are **performed simultaneously or in one sequence**

2. Segmenting: when a contract covers **different assets**, the construction of each asset shall be treated as a separate contract when:

- (a) Separate proposals have been submitted for each asset.
- (b) Each asset was subject to separate negotiations and the parties are able to accept or reject the part related to each asset.
- (c) The costs and revenues of each asset are identifiable.

4.3 Need for a standard on construction contract

The date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Sometimes, the contracts run into several accounting periods. Therefore, it becomes necessary to allocate the contract revenues and costs to the accounting periods during which the work is performed.

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IAS 11 lays down clear guidance about when to use the stage of completion (or percentage of completion) method in connection with construction contracts. If this guidance is followed correctly, it would amount to a fairer presentation of the financial statements rather than profit smoothing. However, **if the revenues and costs are determined so as to arrive at pre-determined profits** without regard to the principles laid down in IAS 11, **this amounts to profit smoothing.**

4.4 Contract revenue

Contract revenue consists of the following:

1. The initial amount of **revenue as agreed in the contract** will form part of the contract revenue.
2. **Variations, claims and incentives:** as discussed earlier, the construction contracts are spread over a longer period and hence open to **more uncertainties**. Estimates may be revised and the amounts may be increased or decreased.

The three words '**variations**', '**claims**' and '**incentives**' have different meanings, as discussed below:

- (a) **Variations:** instructions from the customer for changes in the scope of work.
- (b) **Claims:** amounts which the contractor seeks to recover from the customer towards costs not included in the contract price.
- (c) **Incentives:** additional payments by the customer to a contractor who has **met or exceeded performance standards**.

4.5 Conditions to be satisfied: before contract revenues are to be recognised, the following conditions are to be satisfied:

1. It is **probable** that they will **result in revenue**
2. They can be **measured reliably**.



Example

TCC is a construction company. It was awarded a contract for the construction of factory premises for Tshs60 million.

The customer later added the work of a security guard's cabin and a compound wall to the scope of contract and authorised Tshs2 million for the extras (this is a variation).

The cost of cement increased by a large margin compared with the cost when the contract was signed. TCC raised an escalation claim for Tshs4 million.

If the work is completed within 1 year, TCC is to be given an incentive of Tshs2.5 million.

Assuming that the contract was actually completed within 1 year, all of these amounts satisfy the conditions for recognition; therefore total contract revenue is Tshs60 million + Tshs2 million + Tshs4 million + Tshs2.5 million = Tshs68.5 million.

4.6 Contract costs

Contract costs consist of the following:

1. Costs directly relating to the specific contract.
2. Costs generally related to contract activity, which can be allocated to the contract.
3. Other costs specifically chargeable to the customer under the terms of the contract.

Taking each of these in turn:

1. Costs directly relating to the specific contract. The IAS lists the following examples:

- (a) Site labour costs, including site supervision
- (b) Costs of materials used in construction
- (c) Depreciation of plant and equipment used on the contract
- (d) Costs of moving plant, equipment and materials to and from the contract site
- (e) Costs of hiring plant and equipment
- (f) Costs of design and technical assistance that is directly related to the contract (g) Estimated costs of rectification and guarantee work, including expected warranty costs (h) Claims from third parties.



Example

AXN Constructions is working on ten contracts and the following amounts relate to contract Sun Rays:

	Tshs million
Site labour cost:	320,000
Materials purchased:	560,000
Depreciation of plant & equipment:	75,000
Costs of moving plant equipment & materials to and from the contract site:	10,000
Costs of hiring plant and equipment:	15,000
Costs of design and technical assistance (inclusive of Tshs 5,000 which is related to contract Sun Beam)	25,000
Costs to fix a mistake made by AXN:	50,000
Claims from local authority for causing environmental pollution:	5,000
Unused material at the SOFP date:	60,000

Costs directly related to the contract	Tshs million
Site labour cost	320,000
Materials used (Tshs560,000 - Tshs60,000)	500,000
Depreciation of plant and equipment	75,000
Costs of moving plant and equipment etc.	10,000
Costs of hiring plant and equipment	15,000
Costs of design and technical assistance (Tshs25,000 - Tshs5,000)	20,000
Estimated costs of rectification	50,000
Claims for damages Total	5,000
	995,000



Test Yourself 9

The following amounts relate to contract no.5 undertaken by GSB Constructions:

- 1. Materials purchased: Tshs200 million
- 2. Unused materials on the reporting date: Tshs15 million
- 3. Wages paid to workers and supervisors: Tshs60 million; this includes wages of Tshs8 million paid to a supervisor who spent half of his time at head office doing work other than on contract no. 5
- 4. Depreciation of plant and equipment used for contract no.5: Tshs25 million
- 5. Hire charges for equipment used for the contract: Tshs10 million
- 6. Architect's fees: Tshs17 million
- 7. Claims from the neighbouring plot holder, for damage caused by GSB to his property, while working on this site: Tshs5 million
- 8. Cost of roadworks benefiting 5 contracts in the vicinity: Tshs80 million

Required:

Calculate the costs directly related to contract no. 5

2. **Costs generally related to contract activity**, which can be allocated to the contract, such as:

- (a) Construction overheads e.g. salaries of engineers supervising a number of sites.
- (b) Insurance, not directly related to the contract.
- (c) Costs of design and technical fees not related to a specific contract.

3. **Other costs specifically chargeable** to the customer under the terms of the contract.

These depend upon the terms of the contract. For example the terms of contracts may specify that general administration costs at 5% of the total of raw material cost and wages cost are to be added.

4.7 Recognition of profits

Recognition of profits will be the result of recognising the **contract revenues and costs**.

Earlier, we noted that construction contracts are subject to some uncertainties that are not applicable to other transactions. Recognition of contract revenues and expenses depends on whether the **outcome of a contract can be estimated reliably**.

Therefore, the **rules of recognition** are divided between the following **two classes**:

- 1. When the outcome of a construction contract **can be estimated reliably**.
- 2. When the outcome of a construction contract **cannot be estimated reliably**.

These are discussed in detail below:

1. When the outcome of a construction contract can be estimated reliably

- (a) **Contract revenues and costs** should be recognised as revenue and expense respectively by reference to **the stage of completion** of contract activity on the end of the reporting period. The 'stage of completion' method is discussed further in paragraph 5.6
- (b) An **expected loss** on the contract shall be **recognised as an expense** immediately.



Example

Golden Construction Co is executing a contract worth Tshs1,500 million. The **outcome** of this contract **can be estimated reliably**. On 31 December 20X6 (its end of the reporting period), it had completed 50% of the work.

It will recognise 50% of the revenues and costs related to the contract.

2. When the outcome of a construction contract cannot be estimated reliably:

- (a) Revenue shall be recognised only to the extent that the contract **costs incurred are probably recoverable**.
- (b) Contract **costs** shall be **recognised as expenses** in the period in which they are incurred.
- (c) An **expected loss** on the contract shall be **recognised as an expense** immediately.

If all the costs incurred are likely to be recovered, then the net income will be zero. This is because the revenue recognised will be equal to the costs incurred.

During the early stages of the contract, the outcome cannot be estimated reliably. However, it may be possible to recover the costs incurred.

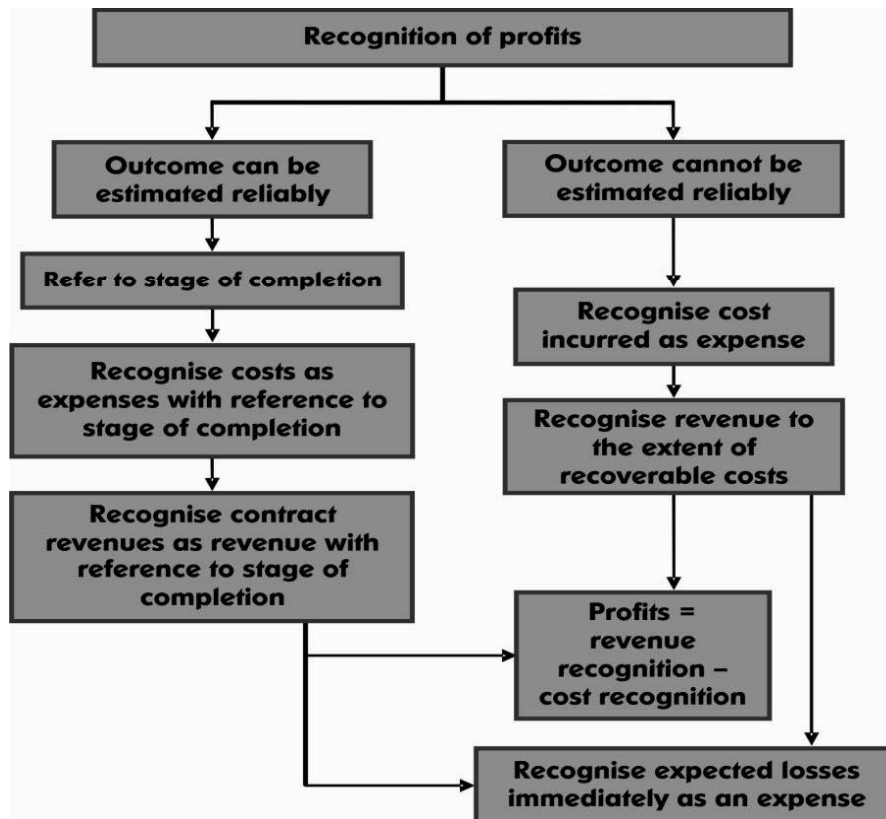
Example

Assume that the outcome of this contract cannot be estimated reliably. On 31 December 20X6, Golden had incurred costs of Tshs6,200 million. It expects to recover Tshs5,900 million of this cost.

Golden should recognise the cost of Tshs6,200 million and revenue of Tshs5,900 million only. Therefore, a loss of Tshs300 million will be shown in the statement of profit or loss.

When the uncertainties that prevented the outcome from being estimated reliably cease to exist, the rules in paragraph 1 above are to be applied, rather than those in paragraph 2).

Diagram 5: Construction Contracts



The above discussions bring out some important issues i.e. how to determine

- (i) whether the outcome of a contract can be estimated reliably (discussed immediately below); and
- (ii) the stage of completion (discussed below).

4.8 How to determine whether the outcome of a contract can be estimated reliably:

The outcome can be determined reliably when all the following conditions are met:

1. For a fixed price contract

- (a) Total contract revenue can be measured reliably.
- (b) Probable that the economic benefits associated with the contract will flow to the entity.
- (c) **Stage of completion** and the **costs to complete** on the end of the reporting period can be measured reliably.
- (d) **Costs attributable** to the contract can be identified and measured reliably so that they can be compared with the prior estimates.

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2. For a cost-plus contract

(a) It is **probable** that the **economic benefits** associated with the contract **will actually be received**. (b) The contract **costs attributable** to the contract **can be identified and measured reliably**.

4.9 The stage of completion method

1. This is also called a **percentage completion method**.
2. Contract **revenue** is recognised in the **period in which the work is done**.
3. Contract **revenue is matched with the contract costs** incurred in reaching that stage.
4. The expected **excess of contract cost over contract revenue** is recognised as an expense immediately.
5. The contractor may incur costs related to **future activity**; these costs are recognised as an asset to the extent to which it is probable that the costs will be recovered.
6. If any part of the amount recognised as revenue becomes **uncollectible (i.e. a bad debt)**, it should be **recognised as an expense** rather than an adjustment to the amount of contract revenue.

Determining the stage of completion

The entire **accounting** for the contracts whose outcome can be estimated reliably **depends upon the stage of completion**. IAS 11 gives a list of the acceptable methods ((a) - (d) below) but allows other methods if found logical. (The list given is inclusive and not exhaustive. Any other method that reliably estimates the work performed is also acceptable).

(a) The proportion of the contract costs incurred for the work performed to date to the total estimated contract costs

The costs not related to the work performed are to be excluded. For example, payments to subcontractors in advance of the work performed, materials delivered to the contract site but not used, unless they relate to the materials made especially for the contract. For example, total contract cost is Tshs10,000 million, and costs incurred for the work performed are Tshs7,000 million. We can conclude that work completion is 70%.

(b) Survey of the work performed.

For example, a report of an expert, given after surveying the work, states the work is 45% complete. 45% would be used for percentage completed.

(c) Completion of a physical proportion of the contract work.

For example, a record of physical progress e.g. cubic metres of work done can be referred to for finding out the stage of completion. If 6,000 cubic metres out of 10,000 have been completed, it can be said that 60% of that activity is completed.

(d) Ratio of work certified to the total contract price

This method is not specifically mentioned, but is equally reliable. A customer will often appoint an expert such as an architect to verify progress and certify the bills based on verification.

For example, total contract price is Tshs20,000 million; work certified by the architect based on the work performed is Tshs12,000 million. We can conclude that work completion is 60%.

4.10 Recognition of expected losses

The entity keeps track of the progress of work as well as the cost of the work done. When it is **probable that total contract costs will exceed total contract revenue**, this indicates that there is likely to be an overall loss. Such a loss is to be **recognised immediately**.

The **loss** is determined and **recognised irrespective of** the following:

1. Whether the contract work has commenced or not.
2. The stage of completion.
3. The amount of profit expected to arise on other contracts not part of this single contract.

In case of expected loss, the contract revenue and contract cost to be recognised in the statement of profit or loss are to be calculated in the following manner:

- The revenue to be recognised is based on the percentage of completion i.e. we recognise the revenue only to the extent of work completed.
- The losses are to be recognised to the fullest (i.e. 100% of the expected losses).
- Hence the contract cost to be recognised needs to be adjusted – it is the balancing figure (revenue recognised + expected losses).



Example

A company is carrying out 5 independent contracts. On contract no. 2, it expects to incur a future loss of Tshs100 million. On the other contracts, it expects to earn a future profit of Tshs800 million.

It cannot avoid recognising the loss of Tshs100 million on contract no. 2, even though the expected loss is much lower than the expected profits from other contracts. Therefore, the loss of Tshs100 million on contract no. 2 should be recognised immediately.



Test Yourself 10

Alcons Llc signed a contract worth Tshs700 million for the construction of a bridge for Lamonte BV. The company commenced the work and, by the end of the first year, had completed 20% of the work. It had incurred a cost of Tshs110 million at that point.

Alcons wants to recognise a gain of Tshs30 million ((20% x Tshs700 million) – Tshs110 million). It expects to spend another Tshs610 million to complete the contract.

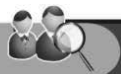
Required:

Advise management on this proposed accounting treatment.

4.11 Changes in estimates

An element of estimation is involved in accounting for some items. Since contracts are for a long duration and any accounting takes into consideration the expected costs and revenues on their completion, the element of estimation is slightly more in the case of contract accounting.

The changed estimates are used for the determination of revenue and expenses in the year of change and in subsequent periods. The effect of the change in estimates is accounted for in accordance with IAS 8 Accounting Policies, changes in accounting estimates and errors.



Example

Jera Constructions got a contract on an estimated price of Tshs500 million and started working on it. The project is 50% complete at the year end and the chief accountant of Jera constructions has sent a report to the directors asking to revise the estimate price of the contract. The normal calculations suggest that the estimated cost for the remaining 50% job is Tshs200 million. However due to a change in government policy, the prices of cement and steel have increased and so the estimated price of the contract has gone up to Tshs400 million and needs revision. Therefore this increase will be used to determine the expenses and the revenue for the year in which the change has taken place and for the subsequent years.

4.12 Important terms

- **Progress billing** - Progress billing is the amount that is billed by the contractor for work performed. It may or may not have been paid by the customer by the end of the reporting period. The part not collected by the end of the reporting period is an asset similar to receivables.

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- **Retentions** - Out of the progress billings, depending on the agreement, the customer while paying the amount holds some part back. This amount is known as retention. It is not paid until certain conditions specified in the contract are satisfied or any defects noticed have been rectified.
- **Advances** - That part of the collection from the customer which is received before the work is performed is known as an advance. This amount is a liability for the contractor.

Let us now see how the application of the accounting principles discussed until now leads to a disclosure in financial statements.



Example

	Tshs'000
Total contract price	200,000
Cost incurred to date	90,000
Estimated cost to completion	64,000
Progress Billing (of this Tshs100,000 is received)	116,000
Percentage complete	60%

Required:

Prepare relevant extracts of statement of profit or loss and other comprehensive income and statement of financial position.

Answer

Stage 1

Check whether the contract makes a profit:
(Else we have to provide for full anticipated loss)

	Tshs'000
Total revenue	200,000
Total cost (90,000+64,000) Profit	154,000
	46,000

Stage 2

Calculate % completion:
Given in this example 60%

Stage 3

Statement of profit or loss extracts

	Tshs'000
Revenue (60% of 200,000)	120,000
Costs (60% of 154,000)	92,400
Profit	27,600

Stage 4

Statement of financial position extracts - Gross amounts due from customers (part of current assets)

	Tshs'000
Contract costs incurred	90,000
Add: Recognised profits-recognised losses	27,600
	117,600
Less Progress Billing	116,000
Amount due from customers	1,600

Trade receivables (current assets)	Tshs'000
Progress Billing	116,000
Less: Cash received	100,000
	16,000

Note: The accounting entries and the ledger accounts are as follows
(These are not the part of solution, but are given to help in understanding.)

Entries during the year (Amounts in Tshs'000)

On spending cash on goods and services

- 1. Dr WIP Tshs90,000
- Cr Cash Tshs90,000
- Being cash spent for the contract

When a bill is raised on the client

- 2. Dr Trade Receivables Tshs116,000
- Cr WIP Tshs116,000
- Being the entry to record bills raised on the client.

When cash is received from the client

- 3. Dr Cash Tshs100,000
- Cr Trade receivables Tshs100,000
- Being the entry to record cash received from client

Entries at the end of the year

Revenue for the period

- 4. Dr WIP Tshs120,000
- Cr Revenue (SOPL) Tshs120,000
- Being entry to recognise revenue for the period (calculated as per stage 3).

- 5. Dr Costs (SOPL) Tshs92,400
- Cr WIP Tshs92,400
- Being entry to recognise costs for the period (calculated as per stage 3).

Ledger Accounts

This may or may not be equal to costs incurred

Work in Progress Account

Dr			Cr		
Date	Tshs'000	Date	Tshs'000		Tshs'000
	(1) Cash: Costs incurred	90,000		(2) Trade receivables	116,000
	4) SOPL : Revenue recognised	120,000		(5). SOPL : Cost recognised	92,400
				Balance c/f (Amount due from)	1,600
	TOTAL	<u>210,000</u>		TOTAL	<u>210,000</u>

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Cash Account (extracts)

Dr			Cr		
Date		Tshs'000	Date		Tshs'000
	(3) Receivables : collections	100,000		(1) WIP-Costs incurred	90,000
	Total			Total	

Trade Receivables

Dr			Cr		
Date		Tshs'000	Date		Tshs'000
	(2) WIP: Billing	116,000		(3) Cash : collections	100,000
	Total	116,000		Balance c/f Total	16,000
					116,000

Statement of profit or loss (SOPL)

Dr			Cr		
Date		Tshs'000	Date		Tshs'000
	(5) WIP: Cost recognised	92,400		(4) WIP: Revenue	120,000
	Profit	27,600		Total	
	Total	120,000			120,000

Example for gross amounts due to customers



Example

In the above example, suppose that the progress billing amounted to Tshs126 million. Only the statement of financial position presentation will change as follows:

Extracts of SOFP

Gross amounts due to customers (part of current liabilities)

	Tshs'000
Contract costs incurred	90,000
Add: Recognised profits-recognised losses	27,600
	117,600
Less: Progress Billing	126,000
Amount due to customers	8,400

Trade receivables (current assets)

	Tshs'0000
Progress Billing	126,000
Less: Cash received	100,000
	26,000



Test Yourself 11

From the following details, calculate contract profits or loss and show the presentation in the financial statements.

		Contract X	Contract Y
		Tshs'000	Tshs'000
i	Costs incurred to date	39,200	42,000
ii	Total contract price	70,000	56,000
iii	Progress billing	33,600	28,000
iv	Anticipated future costs	16,800	25,200
v	Payments received	11,200	-
vi	Work completed at 31/12/20X6	60%	50%
vii	Work completed at 31/12/20X5	30%	*
viii	Recognised as revenue at 31/12/20X5	19,600	5,600
ix	Recognised as costs at 31/12/20X5	15,400	5,600

No loss was expected on contract Y as at 31/12/20X5

* Not determinable

Answers to Test Yourself

Answer 1

Comfort Drive Pvt Ltd cannot recognise the amount of Tshs62 million as revenue in its financial statements because it is not possible to measure the expenses reliably. The amount received will have to be recognised as a liability (Advance received from Grace International Tours and Travels) in the statement of financial position.

Answer 2

In this case, no revenue can be recognised for services rendered because the **stage of completion of the transaction** at the statement of financial position date is zero, even though:

- Ⓐ the amount of revenue can be measured reliably;
- Ⓑ it is probable that the economic benefits associated with the transaction will flow to the entity; and
- Ⓒ the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

Hence, this amount of Tshs15 million **will not be recognised in the statement of profit or loss as fees for services rendered**. It will be recognised as **an advance from customer in the statement of financial position**.

Answer 3

In this case, the amount receivable as interest and premium on this bond is:

	Tshs'000
On account of interest (5,000 x 5%) x 3 years)	750
On account of premium on redemption (5,830 – 5,000) Total amount receivable	1,580

Wear Co must allocate the amount receivable over the life of the bond at a constant rate on the carrying amount of the bond. The effective interest rate it has to apply in order to allocate the amount receivable over three years is 10%.

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Year	Amortised cost at beginning of year (1)	Amount receivable at effective rate of 10% (2)	Amount actually received during year (3)	Amortised cost at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
20X5	5,000	500	(250)	5,250
20X6	5,250	525	(250)	5,525
20X7	5,525	*555	(5,830 + 250)	-

* - rounding adjustment at end

Amortised cost at the end of the year = Amortised cost at the beginning of the year (1)
 + Amount receivable at effective rate of 10% (2) -
 Amount actually received during the year (3)

Thus, the effective rate is that rate which helps allocate the estimated future cash payments or receipts through the expected life of the financial instrument. In an examination question, it is likely that this rate will be provided.

The interest is recognised in the following manner

In 20X5: (Amounts in Tshs'000)

Dr Bank Tshs250
 Cr Interest received Tshs250
 Being amount received as interest

Dr Bond Tshs250
 Cr Interest received Tshs250
 Being bond revalued at amortised cost (Tshs500 - Tshs250)

In 20X6: (Amounts in Tshs'000)

Dr Bank Tshs250
 Cr Interest received Tshs250
 Being amount received as interest

Dr Bond Tshs275
 Cr Interest received Tshs275
 Being bond revalued at amortised cost (Tshs525 - Tshs275)

In 20X7: (Amounts in Tshs'000)

Dr Bank Tshs250
 Cr Interest received Tshs250
 Being amount received as interest

Dr Bond Tshs305
 Cr Interest received Tshs305
 Being bond revalued at amortised cost (Tshs555 - Tshs250)

Dr Bank Tshs5,830
 Cr Bond Tshs5,830
 Being amount received on maturity of bond
 (Tshs5,000 + Tshs250 + Tshs275 + Tshs305)

Answer 4

In this case Lolo can recognise the revenue if:

- ⑩ It is probable that she will deliver the computers.

- ⓐ If the computers are identified and ready for delivery and Lolo is only waiting for instructions from Bebo to deliver the computers.

However if Lolo dispatches these computers (identified for Bebo) to some other person then the amount received cannot be recognised as revenue.

Answer 5

In this case as the base price is fixed Wheat Growers can recognise Tshs2 million as sale revenue as soon as All Grain Merchants accept the delivery of the goods.

The additional Tshs0.2 million can be recognised if after inspection All Grain Merchants agree to pay that amount.

Answer 6

Rain Co will recognise Tshs15 million as sale revenue in the statement of profit or loss.

Tshs10 million (Tshs25 million - Tshs15 million) is recognised in the statement of financial position as inventory at cost with Gain Co. This is because sales revenue is recognised by the consignor when the consignee sells the goods to third party.

Answer 7

Apricot Co can recognise Tshs25 million as sale revenue in the statement of profit or loss on the basis of his past experience when Perfect Industries has paid a sizeable deposit (which in this case can be after payment of 3 instalments).

However, it is essential that the Apricot Co has the goods in hand, identified and ready for delivery to Perfect Industries, when he recognises the sales revenue.

Answer 8

In this case the legal form is that of a sale of land by Superb Co. However, the substance of the transaction clearly shows that:

- Superb Co has obtained a loan from Excellent Co.
- It has handed over the plot of land as security.
- The repurchase price includes an element of interest.

Hence, Superb Co will not recognise this sale as revenue. It will be reflected as Loan from Excellent Co in the statement of financial position.

Answer 9

Costs directly related to the contract	Tshs'000
Materials used (Tshs200,000 – Tshs15,000)	185,000
Wage (Tshs60,000 – (Tshs8,000/2) = Tshs60,000 – Tshs4,000)	56,000
Depreciation	25,000
Hire of equipment	10,000
Architect's fees	17,000
Claims for damages	5,000
Total	298,000

Roadworks are not a direct cost. However, they may be allocated on a suitable basis to the contracts which benefited from them.

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Answer 10

Assuming all costs incurred for work performed to date are included in the Tshs60 million, it may be true that there is a gain of Tshs30 million for this stage. However, IAS 11 requires Alcons to compare total contract costs with total revenue.

Total estimated contract costs = Tshs110 million + Tshs610 million = Tshs720 million
 Total contract revenue = Tshs700 million
 Estimated loss = Tshs20 million

Instead of recognising any gain, Alcons must recognise a loss of Tshs20 million.

Even if there was no loss anticipated, the revenue and costs both would have been recognised to the extent of 20% of the respective totals.

Alcons – Statement of profit or loss and OCI (extract)

	Tshs million
Revenue for the period (20% of Tshs700 million)	140
Cost of sales (balancing figure)	(160)
Gross loss	(20)

Full loss is to be recognised under IAS 11.

Answer 11

Stage 1: Calculation of anticipated final result

	Contract X		Contract X	
	Tshs'00	Tshs'000	Tshs'000	Tshs'00
Total contract price (a)		70,000		56,000
Costs incurred to date	39,200		42,000	
Anticipated future costs	16,800		25,200	
Expected total costs (b)		(56,000)		(67,200)
Anticipated final result (a) – (b)		14,000		(11,200)

Stage 2: Revenue disclosure in the statement of profit or loss

	Tshs'000	Tshs'000	
Cumulative revenue to 31/12/20X6 70,000 x 60% and 56,000 x 50% (total contract price x % completion)	42,000	28,000	
Cumulative revenue recognised previously at 31/12/20X5	(19,600)	(5,600)	Note 1
Revenue to be recognised for year	22,400	22,400	

Note 1

Where the stage of completion cannot be estimated reliably, IAS 11 requires the revenue recognised to be equal to the costs incurred (to the extent they are recoverable). Therefore, it is assumed that the revenue recognised for contract Y for the year ended 31/12/20X5 was Tshs5.6 million i.e. the cost incurred for 31.12.20X5.

Stage 3: Expense disclosure in the statement of profit or loss

	Tshs'000	Tshs'000	
Costs proportionate to the stage of completion 56,000 x 60% and 67,200 x 50% (expected total costs x % completion)	33,600	33,600	Note 2
Add: Allowance for future losses		5,600	
Less: Costs recognised until the previous year	(15,400)	(5,600)	
	18,200	33,600	

Note 2

	Tshs'000
Cumulative loss (Tshs33,600 - Tshs22,400) (see calculations at stage 1 and 2)	11,200
Less: Cumulative revenue – cumulative expense (Tshs28,000 – Tshs33,600), which is recognised (see calculations at stage 1 and 2)	(5,600)
Since full loss is to be recognised, additional loss	(5,600)

Stage 4: Extracts of Statement of profit or loss

	Contract X	Contract Y
	Current year	Current year
	Tshs'000	Tshs'000
Revenue	22,400	22,400
Expense (including anticipated losses)	(18,200)	(33,600)
Net income/(expense)	4,200	(11,200)

	Contract X	Contract Y
	Cumulative	Cumulative
Revenue	42,000	28,000
Expense (including anticipated losses)	(33,600)	(39,200)
Net income/(expense)	8,400	(11,200)

Stage 5: Extracts of statement of financial position**Amount due to / due from customers**

	Contract X	Contract Y
	Tshs'000	Tshs'000
Costs incurred to date	39,200	42,000
Add: Recognised cumulative profits (less losses)	8,400	(11,200)
Less: Progress billings	(33,600)	(28,000)
Due from customers / (to customers)	14,000	2,800

Trade receivables

	Contract X	Contract Y
	Tshs'000	Tshs'000
Progress Billing	33,600	28,000
Less: Amount received	11,200	
	22,400	28,000

Quick Quiz

1. State the recognition criteria for recognition of revenue **from the sale of goods**.
2. State the basis of recognition of revenue received as interest, dividend and royalties.
3. A construction company has 35 different ongoing contracts. Is it essential that the accountant also has exactly 35 contract accounts?
4. The total sales value of a contract is Tshs700 million. On the end of the reporting period, 30% of the work is completed. The outcome of the contract cannot be reliably estimated. Management wants to recognise 30% of the profit. Do you agree?
5. An accountant of a construction company approaches you. He informs you that there is a likely loss of Tshs200 million on one of its contracts. He requests you to suggest a method whereby this loss, being only a future loss, need not be recognised.

Answers to Quick Quiz

1. The recognition criteria for recognition of revenue from the sale of goods.
 - (a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
 - (b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
 - (c) The amount of revenue can be measured reliably.
 - (d) It is probable that the economic benefits associated with the transaction will flow to the entity. (e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.
2. The basis of recognition of revenue received as interest, dividend and royalties.
 - (a) Interest shall be recognised using the effective interest method
 - (b) Dividends shall be recognised when the shareholder's right to receive payment is established (c) Royalties shall be recognised on an accrual basis accordingly to substance of the agreement
3. Normally the accountant will have the same number of contract accounts. However, depending on the circumstances, there may be combining and segmentation of contracts, in which case the number of contracts in the accounts may be more or less.
4. No. When the outcome of the contract cannot be reliably estimated, the stage of completion method is not to be followed. The entire cost incurred is to be recognised as an expense and the revenue is to be recognised only to the extent that the recovery of the costs is probable.
5. The method is not open to choice, but rather it depends on the circumstances. However, whichever method is followed, any expected loss should immediately be recognised as an expense.

Self Examination Questions

Question 1

Goldfish Fisheries is a fishing company which has entered into the following transactions for the year to 31 December 20X6. State with reasons, which of the following transactions can be recognised as revenue.

- (a) Goldfish Fisheries sold one of its ships to Shark Plc for Tshs200 million on the condition that it will repurchase the ship from Shark Plc after one year on a payment of Tshs250 million.
- (b) It sold one of its boats and nets to Guppy Ltd on 1 August 20X6 for Tshs25 million. A condition of sale states that Guppy Ltd should sell it fish worth more than Tshs1.7 million per month for one year of sale. If it fails to do so then Goldfish Fisheries will retake possession of the boat. Guppy Ltd complies with this condition during December 20X6.

- (c) It sends goods worth Tshs17 million to Dollarfish Ltd. Dollar Fish Ltd is an intermediary and does not have storage facility. Therefore the insurance and warehouse costs are borne by Goldfish Fisheries. On 1 September 20X6 Dollarfish sells these goods to a third party.
- (d) Goldfish has taken an advance of Tshs15 million from Rola Gola soft drinks for advertising their product by painting them on 3 of their ships and 5 of their boats. The agreed price is Tshs1.5 million for each boat and Tshs2.5 million for each ship. Till the statement of financial position date five boats are painted. The three ships have not been painted till the statement of financial position date.

Question 2

Omega Inc prepares its accounts up to 31 March each year. On 30 March 20X7, Omega Inc sold a consignment of products for Tshs45 million. This sale is debited to trade receivables and credited to revenue.

The terms of sale of the products were that Omega would provide an after sales service which required Omega to correct any defects that became apparent in the products for a one year period from the date of sale. The estimated cost of correcting defects would be Tshs1.5 million. The gross profit margin for corrective work would be 20%.

Revenue as recorded in trial balance as at 31 March 20X7 is Tshs360 million.

Required:

Determine the revenue to be recognised in the statement of profit or loss and other comprehensive income according to IAS 18.

Question 3

Franc Pipes Plc is awarded a contract worth Tshs22.5 million to lay a pipeline. The revenue agreed initially in the contract is Tshs22.5 million. Initially, Franc estimated contract costs at Tshs20 million. It is expected that the work will take 3 years to complete.

Franc's estimate of costs increased to Tshs21 million by the end of the second year, and to Tshs21.5 million by the end of year 3. The customer approved a variation worth Tshs2 million by the end of year 3.

Standard materials valued at Tshs0.5 million, stored at the site to be used in future to complete the project, were included in the costs for year 1.

Franc determines the stage of completion of the contract by calculating the proportion of (i) costs incurred for work performed to (ii) estimated total contract costs.

A summary of the data is given below:

	Year 1	Year 2	Year 3
	Tshs'000	Tshs'000	Tshs'000
Initial amount of revenue agreed in contract	22,500	22,500	22,500
Variation	-	-	2,000
Total contract revenue	22,500	22,500	24,500
Contract costs incurred to date	5,233	15,420	20,500
Contract costs to complete	14,892	5,080	-
Total estimated contract costs	20,125	20,500	20,500
Estimated profit	2,375	2,000	4,000
Progress billings	5,000	12,500	7,000
Cash received	4,500	13,500	6,500

Find out the amount of revenues, expenses and profits to be recognised for each of these years.

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Question 4

From the details given in question 2 above, prepare the ledger accounts for year 1.

Question 5

Bon Ami Projects is a construction company that prepares its financial statements on 31 March every year. The company bagged a prestigious contract to construct a new office of the Provincial Government. The contract is expected to take seven years to complete.

The construction is to be accounted for using the percentage of completion method and the percentage of completion is to be based on the costs to date compared to the estimated total contract costs. The details of the project as on 31 March 20X9 are as follows:

	Tshs'000
Contract price	9,000
Progress payments	7,560
Actual costs incurred until 31 March 20X9	7,200
Costs estimated to complete on 31 March 20X9	2,400

Required:

What impact would this contract have on Bon Ami Project's financial statements for the year ending 31 March 20X9?

Answers to Self Examination Questions

Answer to SEQ 1

- It will not recognise Tshs200 million as revenue from sale of ship. The substance of the transaction shows that Goldfish Fisheries has taken a loan from Shark Plc. It has pledged one of its ships as mortgage and the increase in the re-purchase price shows the element of interest in the transaction.
- The Tshs25 million is a receipt from the sale of non-current assets. Goldfish Fisheries will recognise Tshs25 million in December 20X6 as the condition of the sale has been fulfilled. If there is any condition in the sale agreement, then revenue is recognised when the condition is fulfilled.
- Goldfish Fisheries will recognise Tshs17 million as revenue in September 20X6 as the risks and rewards of ownership are retained by Goldfish Fisheries as it bears the insurance and warehouse expenses of the goods. Revenue will be recognised when the goods are sold to a third party on 1 September 20X6.
- Gold fish will recognise Tshs7.5 million as revenue as it has painted only five boats till the statement of financial position date at Tshs1.5 million each. The advance taken for the rest of the ships cannot be recognised as revenue as the assignment has not been completed. Therefore it is recognised in the statement of financial position as liability on a percentage of completion basis.

Answer to SEQ 2

IAS 18 'Revenue' requires that where sale of the product includes terms for after sales service then a portion of revenue is deferred and amortised over the period of performance of the service. The amount deferred should cover expected cost of service plus reasonable profit on these services.

Revenue to be recognised in the statement of profit or loss and OCI according to IAS 18 as at 31 March 20X7 is:

	Tshs '000
Revenue as shown in trial balance	360,000
Revenue deferred (1500 x 100/80)	(1,875)
Revenue to be recognised	358,125

Answer to SEQ 3

(All figures in Tshs'000)

First of all, let us determine the stage of completion:

Stage of completion (costs to date/total estimated costs) for year 1 determined by deducting the value of unused material (Tshs500) from the costs incurred (Tshs5,233)	24% (5,233 – 500)/20,125,	75% (15,420/20,500)	100% 20,500/20,500)
---	------------------------------	------------------------	------------------------

The table below gives the amounts of revenue, expenses and profits to be recognised in the three years:

	To date	Prior years	Current year
	Tshs'000	Tshs'000	Tshs'000
Year 1			
Revenue (Tshs22,500 × 24%)	5,400	-	5,400
Less: Expenses (Tshs20,125 × 24%)	(4,830)	-	(4,830)
Profit	570	-	570

	Tshs'000	Tshs'000	Tshs'000
Year 2			
Revenue (Tshs22,500 × 75%)	16,875	5,400	11,475
Less: Expenses (Tshs20,500 × 75%)	(15,375)	(4,830)	(10,545)
Profit	1,500	570	930

	Tshs'000	Tshs'000	Tshs'000
Year 3			
Revenue (Tshs24,500 × 100%)	24,500	16,875	7,625
Less: Expenses (Tshs20,500 × 100%)	(20,500)	(15,375)	5,125
Profit	4,000	1,500	2,500

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Answer to SEQ 4

Work in progress account

	Tshs'000		Tshs'000
Cash account (Cost incurred)	5,233	Trade receivables account (Progress billing)	5,000
SOPL (Revenue recognised)	5,400	SOPL (Costs recognised) Balance c/f (Cost + profit - billing) (Gross amount due from customers)	4,830 803
	10,633		10,633

Trade receivables account

	Tshs'000		Tshs'000
Work in progress account (Progress billing)	5,000	Cash account (extracts) (cash received) Balance c/f	4,500 500
	5,000		5,000

Cash account (extracts)

	Tshs'000		Tshs'000
Trade receivables account (Cash received)	4,500	WIP (Cost incurred)	5,233

Statement of profit or loss

	Tshs'000		Tshs'000
Work in progress account (Costs recognised)	4,830	Work in progress account (Revenue recognised)	5,400
Gain recognised	570		
	5,400		5,400

Answer to SEQ 5

The details of the construction contract would be reflected as follows in Bon Ami's financial statements:

Bon Ami Projects – Statement of profit or loss(extract) for the year ended 31 March 20X9

	Tshs'000
Revenue for the period (balancing figure)	6,600
Cost of sales	*(7,200)
Gross loss	(600)

Full loss is to be recognised under IAS 11.

Bon Ami Projects – Statement of financial position (extract) as on 31 March 20X9

	Tshs'000
Current liabilities	
Liability on construction contract (W2)	960

The impact of the construction contract on Bon Ami Project would be measured as follows:

Workings

W1 Calculation of expected profit or loss on the project

	Tshs'000
Contract price	9,000
Total cost (Tshs7,200 + Tshs2,400)	(9,600)
Expected loss on the contract	(600)

Percentage of completion = $Tshs7,200 / Tshs9,600 \times 100 = 75\%$

Cost estimated to complete until 31 March 2009 + Actual cost incurred until 31 March 2009

W2 Calculation of liability on construction contract

	Tshs'000
Costs incurred to date	7,200
Less: Loss recognised to date	(600)
Less: Progress payments	(7,560)
Liability on construction – Amounts due to customers	(960)

*** Note:**

Bon Ami uses the cost method to calculate the stage of completion. In accordance with IAS 11, when there is an expected loss on the contract to be recognised:

- For the work-certified accounting policy, the work certified for the year should be taken to the revenue line and the cost of sales will be the balancing figure.
- In case of cost method accounting policy, the costs incurred to date should be taken to the cost of sales line and the revenue will be the balancing figure.

Cost estimated to complete until
31 March 2009 + Actual cost incurred until 31 March 2009

STUDY GUIDE B6: FINANCIAL INSTRUMENTS

Get Through Intro

Financial instruments embrace a broad range of assets and liabilities. They include both– financial assets and financial liabilities. This Study Guide discusses the presentation, recognition and measurement aspects of these financial instruments. It explains how a financial asset of one entity immediately gives rise to a financial liability of another entity.

It is essential to understand these concepts clearly because the related accounting standard has given different bases of measurement for different classes of financial assets. Correct classification of financial instruments into debt instruments and equity instruments is also extremely important for the correct assessment of the 'risk / stability' position of a company.

You need to understand these concepts clearly because, as the Finance Manager of a company, you will be required to make these classifications. Any errors of classification of financial instruments on your part will lead to the preparation of an incorrect set of financial statements in real life. It will also lead to a loss of marks in the examination.

Learning Outcomes

- a) Define the key terms and definitions in the context of financial instruments.
- b) Classify financial instruments in accordance with the guidance given under international accounting standards.
- c) Describe the accounting treatment for debt instruments and equity instruments.
- d) Describe the initial and subsequent measurement of financial instruments in accordance with international accounting standards.
- e) Present the accounting of fixed interest rate and compound financial instrument.
- f) Present and disclose of financial instruments in accordance with international accounting standards.

1. Define the key terms and definitions in the context of financial instruments.

[Learning Outcome a]

1.1 Definition of financial instrument



Definition

A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

IAS 32 Para 11

A **contract** is an agreement between two or more parties which the parties cannot avoid as it is usually enforceable by law. A contract has clear economic consequences. It is important to note that **contracts** need not be in writing. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument.



Example

Rohan deposited Tshs100 million in a bank.

The deposit of cash is a financial asset, as it represents the contractual right of Rohan to obtain cash or draw a cheque from the bank. Equally it is a financial liability in the Bank's financial statements as the bank has to pay the money back to Rohan at some point when Rohan requests it.

To understand what financial instruments are, we need to know the terms '**financial assets**', '**financial liabilities**', '**equity instruments**' and '**derivatives**'.

1. The terms '**financial asset**', '**financial liability**', and '**equity instrument**' are defined by IAS 32 'Financial Instruments : Presentation' as follows:



Definition

Any of the following assets is a **financial asset** of an entity:

- (a) **Cash**
- (b) An **equity instrument of another entity**
- (c) A **contractual right**
 - (i) to receive **cash** or **another financial asset** from another entity.
 - (ii) to **exchange financial assets or financial liabilities** with another entity under conditions that is potentially favourable to the entity.
- (d) A contract that will or may be settled in the entity's own equity instruments and is
 - (i) That is a **non-derivative** for which the entity is or may be obliged to **receive a variable number of its own equity instruments**. Or
 - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

**Definition**

Any of the following becomes a **financial liability** of an entity:

(a) A **contractual obligation**:

- (i) to deliver cash or another financial asset to another entity.
- (ii) to exchange financial assets or financial liabilities with another entity under conditions those are potentially unfavourable to the entity.

(b) A **contract** that will or may be settled in the **entity's own equity instruments and is**:

- (i) A **non-derivative** for which the entity is or may be obliged to **deliver a variable number of the entity's own equity instruments. Or**
- (ii) A **derivative** that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a **fixed number of the entity's own equity instruments.**

Some common examples of financial assets and corresponding financial liabilities representing a contractual right / obligation to receive / deliver cash in the future are:

- Trade accounts receivable and payable
- Loans receivable and payable
- Bonds receivable and payable

Liabilities or assets that are not contractual are not financial liabilities or financial assets. These would include taxes, which are the result of statutory requirements.

**Tip**

Remember assets and liabilities relating to taxes that are a result of statutory requirements imposed by governments are not financial instruments, as there is no contract between the government and an entity.

**Test Yourself 1**

Give some examples of financial assets and financial liabilities which represent a contractual obligation to deliver cash in the future.

**Definition**

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

In simple terms, an equity instrument of company A gives a person a share of the equity of company A.

**Example**

Ordinary shares issued by a company are examples of equity instruments.

**Definition**

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A **derivative** is a financial instrument or other contract within the scope of IFRS 9, with all three of the following characteristics:

- (a) Its **value changes** in response to a change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable provided in the case of a non-financial variable that the variable is not specific to a party to the contract (known **as the underlying item**).
- (b) It requires **no initial net investment or an initial net investment** that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- (c) It is settled at a future date.

IFRS 9, Appendix A



Example

Baron Co enters into a contract. Under this contract, Baron Co will pay Tshs5 million if XYZ's share price increases by Tshs1,000 or more during an eight-month period; it will receive Tshs5 million if the share price decreases by Tshs1,000 or more during the same eight-month period; and no payment will be made if the price swing is less than Tshs1,000 up or down.

In this case, the settlement amount changes with XYZ's share price. Although there is no notional amount to determine the settlement amount, there is a payment provision that is based on changes. All the other characteristics of a derivative mentioned above (the **value of an instrument changes, no initial investment is needed and it can be settled at a future date**) are also present.

Hence, the contract entered into by Baron Co is a **derivative**.

Different types of derivatives are:

- **Forwards** are contracts to purchase or sell a specific quantity of a financial instrument with delivery or settlement on a pre-agreed future date. These are over-the-counter contracts.
- **Interest rate swaps** are contracts to exchange cash flows as of specified dates based on a notional amount.
- **Futures** are similar to forward contracts. These are exchange-traded contracts.
- **Options** are contracts that give the purchaser the right, but not the obligation to buy or sell a specified quantity of a particular financial instrument.



Example

A flour milling company enters into a forward contract to buy 1,000 tonnes of wheat in 6 months' time, at an agreed price. The contract can either be settled by delivery of wheat to the company's mill, or by a cash payment representing the difference between the forward price and the spot price of the wheat on the delivery date. It can be argued that IAS 39 would be applicable to this transaction, since it can be settled net in cash.

However, the contracts those were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are excluded from the scope of IAS 39. Looking at the facts, it appears that the transaction is entered into for the purpose of acquiring wheat for the usage at the mill. Hence, this transaction would be out of the scope of IAS 39.

2. IAS 32 states that the following items are not financial instruments:

- (a) **Physical assets** (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks).

Physical and intangible assets are not financial instruments because they help generate a **future** inflow of cash or another financial asset, but do not give rise to a **present right** to receive cash or another financial asset.

- (b) **Assets such as pre-paid expenses** (expenses that are to be paid in advance are called pre-paid expenses).

Assets such as pre-paid expenses are not financial instruments because they help generate a future economic benefit:

- (i) in the form of the receipt of goods or services; **and not**
- (ii) in the form of the right to receive cash or another financial asset.

- (c) Items such as **deferred revenue** and most warranty obligations.

Deferred revenue and most warranty obligations are not financial liabilities because the outflow of economic benefits associated with them:

- (i) is the delivery of goods and services; and not
- (ii) a contractual obligation to pay cash or another financial asset.

3. Financial instruments which fall outside the scope of IAS 32 (each of these items is covered by its own separate accounting standard)

- (i) obligations arising under insurance contracts
- (ii) interests in subsidiaries
- (iii) interests in associates
- (iv) interests in joint ventures
- (v) employee benefit plans

These financial instruments are recognised and measured according to the provisions of standards which deal specifically with them.

**Test Yourself 2**

Red Co enters into the following transactions:

- (a) An electricity bill of Tshs1 million is paid in advance.
- (b) Enters into a contract to purchase goods for Tshs2 million after 6 months at the future rates.

Required:

Which one of them will be considered a financial instrument and why?

2. Classify financial instruments in accordance with the guidance given under international accounting standards.

[Learning Outcome b]

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2.1 Classification of financial assets

Under IFRS 9, all financial assets should be classified into either of the two categories:

1. those measured at amortised cost; and
2. those measured at fair value through profit or loss. (which is further divided into two classes depending upon whether the changes in the values are recognised in profit or loss or other comprehensive income)

1. Amortised costs

A financial asset at amortised cost is a financial asset other than an equity instrument that meets the following conditions:

- (a) **Business model:** the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
- (b) **Contractual cash flow:** the contractual cash flow characteristic must represent repayment of principal and the interest on principal, where the interest represents compensation for time value of money.
- (c) **Fair value option:** the entity has not invoked the fair value option for measurement of financial asset to reduce an accounting or measurement mismatch.

Guidance for determining business model

The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business models for managing its financial instruments. Therefore, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.



Example

Brick Co purchases portfolios of loans. If payment on the loans is not received on a timely basis, the entity attempts to extract the contractual cash flows through various means—for example, by contacting the vendor by mail, telephone or other methods. In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio of investments to make profit by selling them.

Moreover, the fact that the entity has entered into interest rate swaps to modify the cash flows of the portfolio does not in itself change the entity's business model. If the portfolio is not managed on a trading basis, the objective of the business model could be to hold the assets to collect the contractual cash flows.



Test Yourself 3

Core Co is a mutual fund company. Its investments include one group of investments which are usually held until they mature. However, as part of its investment strategy, management decides that it can sell a portion of the portfolio if the profits from an early sale are substantial.

Required:

Determine how these financial assets will be classified.

2. Financial assets measured at fair value

In accordance with IFRS 9, a financial asset shall be measured at fair value unless it is measured at amortised cost.

An entity may, at initial recognition, designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.


Example

A limited invests in listed shares of B Ltd. Since this is an equity investment, the concept of contractual cash flows - to receive on specific dates the principal and interest on the principal - does not apply. Hence, the investment is considered as financial asset measured at fair value.

Investment in equity instruments

It should be noted in particular that equity instruments and derivatives cannot satisfy the contractual cash flow characteristic discussed above. Hence, equity instruments and derivatives cannot be classified under the category of amortised cost; these are always measured at fair value.

Fair value changes for equity instruments are taken to **profit or loss** unless an option to present subsequent changes in other comprehensive income is opted for. The option to show the gains and losses on equity instruments in the other comprehensive income is irrevocable once opted for, and can be made on an instrument-by-instrument basis. However, the dividend income is recognised in profit or loss for all equity instruments.

In the case of an equity instrument not held for trading, an entity has the following additional choice:

At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in **an equity instrument within the scope of this IFRS that is not held for trading**.

The above discussion for financial assets can be summarised in the table below:

Type of instruments	Details
Debt instruments	<p>Measured at amortised cost if it satisfies the two characteristics:</p> <ul style="list-style-type: none"> ⑩ Business model characteristic ⑩ Contractual cash flow characteristic <p>If the above requirements are not met, asset is measured at fair value.</p> <p>However, debt instruments can be designated as fair value through profit or loss for elimination of an accounting mismatch.</p>
Equity instruments	<p>Measured at fair value through profit or loss or fair value through other comprehensive income</p> <p>Only equity instruments can be designated as FVTOCI.</p> <p>For instruments designated as FVTOCI, fair value changes are recognised in OCI and there is no recycling of gains or losses on sale of investment.</p>



Test Yourself 4

Sun invests Tshs 25 million in unquoted share capital of Moon Inc.

Required:

Determine how these financial assets will be classified initially.



Test Yourself 5

Axl & Rose (A&R) Plc, a CD manufacturing company, has entered into the following transactions involving financial instruments:

- (a) A&R gave a loan to A&S, an upcoming recording company, during the year. Although A&S owes A&R money, this transaction does not give rise to a trade receivable. It is a part of the portfolio that the company manages in order to collect the contractual cash flows.
- (b) During the year, A&R made an investment in 500 equity shares at Tshs1,200 per share of Slash Plc quoted in an active market. However, this investment was not made or held for trading purposes.
- (c) A&R made an investment in 200 equity shares at Tshs1,000 per share of Cowell Industries - which are not held for trading, do not have a quoted price and their fair value cannot be reliably measured.
- (d) A&R has invested in debt securities, which are not quoted in an active market and are not held for trading.
- (e) During the year, A&R purchased debt securities of Nickel front Corp. These debt instruments were quoted in an active market and A&R plans on holding on to them until maturity. However, if market interest rates fall significantly, A&R will consider selling the debt securities in order to realise the associated gain.
- (f) A&R made a strategic investment in an equity instrument which the company, at the moment, has no intention of selling.
- (g) During the year, A&R made another investment in Slash Plc, which was held for trading purposes.

Required:

As an accountant, you are required to help Axl & Rose Plc classify these transactions into the appropriate category of financial asset or liability. Remember, the transactions can fall into more than one category.

Summary of provisions

Instrument	IFRS 9			
Financial instrument: Asset	IFRS 9 classification	Subsequent Measurement	Value changes	Impairment testing?
Debt instruments	Amortised cost	Amortised cost	Not relevant - unless impaired	Yes
	FVTPL	FV	Through Profit or loss	No
Equity investment	FVTOCI – if irrevocable election made on initial recognition	FV	Through OCI	No
	FVTPL	Fair value	Through Profit or loss	No
Financial liabilities	FVTPL	Fair value	Through profit or loss for the changes not attributable to changes in credit risk. For changes attributable to credit risk, the changes are presented in other comprehensive income	No
	Amortised Cost	Amortised Cost	Not relevant – unless impaired	No

At the time of initial recognition itself the financial assets and financial liabilities must be classified into one of the categories as their classification determines the valuation principles to be followed while measuring the financial assets. More precisely, the classification of financial assets and financial liabilities determines the following:

1. Whether the asset or liability should be measured:
 - (a) at amortised cost; or
 - (b) at fair value, in the statement of financial position.
2. Whether the gain or loss should be recognised in the statement of profit or loss or in other comprehensive income i.e. equity.

2.2 Classification of financial liabilities

Under IFRS 9, all financial liabilities should be classified into either of the two categories:

1. financial liabilities measured at fair value through profit or loss
2. financial liabilities measured at amortised cost

(The basic accounting model for financial liabilities remains the same as specified in IAS 39, except for few changes)

1. Financial liabilities designated at fair value through profit or loss

Financial liabilities held for trading are measured at FVTPL. All other financial liabilities are measured at amortised cost unless the fair value option is applied. IFRS 9 provides that the fair value option is applied only if:

- (a) recognition inconsistency (referred to as an 'accounting mismatch') that would arise on measuring or recognising gain or loss on financial liability on some different basis is either eliminated or significantly reduced by using this option; or

- (b) the liability is part of a group of financial liabilities or financial assets and financial liabilities that is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.

2. Financial liabilities measured at amortised cost

An entity shall classify all financial liabilities as subsequently measured at amortised cost using the effective interest method, except for financial liabilities measured at fair value through profit or loss.

Generally, deposits from customers and issued debt instruments are classified under this category.

 **Example**

An entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. The entity regularly buys and sells these bonds. However, it rarely, buys and sells the loans. Reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

2.3 Reclassification of an asset

A financial asset may be reclassified when and only when an entity changes its business model for managing the financial assets.

If an entity reclassifies financial assets, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses or interest.

If an entity reclassifies a financial asset so that it is measured at fair value, its fair value is determined at the reclassification date. Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss.

If an entity reclassifies a financial asset so that it is measured at amortised cost, its fair value at the reclassification date becomes its new carrying amount.

If an entity reclassifies a financial asset	
From amortised cost to fair value	Its fair value is determined on the reclassification date. Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss.
From fair value to amortised cost	Its fair value at the reclassification date becomes its new carrying amount.

 **Example**

A banking company engaged in the business of retail banking, invests in debt instruments. The objective of these investments is to collect collateral cash flows of loan assets. Carrying value of such investments measured at amortised cost is Tshs1,000 million. However, the company changes its business model and starts investment banking, where such loan assets are sold whenever an opportunity to earn profit arises. Here, the company has changed the business model. On the date of change in the business model, the fair value of such loan assets is Tshs1,500 million. The difference between the carrying amount and the fair value, i.e., Tshs500 million, is recognised in profit or loss.

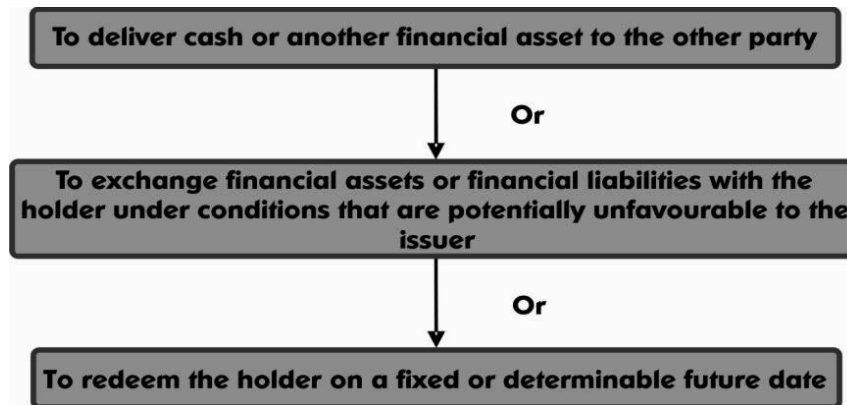
2.4 Reclassification of a financial liability

An entity shall not reclassify any financial liability

3. Describe the accounting treatment for debt instruments and equity instruments [Learning Outcome c]

3.1 The classification of a financial instrument as debt or equity primarily depends upon whether there is an obligation on the issuer:

Diagram 1: Classification of a financial instrument as debt or equity



If there is **no** such **obligation**, then the financial instrument is an **equity instrument**.



Example

When an entity issues **ordinary shares**, it is possible that it will declare a dividend. However, there is no compulsion to do so. The entity is **under no obligation** to deliver cash or another financial asset to the ordinary shareholders, or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

This means that **the ordinary shares** are **equity instruments** of the entity.

If there is **such an obligation**, then the financial instrument is a **debt instrument**.



Example

When **debentures** are issued by an entity, it has to pay the agreed amount of interest.

At the end of the maturity period, the entity must repay the debenture holders either in cash or by issuing some other financial instrument. All these terms are included in the terms of issue and are binding upon the entity. The entity is **under an obligation** to deliver cash or another financial asset to the debenture holders.

This means that **the debentures** are **debt instruments** of the entity.

It is essential to consider the **substance of the obligation rather than the legal form**. There could be instances where the instrument is actually a debt instrument but with the outward appearance of an equity instrument.

Each category of financial instruments issued by an entity has to be assessed carefully in order to determine its classification. This becomes necessary because an improper classification will lead to a misrepresentation in the financial statements.



Example

Brand Co issues 10% preference shares with a fixed interest rate and a redemption clause.

The legal term used in this transaction is 'preference shares' which reflects the fact that it is an equity instrument in form.

The substance of the transaction is that Brand Co is obliged to:

- Payment of fixed interest or
- redeem the preference shares at a particular date

The substance of the transaction shows that it is a debt instrument.

Hence, the form of the transaction is different from the substance.



Test Yourself 6

Pear Co issues preference shares. The terms of issue are:

- 20,000 preference shares of Tshs1,500 each redeemable after 5 years
- 24,000 8% preference shares of Tshs1,500 each

Required:

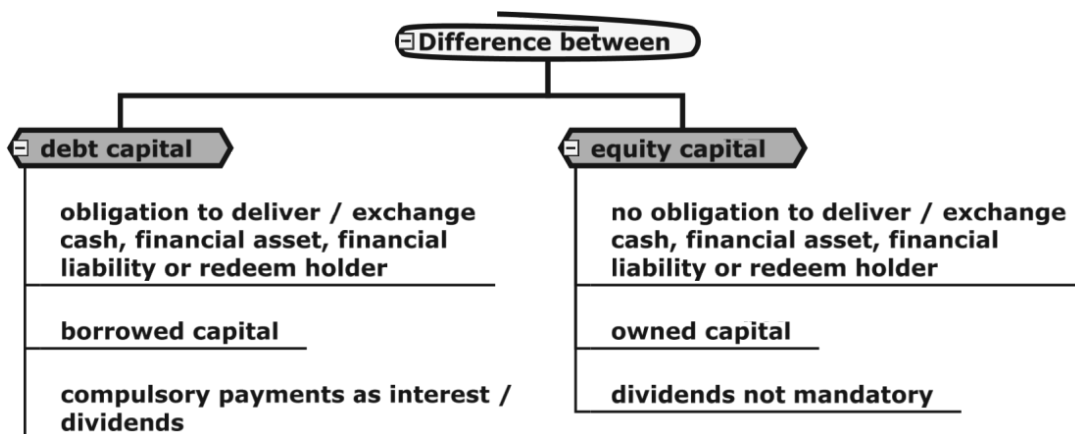
Determine whether they have to be classified as debt instruments or equity instruments.

Note: If the shares are irredeemable and the holders of the shares do not have a right to ask for redemption, such shares would be classified under equity, since there is no obligation on the company issuing these irredeemable shares to repay the amount.

Other main differences between debt capital and equity capital

- Holders of equity instruments are the legal owners of the entity. They receive dividends, which are an appropriation of its post-tax profits.
- Debt instruments represent an entity's borrowed capital. The interest / dividends paid to holders of debt instruments are a charge against its pre-tax profits. This is tax usually deductible expenditure for the company.(depending upon the local tax laws)

SUMMARY



3.2 Requirements of relevant accounting standards for the issue and finance costs of financial instruments

The **finance (transaction) costs** are the incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability.

The various transaction costs that an entity incurs in issuing financial instruments might include:

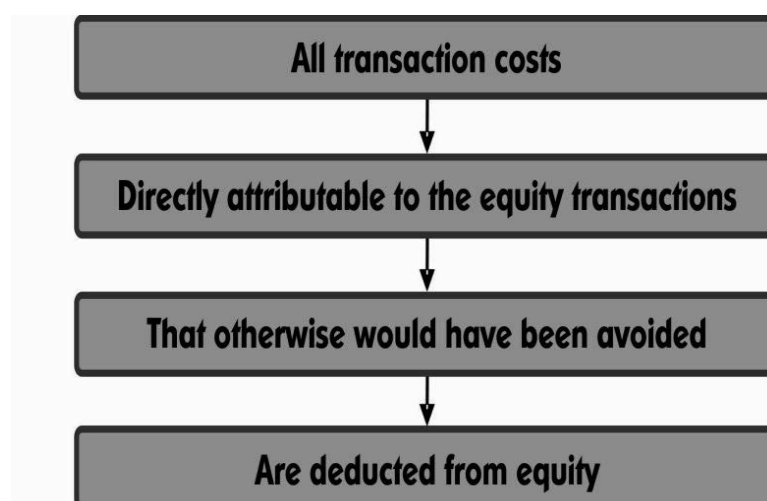
- Registration and other regulatory fees
- Amounts paid to legal, accounting and other professional advisers
- Printing costs
- Stamp duties

The transaction costs are very important and an integral part of the financial instruments. They need to be accounted for in the financial instruments' initial measurement as follows:

1. Finance costs of **equity instruments**: IAS 32 states that transaction costs of an equity transaction shall be accounted for as a deduction from equity, net of any related income tax benefit.

IAS 32 gives the following guidelines on the accounting of transaction (finance) costs:

Diagram 2: Accounting of transaction costs



Example

Straw Inc has issued 500,000 shares of Tshs1,000 for Tshs3,000 each. The stamp duty paid for this issue is Tshs25 million. The printing bill is Tshs10 million, including Tshs4 million paid for the printing of bonds which were also issued by the company.

The transaction costs directly attributable to the issue of shares are:

	Tshs'000	Tshs'000
Stamp duty paid		25,000
Printing bill	10,000	
Less: Paid for printing of bonds	(4,000)	6,000
		31,000

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These equity instruments will be reflected in accounts in the following manner:

	Tshs'000	Tshs'000
Ordinary shares issued		500,000
Share premium	1,000,000	
Less: Transaction costs	(31,000)	969,000
		1,469,000

In the similar manner the printing costs of bonds will be reduced from the proceeds of the bond, while determining the initial value of the liability.

The **costs** of an **equity transaction** that is **abandoned** are recognised as an **expense**.



Example

Continuing with the above example of Straw Inc

If Straw decides that it would issue only 250,000 shares:

In this case, out of the total printing bill of Tshs6 million, 50% relates to costs of an equity transaction which was abandoned. Hence, **Tshs3 million (the printing cost of the abandoned equity transaction)** will be **recognised as an expense in the statement of profit or loss**.

The 250,000 shares will be reflected in accounts in the following manner:

	Tshs'000
Ordinary shares issued	250,000
Share premium	500,000
Less: Transaction costs (Tshs31,000 - Tshs3,000)	(28,000)
	722,000

Transaction costs that relate to the issue of a compound financial instrument are **allocated to the liability and equity components** of the instrument in **proportion to the allocation of proceeds**.

Compound financial instruments have been discussed below in detail.



Example

Wonder Inc issues convertible debentures. Their liability component is Tshs350 million and their equity component is Tshs50 million. If the transaction costs relating to the issue are Tshs16 million, then they will be allocated in the following manner:

Liability component: equity component = Tshs350 million: Tshs50 million = 7:1

Transaction costs allocated to liability component = $\frac{7}{8} \times \text{Tshs16 million} = \text{Tshs14 million}$

Transaction costs allocated to equity component = $\frac{1}{8} \times \text{Tshs16 million} = \text{Tshs2 million}$

Transaction costs that relate **jointly to more than one transaction** are allocated to those transactions using a **basis of allocation that is rational and consistent with similar transactions**.



Example

If there is a concurrent (simultaneous) offer of shares, then the transaction costs directly attributable to this issue will be allocated in a rational manner – probably in proportion to the allocation of proceeds.

The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately under IAS 1 Presentation of Financial Statements.



Test Yourself 7

Ship Inc has issued ordinary shares worth Tshs300 million and convertible debentures worth Tshs200 million at the same time. The equity portion of the convertible debentures is Tshs25 million. Ship Inc has paid a printing bill of Tshs30 million, including the costs of the total issue as well as Tshs5 million for regular printing jobs. The stamp duty for the share issue is Tshs9 million and, for the debenture issue, Tshs6 million. Retained earnings are Tshs50 million.

Required:

Calculate the equity which will appear in Ship Inc's books.

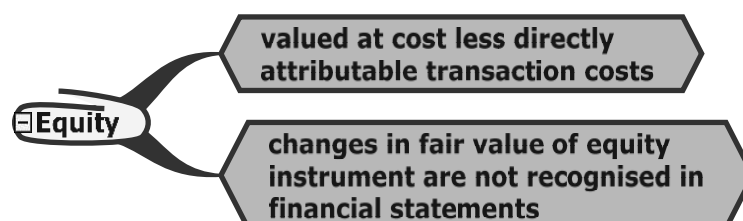


Tip

Changes in the fair value of equity are not recognised in the financial statements.

Preference shares and debt instruments with no conversion rights are **debt instruments** and **not equity instruments**. They will be measured and recognised in the statement of financial position according to the guidelines given in IAS 32 for the measurement of **financial liabilities**.

SUMMARY



4. Understand the initial and subsequent measurement of financial instruments in accordance with international accounting standards.

[Learning Outcome d]

4.1 Initial measurement of financial instruments

A financial instrument can be recognised when the contractual obligations become binding on both entities involved in the transaction. Discussions do not become a binding contract. A planned purchase cannot be recognised as a financial asset.

When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus/minus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability except for a financial asset or financial liability classified as 'at fair value through profit or loss'.

For financial instruments measured at amortised cost, and financial liabilities that are not at fair value through profit or loss, transaction costs are included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.



Example

Dolla Co issued bond for Tshs30 million, to be measured at amortised cost. Issuance costs are Tshs0.6 million. In this case it should be recognised at Tshs29.4 million (Tshs30 million – Tshs0.6 million) i.e. net of transaction costs.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

1. Initial recognition of financial liabilities

When a financial liability is recognised initially, an entity shall measure it at its fair value minus, in the case of a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the issue of the financial liability. All financial liabilities **designated as ‘at fair value through profit or loss’ are initially measured at their fair values.**

- (a) Transaction costs should be deducted from the Fair Value of liabilities in the initial measurement of financial liabilities other than those at fair value through profit or loss.
- (b) Transaction costs for ‘at amortised cost’ financial liabilities should be capitalized, i.e. deducted from the initial value, on initial recognition. If the financial liability has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method.



Example

Speciality Co purchased 500 shares of Quality for Tshs12 million. For this, Speciality incurred broker fees of Tshs0.12 million.

The journal entries to record the transaction will depend on the classification:

If Specialty holds the shares for trading, it has to classify the shares as at fair value through profit or loss, and the journal entries would be (on initial recognition):

	Tshs’000	Tshs’000
Dr Financial assets at fair value through profit or loss	12,000	
Dr Fee expense	120	
Cr Cash		12,120
Being acquisition of 500 shares at fair value recognised		

If the shares are not held for trading and Specialty wishes to classify the shares at FVTOCI, the entry would be:

	Tshs’000	Tshs’000
Dr Financial assets at fair value through OCI	12,000	
Dr Fee expense	120	
Cr Cash		12,120
Being acquisition of 500 shares at fair value plus transaction costs recognized		



Example

Dolla Co issued bond for Tshs30 million, to be measured at amortised cost. Issuance costs are Tshs0.6 million. In this case it should be recognised at Tshs29.40 million (Tshs30 million – Tshs0.6 million) i.e. net of transaction costs.

2. Initial recognition of financial assets

When a financial asset is recognised, an entity shall initially measure it in the following manner:

- (a) for a financial assets at fair value through profit or loss: **at fair value**
- (b) for a financial assets **not** at fair value through profit or loss: **at its fair value plus the transaction costs directly attributable to the acquisition of the financial asset**

If redeemable preference shares and debt instruments with no conversion rights are not to be recognised at fair value through profit or loss, then all **transaction costs directly attributable** to the **acquisition** will be **added to their fair value**.

3. For determining fair values, IFRS 13 gives the guidance:

IFRS 13 specifies the ranking for inputs based on which fair value is to be determined; it does not specify the measurement technique as it will differ according to circumstances. The hierarchies of inputs are to be followed in sequence.

- **Level 1 inputs:** Quoted price for identical asset or liability, if this price is available use it for calculating fair value. Example: Prices of listed shares.
- **Level 2 inputs:** If level 1 inputs are not available we need to consider level 2 inputs for fair value measurement. These inputs include observable inputs other than quoted prices. Example: Valuation of fixed income securities like interest rate swaps, which use information like LIBOR or other observable inputs.
- **Level 3 inputs:** These inputs include non-observable inputs. This is the option of last resort, if no inputs for level 1 or Level 2 are available level 3 inputs are to be used. Example: Value of Non-current assets whose prices are usually not determinable in market. Comparable information like price of a property sold in the similar area is used as a non-observable input.



Example

James purchased unquoted shares with a face value of Tshs30.50 million for Tshs60 million from his friend. He intends to sell them as soon as a favourable sale can be made.

As these shares fall under the category of financial assets at fair value through profit or loss, they are to be recognised at their fair value. As the shares are unquoted, market prices are not available and if a reliable estimate of the fair value is not possible, IFRS 9 provides guidance as to when cost will be best estimate of fair value. If the conditions laid down in IFRS 9 are fulfilled, the shares can be recognised at cost, i.e. Tshs60 million.



Test Yourself 8

Air South Pacific Plc acquired the following financial assets and incurred following liabilities during the year 20X7. As their accountant, determine the initial carrying amount of each of these financial instruments:

- (a) Purchase of a debt security for Tshs25 million with transaction costs of Tshs0.2 million. The debt security is held for trading purposes.
- (b) Equity shares purchased for Tshs4 million. The dealer fee paid was Tshs0.75 million. Air South Pacific elected to classify these shares as financial assets at fair value.

4.2 Subsequent measurement of financial instruments

It has already been mentioned that financial instruments are classified into one of two categories. Following their initial recognition, this classification determines how the financial instrument is subsequently measured.

1. Financial instruments measured at amortised cost using the effective interest method



Definition

The **amortised cost of a financial asset or financial liability** is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

**Definition**

The **effective interest method** is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

IAS 39 Para 9

**Definition**

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

IAS 39 Para 9

**Tip**

The effective interest method and effective interest rate are already defined in Study Guide B5 dealing with revenue recognition.

**Example**

On 1 January 20X4, Tail Co issued bonds worth Tshs400 million. The transaction costs directly attributable to the issue are Tshs20 million. The rate of interest is 6% payable annually and the bonds will be redeemed on 31 December 20X7 for Tshs485 million. The effective interest rate is 12%.

In this case, the bonds will be initially recognised at proceeds received less transaction cost:

	Tshs'000
Proceeds received	400,000
Less: Transaction cost	(20,000)
Carrying amount	380,000

The amount payable as interest and premium on redemption of bonds is:

	Tshs'000
On account of interest ((Tshs400,000 x 6%) x 4 years)	96,000
On account of premium on redemption (Tshs485,000 – Tshs380,000)	105,000
Total amount payable	201,000

Tail Co must allocate the total outflow over the life of the shares at a constant rate on their carrying amount. The effective interest rate it has to apply in order to allocate the amount receivable over four years is 12% (with a rounding adjustment at the end). The carrying amount of bonds is increased each year by the finance cost and reduced by any payments made to the holders of the bonds.

Year	Amortised cost at beginning of year	Amount payable at effective rate (12%)	Amount actually paid during year	Amortised cost at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
20X4	380,000	45,600	(24,000)	401,600
20X5	401,600	48,192	(24,000)	425,792
20X6	425,792	51,095	(24,000)	452,887
20X7	452,887	56,113	(485,000 + 24,000)	-
Total		201,000	581,000	

A **gain or loss** on account of **subsequent measurement** is **recognised in profit or loss** only when the **financial asset is impaired or the financial asset or financial liability is derecognised**

However, **interest calculated** using **the effective interest method** is **recognised in profit or loss every year**.

An entity is required to assess, on each reporting date, whether, in objective terms, a financial asset or group of financial assets is impaired. A financial asset measured at amortised cost is said to be impaired when its carrying value exceeds the present value of the future cash flows (discounted at the financial asset's original effective interest rate).

2. Financial instruments measured at fair value through profit or loss

Financial instruments at fair value through profit or loss are measured at their **fair values without any deduction for transaction costs** that may be **incurred on sale or disposal**.

A gain or loss on account of subsequent measurement is recognised in profit or loss (Except in few cases mentioned below). Dividends and interests received / receivable (in case of financial assets) or paid / payable (in case of financial liabilities) are recognised in profit or loss.

The method of determination of fair value for subsequent measurement will be consistent with the method used at the time of initial measurement.

3. Financial instruments measured at fair value through OCI

For equity instruments not held for trading, for which an irrevocable election has been made at the time of initial recognition to recognise subsequent changes in the fair value in other comprehensive income, the gain or loss on re-measurement is recognized in OCI, with dividends from that investment being recognized in profit or loss when the entity's right to receive payment of the dividend is established.

4. Financial liabilities measured at fair value

The gains or losses arising on financial liabilities measured at fair value through profit or loss are presented in profit or loss, except the fair value changes which are attributable to changes in the credit risk of the financial liability which are presented in other comprehensive income. However, IFRS 9 provides an option for recognition of fair value changes attributable to changes in the credit risk in profit or loss if, recognition of these changes in other comprehensive income enhances or creates an accounting mismatch in profit or loss.

De-recognition is the term used for the removal of a previously recognised financial asset (or financial liability) from an entity's statement of financial position. De-recognition of a financial asset occurs when the contractual rights to the cash flows of the financial asset have expired or the financial asset has been transferred. As derecognition and initial recognition are connected issues, the principle for discontinuing the recognition of a financial asset or liability should be consistent with the principle for recognition.



Example

In continuity of the example on amortised cost and effective interest

In the referred example, a gain or loss on account of subsequent measurement will be recognised in the statement of profit or loss only if the bonds are impaired or derecognised (because of e.g. maturity, early disposal).

However, every year the interest calculated using the effective interest method is recognised in the statement of profit or loss in the following manner:

In 20X4 (Amounts in Tshs'000)

Dr	Bank	Tshs400,000	
	Cr 6% Bond		Tshs400,000

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Being 6 % Bonds issued

Dr	Transaction costs	Tshs20,000	
	Cr Bank		Tshs20,000

Being transaction costs incurred

Dr	6% Bond	Tshs20,000	
	Cr Transaction costs		Tshs20,000

Being transaction costs charged to bond value

Dr	Statement of profit or loss (loss)	Tshs45,600	
	Cr 6% Bond		Tshs45,600

Being effective interest on bond recognised in statement of profit or loss

Dr	6% Bond	Tshs24,000	
	Cr Bank		Tshs24,000

Being amount paid during the year

In 20X5 (Amounts in Tshs'000)

Dr	Statement of profit or loss (loss)	Tshs48,192	
	Cr 6% Bond		Tshs48,192

Being effective interest on bond recognised in statement of profit or loss

Dr	6% Bond	Tshs24,000	
	Cr Bank		Tshs24,000

Being amount paid during the year

In 20X6 (Amounts in Tshs'000)

Dr	Statement of profit or loss	Tshs51,095	
	Cr 6% Bond		Tshs51,095

Being effective interest on bond recognised in statement of profit or loss

Dr	6% Bond	Tshs24,000	
	Cr Bank		Tshs24,000

Being amount paid during the year

In 20X7 (Amounts in Tshs'000)

Dr	Statement of profit or loss (loss)	Tshs56,113	
	Cr 6% Bond		Tshs56,113

Being effective interest on bond recognised in statement of profit or loss

Dr	6% Bond	Tshs509,000	
	Cr Bank		Tshs509,000

Being amount paid during the year

6% Bond account

Dr			Cr		
Year		Amount Tshs'000	Year		Amount Tshs'000
20X4	Transaction costs	20,000	20X4	Bank	400,000
	Bank	24,000		Statement of profit or loss	45,600
	Balance C/D	401,600			
		445,600			445,600
20X5	Bank	24,000	20X5	Balance b/d	401,600
	Balance C/D	425,792		Statement of profit or loss	48,192
		449,792			
		449,792			449,792
20X6	Bank	24,000	20X6	Balance b/d	425,792
	Balance C/D	452,887		Statement of profit or loss	51,095
		476,887			
		476,887			476,887
20X7	Bank	509,000	20X7	Balance b/d	452,887
				Statement of profit or loss	56,113
		509,000			
					509,000



Test Yourself 9

On 1 January 20X5, Wear Co purchased a bond worth Tshs5 million. The bond attracts interest of 5% every year. On 31 December 20X7, it will be redeemed for Tshs5.83 million. The effective interest rate is 10%. Wear Co decided to designate these bonds as financial liability measured at amortised costs.

Required:

What will be the amortised cost of the bond at the end of each year until it is redeemed?

Show how the gain and loss will be reflected in the statement of profit or loss and other comprehensive income.



Example

Cruise Co purchases a 10% holding in the ordinary shares of Katie Co, a non-public, start-up company. Cruise Co paid Tshs70 million for its investment in cash.

As there is no active market for these shares, and there is insufficient information available to determine the fair value (as there is a wide range of possible fair value measurements), cost may not represent the best estimate of fair value. Under IFRS 13, investments in unquoted equity instruments cannot be measured at cost even where fair value cannot be reliably determined. Thus, Cruise Company needs to determine the fair value of ordinary shares purchased based on inputs available. As in this case quoted prices are not available we need to consider observable inputs. If these inputs are not available the fair value is to be determined using unobservable inputs as per IFRS 13.



Example

Audy Inc purchased 6,000 shares of Xeta Inc for Tshs8 million on 31 July 20Y0. On 31 December 20Y0, the fair value of these shares was Tshs9 million and during this period, Audy Inc received a dividend of Tshs60,000.

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In its financial statements for the year ended 31 December 20Y0, Audy Inc will value its investment in Xeta Inc at Tshs8 million, and Tshs2 million, i.e. the increase in fair value, will be recognised in other comprehensive income. The dividend received will be recognised in profit or loss.



Important

Impairment of Financial Assets

At the end of every reporting period, an entity shall assess whether its financial assets have suffered any impairment. If there is evidence suggesting that the financial asset or group of assets has impaired, then impairment losses should be recognised immediately in the statement of profit or loss

(a) For financial assets measured at amortised cost:

Impairment loss = Carrying value of financial asset - Recoverable value

Where recoverable value is the present value of future cash flows and the discount rate used for calculation is the original effective interest rate.

(b) For financial assets measured at fair value:

Impairment loss = Acquisition cost (net of principal repayments and amortisation, if any)
(less) Current fair value or recoverable amount
(less) Previously recognised impairment loss, if any



Test Yourself 10

Neon Co acquires equity instruments at its fair value of Tshs1.5 million. At the end of the entity's financial year, the asset's quoted market price is Tshs1.6 million. Brokerage of Tshs1,000 is payable on each purchase or sale transaction.

Required:

How would the asset be measured when acquired and also at the end of the financial year?

A gain or loss on account of **subsequent measurement** is recognised directly in equity, through the statement of changes in **equity**.

However, **dividends received / receivable** on such equity instrument are recognised in the **statement of profit or loss** when the entity's right to receive payment is established.



Example

Broom Co has recognised shares held in Vroom Co for Tshs23 million in the statement of financial position as at 31 December 20X3. It has classified them as investments at fair value through other comprehensive income. On subsequent measurement on 31 December 20X4, their fair value was Tshs24.5 million.

The shares were sold on 30 June 20X5 for Tshs25 million. The dividend received on them was Tshs0.2 million in 20X4 and Tshs0.235 million in 20X5.

In this case, the entries are: (Amounts in Tshs'000)

In 20X4

Dr	Bank	Tshs200	
	Cr	Dividend received	Tshs200

Being dividend received on shares held in Vroom Co

Dr	Shares in Vroom Co	Tshs1,500	
	Cr	Equity	Tshs1,500

Being profit (Tshs24,500 – Tshs23,000) on subsequent measurement of shares in Vroom Co transferred to equity.

In 20X5

Dr	Bank	Tshs235	
	Cr	Dividend received	Tshs235

Being dividend received on shares held in Vroom Co

Dr	Bank	Tshs25,000	
	Cr	Shares in Vroom Co	Tshs24,500
	Cr	Profit on sale of shares	Tshs500

Being profit on sale of shares held in Vroom Co



Test Yourself 11

As at 31 December 20X4, Tech Co holds shares amounting to Tshs15 million of Savvy Inc which have been classified as at fair value through profit or loss.

The fair value of these shares as at 31 December 20X5 is Tshs14.30 million. They were sold for Tshs15.55 million on 25 July 20X6. The dividend received on these shares was Tshs0.15 million in 20X5 and Tshs0.5 million in 20X6.

Required:

How will these transactions be recorded in the books of Tech Co?



Test Yourself 12

Potter Plc, a kitchen appliance manufacturing company, acquired the following financial instruments during the year 20X5:

- Shares (held for trading) of Malfoy Inc, a publishing company quoted on the London stock exchange.
- Unquoted shares of Archimedes, a scientific research company, the fair value of which can be estimated using valuation techniques.
- Shares of Pan Peter, a company manufacturing children's clothing, that are not quoted on the stock exchange and whose fair value cannot be measured reliably.
- Derivative instruments that are linked to and must be settled by unquoted equity instruments, the fair value of which cannot be measured reliably.
- Bonds of Granger Corp quoted on the active market.
- Unquoted bonds of Frodo Machinery.

Required:

How would the above financial instruments be measured at the end of the financial year?

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All financial assets except those measured at fair value are subject to review for impairment.

5. Present the accounting treatments of fixed interest rate and compound financial instrument.

[Learning Outcome e]

5.1 Fixed interest rate

Debt instruments represent an entity's borrowed capital. It is mandatory for a company to pay interest on these financial instruments.

The interest paid to the holders of debt instruments is a charge against their pre-tax profits and has to be shown as an expense in the statement of profit or loss, as it is tax deductible expenditure for the company

The effective interest method is applied to instruments that have fixed payments and a fixed term. It has been discussed earlier in Learning Outcome, c.

5.2 Compound financial instruments

Compound financial instruments are instruments that contain both a debt element and an equity element. A convertible bond is an example of a compound instrument, since it has a debt element and a potential equity element (on conversion). The economic effect of issuing the convertible bond is the same as issuing a nonconvertible bond and an option to purchase shares. The value of the convertible bond should therefore be split into its component parts to show the **substance** of the instrument. An entity should estimate the fair value of the component parts.



Example

Melon Co has issued 5% debentures for Tshs500 million. The debenture holders have the option of converting these debentures into ordinary shares at a premium of 25% at the end of four years.

These instruments contain a debt element as well as an equity element and are hence called 'compound financial instruments' or 'compound instruments'.

IAS 32 Financial Instruments – Presentation gives the following guidelines for the recognition of such instruments:

- The **carrying amount of the liability component** is determined **first**. This is equal to the fair value of a **similar liability that does not have an associated equity component**.
- The **carrying amount of the equity instrument** represented by the **option to convert the instrument into ordinary shares** is then determined in the following manner:

Diagram 3: Compound financial instruments



Example

On 1 January 20X7, Pineapple Co has issued 5,000 convertible debentures with a face value of Tshs100,000 per debenture. The interest rate on the debentures is 5%. The debenture holders have the option of converting these debentures into ordinary shares at the end of four years. The prevailing market rate for a similar debt which does not have a conversion right is 7%.

Carrying amount of liability portion:	Tshs'000
Present value (PV) of principal: Tshs500,000 at end of 4 years discounted to PV (Tshs500,000 x 0.763*)	381,500
PV of interest: Tshs25,000 annually in arrears for 4 years (Tshs25,000 x 3.387**)	84,675
	466,175

*PV of Tshs1 at 7% after 4 years (taken from discount value table)

** Annuity value of Tshs1 at 7% after 4 years (taken from the annuity tables)

	Tshs
Proceeds of the issue (Tshs5,000 x 100)	500,000
Less: Carrying amount of liability portion	(466,175)
Carrying amount of equity portion	33,825

Note: For the calculation of present values, a discount rate of 7% (the prevailing market rate for a similar debt which does not have a conversion right) is used.

Subsequently the annual interest expense recognised in profit or loss should be calculated by reference to the interest rate used in the initial measurement of the liability component. If all or part of the compound financial instrument is eventually converted into equity, the relevant proportion of the carrying amount of the financial liability should be reclassified as equity, being added to the equity amount initially recognised. No gain or loss should be recognised on conversion of the instrument.



Example

Year	Opening Balance	Interest Expense @ 7%	Interest paid	Closing balance
	Tshs	Tshs	Tshs	Tshs
20X7	466,175	32,632	(25,000)	473,807
20X8	473,807	33,166	(25,000)	481,973
20X9	481,973	33,738	(25,000)	490,712
20Y0	490,712	34,350	(25,061)	500,000

If on 31 December 20Y0 all the bond holders elect to convert into equity, then the Tshs500,000 million liability should be reclassified to equity, making Tshs533,825 in total. The double entry should be:

Dr Financial liability Tshs533,825
Cr Equity Tshs533,825

If none of the bonds are converted to equity, the liability of Tshs500,000 will be extinguished by the cash repayment. However, the amount already included in equity of Tshs33,825 should remain there. The double entry should be:

Dr Financial liability Tshs500,000
Cr Cash Tshs500,000



Test Yourself 13

Cherry Co has issued 3,000 convertible bonds with a face value of Tshs100,000 per debenture. The interest rate on the debentures is 4%. The debenture holders have the option of converting these debentures into ordinary shares at the end of five years. The prevailing market rate for a similar debt which does not have a conversion right is 6%.

Required:

How will this financial instrument be recognised in the statement of financial position?

6. Present and disclose of financial instruments in accordance with international accounting standards.

[Learning Outcome f]

6.1 Presentation requirements related to financial instruments

When an entity issues a financial instrument, it should classify it according to the substance of the contract under which it has been issued. Classification will be as a **financial asset, financial liability or an equity instrument**.

Financial instruments should be grouped into classes that are appropriate to the nature of information disclosed, taking into account matters such as the features of the instruments and the measurement basis applied. If a financial instrument meets any of the criteria set out in the definition of a financial liability, then it should be classified as a financial liability and not as an equity instrument. In general, classes should distinguish items carried at amortised cost from items carried at fair value and there should be sufficient information to permit a reconciliation to the relevant statement of financial position items.

On reading the definitions of **current assets and current liabilities given in IAS1**, it can be inferred that financial assets classified as held for trading should be presented as current assets. Similarly, trading derivative assets should also be presented as current assets.

Also, financial assets, other than derivatives and those held for trading should only be presented as current assets if realisation within 12 months is expected. Other financial assets should be classified as non-current assets, although any portion that is expected to be realised within 12 months of the reporting date should be presented as a current asset.

The standard further emphasises that judgement should be exercised in determining the level of details to be disclosed, taking into account the relative importance of the particular instrument concerned. A balance should be maintained between avoiding excessive detail and keeping important information in aggregated disclosures. This information should include a combination of **narrative descriptions and specified quantified data**, as appropriate to the nature of the instruments and their relative importance to the entity.

Financial liabilities should be classified as current or non-current using the same criteria as for financial assets.

6.2 Disclosure of financial instruments

Disclosures should be made to provide the users of the financial statements with an understanding of the effect that financial instruments have on an entity's financial performance, position and cash flow. Disclosure requirements are dealt with in IFRS 7.

Statement of financial position disclosures

Disclosure is permitted either in the statement of financial position or in the notes to the financial statements.

1. Disclosures for loans and receivables designated at fair value through profit or loss

- (a) Maximum credit exposures
- (b) Impact of credit derivatives on credit exposures
- (c) Change in fair value of loans and receivables
- (d) If there has been a change in valuation technique, the entity shall disclose that change and the reasons for making it

2. Disclosures for financial liabilities designated at fair value through profit or loss

- (a) Change in fair value of financial liability due to credit risk
- (b) Method used to determine such change in fair value

3. Other sundry disclosures

- (a) Derecognition: nature and carrying amount of financial asset transferred but not derecognised
- (b) Collateral given: terms and conditions, and carrying amount

- (c) Collateral received: terms and conditions, fair value and whether such collateral has been sold or repledged
- (d) Allowance for credit losses: reconciliation for each class of financial asset
- (e) Compound financial instrument: multiple embedded derivatives whose values are interdependent
- (f) Defaults and breaches: carrying amount and details of defaults for loans payable

4. Statement of profit or loss disclosures

An entity should disclose:

- Net gains (losses) for each category of financial instrument.
- Gains (losses) recognised in equity and amounts reclassified from equity to profit or loss.
- Total interest income and total interest expenses (for financial assets or financial liabilities designated other than fair value through profit or loss).
- Fee income and expenses for financial instruments (arising from financial assets and liabilities designated other than fair value through profit or loss).
- Interest income accrued on impaired financial assets. Impairment losses for each class of financial assets.

(a) Credit risk disclosures

- For each class of financial instrument, disclose the maximum credit exposure without taking into consideration collateral or other credit enhancements.
- Information relating to the credit quality of financial assets that are neither past due nor impaired (e.g. A rating analysis).
- A description and fair value of collateral available to the entity as security and other credit enhancements Collateral of which the entity has taken control.
- Carrying amounts of loans granted to customers, deposits paid etc.
- Carrying amounts of derivatives.
- Guarantee amount for financial guarantees provided.
- Amount of loan commitment.

(b) Market risk disclosures

- An entity has to disclose market risk sensitivity analysis.
- Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices and includes interest rate risk, foreign currency risk and other price risk.
- Market risk sensitivity analysis includes the effect of 'a reasonably possible change' in the risk variables in existence at reporting date if applied to all risks in existence at that date.
- The standard does not prescribe any fixed format for this analysis.
- Similar risks are combined for the purpose of the market risk analysis.
- The assumptions and methods used in the market risk analysis are also to be disclosed.

(c) Liquidity risk disclosures

- A maturity analysis for non-derivative as well as derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities.
- a description of how it manages the liquidity risk inherent in the above.

Answers to Test Yourself

Answer to TY 1

Examples of financial assets and corresponding financial liabilities representing a contractual right to receive / deliver cash in the future are:

- Trade accounts receivable and payable
- loans receivable and payable
- Bonds receivable and payable

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Answer to TY 2

The transactions entered into by Red Co

- (a) The electricity bill of Tshs1 million paid in advance will not be considered a financial instrument as it does not give rise to a financial asset for one entity and a financial liability or equity for another; it is a prepaid expense, which would help to generate future economic benefits.
- (b) The contract entered into to purchase goods worth Tshs2 million after six months will be considered a financial instrument as it gives rise to a financial asset for one entity and a financial liability for another. However, if the entity intends to hold this contract for the purpose of delivery of a non-financial item, then according to IAS 39, it will not be considered financial instrument.

Answer to TY 3

These financial assets are measured at amortised cost. An entity may consider, among other information, the financial assets' fair values from a liquidity perspective (i.e. the cash amount that would be realised if the entity needs to sell assets). However, the entity's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective.

Answer to TY 4

These investments are financial assets of Sun and will be classified as at fair value investments. This is because there are no contractual cash flows on specific dates to receive the principal and / or interest on the principal. Regardless of the fact that the shares are unquoted, the fair value of the shares is considered for measurement.

Answer to TY 5

- (a) Unless Axl & Rose takes a decision to designate the receivable as a financial asset at fair value through profit or loss to avoid an accounting mismatch, receivables should be classified as "at amortised cost".
- (b) The equity investment in Slash Plc is classified as at fair value, since there cannot be any contractual cash flows towards principal and interest and hence amortised cost method cannot be used. The subsequent changes in fair value will be recognised in profit or loss unless an irrevocable election to classify them as at fair value through OCI is made.
- (c) This asset should be designated as at fair value. IFRS 9 gives the following guidance: All investments in equity instruments and contracts on those instruments must be measured at fair value. Fair value will be determined by using appropriate valuation technique. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to determine fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.
- (d) This investment in debt securities should be classified as at amortised cost since it appears that the business model is to hold the assets to collect contractual cash flows of principal and interest.
- (e) According to IFRS 9, if an entity holds investments to collect their contractual cash flows but would sell an investment in particular circumstances, the objective of an entity's business model may still be to hold financial assets to collect the contractual cash flows. Hence, this item should be classified as 'at amortised cost'.
- (f) Unless Axl & Rose decides to classify the strategic investment as a financial asset held at fair value through profit or loss, this investment should be classified as 'at Fair value through OCI', through an irrevocable selection
- (g) This second investment in Slash Plc would be classified as a financial asset at fair value through profit or loss.

Answer to TY 6

- ⑩ The 20,000 preference shares of Tshs1,500 each have to be redeemed and so will be classified as debt.
- ⑩ The 24,000 8% preference shares of Tshs1,500 each will be classified as equity because there is no compulsory redemption and interest is not payable if the entity has no distributable profits.

Answer to TY 7

IAS 32 lays down the following guidelines for transaction costs of an equity issue:

- (i) Transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.
- (ii) Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.
- (iii) All transaction costs that can be directly attributed to the equity transaction and that otherwise would have been avoided are accounted for as a deduction from equity.

The equity transaction will appear in the books in the following manner:

	Tshs'000	Tshs'000
Ordinary shares issued		300,000
Equity component of non-convertible debentures		25,000
Retained Earnings	50,000	
Less: Transaction costs of share issue		
Stamp duty	(9,000)	
Printing bill (W3)	(15,000)	
Less: Transaction costs of equity component of Non-convertible debentures		
Stamp duty (W4)	(750)	
Printing bill (W3)	(1,250)	24,000
		349,000

Workings (Amounts in Tshs'000)

W1 Liability component: equity component in convertible debenture issue = 175,000:25,000 = 7:1

W2 Proportion of allocation for proceeds of share and debenture issue:

Share issue: liability component of debenture issue: equity component of debenture issue = 300,000:175,000:25,000 = 12:7:1

W3 Allocation of printing bill

	Tshs'000
Total bill	30,000
Less: On account of regular printing jobs	(5,000)
Printing bill attributable to issue	25,000

Allocated to:

	Tshs'000
Share issue (12/20 x Tshs25,000)	15,000
Liability component of debenture issue (7/20 x Tshs25,000)	8,750
Equity component of debenture issue (1/20 x Tshs25,000)	1,250

W4 Allocation of stamp duty for debenture issue

	Tshs'000
Liability component of debenture issue (7/8 x Tshs6,000)	5,250
Equity component of debenture issue	750

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Alternative workings: (Amounts in Tshs'000)

Particulars	Retained Earnings	Convertible	debentures	Ordinary Shares
Balance	50,000	Debt Component	Equity Component	
Proceeds		175,000	25,000	300,000
Printing Costs	(5,000)	(8,750)	(1,250)	(15,000)
Stamp Duty	(9,000)	(5,250)	(750)	

Answer to TY 8

- (a) The debt security is held for trading purposes, therefore it will be classified as at fair value. Transaction costs are not recognised in **financial instruments designated at fair value**. Such financial instruments are measured at their fair values only. As a result, the carrying value of this debt instrument will be Tshs25 million while the transaction costs of Tshs0.2 million will be expensed in the statement of profit or loss.
- (b) ASP elected to classify the equity shares at fair value which are initially measured at fair value. Therefore, the carrying value of the equity shares is Tshs4 million with the transaction costs of Tshs0.75 million expensed. The election to carry the financial instrument at fair value could be through profit or loss or through OCI. In either case, the carrying value will still be the same (i.e. the fair value).

Answer to TY 9

In this case, the amount receivable as interest and premium on this bond is:

	Tshs'000
On account of interest (Tshs5,000 x 5%) x 3 years	750
On account of premium on redemption (Tshs5,830 – Tshs5,000)	830
Total amount receivable	1,580

Wear Co must allocate the amount receivable over the life of the bond at a constant rate on the carrying amount of the bond. The effective interest rate it has to apply in order to allocate the amount receivable over three years is 10%.

Year	Amortised cost at beginning of year	Amount receivable at effective rate of 10%	Amount actually received during year	Amortised cost at end of year
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
20X5	5,000	500	(250)	5,250
20X6	5,250	525	(250)	5,525
20X7	5,525	555 (rounded off)	(5,830 + 250)	-

A gain or loss on account of subsequent measurement will be recognised in the statement of profit or loss only if the bonds are impaired or derecognised (because of e.g. maturity, early disposal).

However, every year the interest calculated using the effective interest method is recognised in the statement of profit or loss in the following manner:

In 20X5: (Amounts in Tshs'000)

Dr 5% Bond Tshs5,000
 Cr Bank Tshs5,000
 Being 5% Bonds purchased

Dr Bank Tshs250
 Cr 5% Bond Tshs250
 Being interest received on 5% bond

Dr 5% Bond	Tshs500	
Cr Statement of profit or loss (gain)		Tshs500
Being 5% bond recorded at amortised cost		

In 20X6: (Amounts in Tshs'000)

Dr Bank	Tshs250	
Cr 5% Bond		Tshs250
Being interest received on 5% bond		

Dr 5% Bond	Tshs525	
Cr Statement of profit or loss (gain)		Tshs525
Being 5% bond recorded at amortised cost		

In 20X7: (Amounts in Tshs'000)

Dr Bank	Tshs250	
Cr 5% Bond		Tshs250
Being interest received on 5% bond		

Dr 5% Bond	Tshs555	
Cr Statement of profit or loss (gain)		Tshs555
Being 5% bond recorded at amortised cost		

Dr Bank	Tshs5,830	
Cr Bond (amount as on 1 January 20X7)		Tshs5,830
Being amount received on redemption of bonds		

5% Bond Account

Dr			Cr		
Year		Amount Tshs'000	Year		Amount Tshs'000
20X5			20X5	Bank	250
	Bank	5,000		Balance c/d	5,250
	Statement of profit or loss	500			
		5,500			5,500
20X6			20X6	Bank	250
	Balance b/d	5,250		Balance c/d	5,525
	Statement of profit or loss	525			
		5,775			5,775
20X7			20X7	Bank (250 + 5,830)	6,080
	Balance b/d	5,525			
	Statement of profit or loss	555			
		6,080			6,080

Answer to TY 10

The entity would recognise the financial asset at its fair value, which excludes the transaction cost i.e. financial costs.

Here, the asset will be measured at Tshs1.5 million when the asset is acquired, and financial costs will be charged to profit or loss.

At the end of the entity's financial year, the asset would be recorded at its fair value only i.e. Tshs1.6 million. Brokerage will be ignored for this purpose. The difference of Tshs0.1 million (Tshs1.6 million - Tshs1.5 million) should be recognised in profit or loss. However, for those equity investments for which the entity has elected to report value changes in 'other comprehensive income', it should be recognised in other comprehensive income.

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Answer to TY 11

As these shares have been classified at fair value through profit or loss, a gain or loss on account of subsequent measurement, and any dividends received, will be recognised in the statement of profit or loss.

In 20X5: (Amounts in Tshs'000)

Dr	Statement of profit or loss (loss)	Tshs700	
	Cr Shares of Savvy Inc		Tshs700
	Being loss on subsequent measurement (Tshs15,000 – Tshs14,300) transferred to statement of profit or loss		

Dr	Bank	Tshs150	
	Cr Dividend received		Tshs150
	Being amount received as dividend		

In 20X6: (Amounts in Tshs'000)

Dr	Bank	Tshs500	
	Cr Dividend received		Tshs500
	Being amount received as dividend		

Dr	Bank	Tshs15,550	
	Cr Shares of Savvy Inc		Tshs14,300
	Cr Statement of profit or loss (gain)		Tshs1,250
	Being gain on disposal (Tshs15,550 – Tshs14,300) transferred to Statement of profit or loss		

Answer to TY 12

- Shares held for trading would always be measured at fair value.
- The shares will have to be measured at fair value. If they are not held for trading and on initial recognition an irrevocable election is made to do so, they can be measured at FVTOCI, otherwise, at FVTPL.
- Same as (b) above.
- The derivatives are always measured at fair value through profit or loss.
- Depending on the classification of the bond, the bond can be measured at fair value through profit or loss or at amortised cost.
- This kind of bond is also measured at fair value or amortised cost depending on its classification.

Answer to TY 13

These convertible debentures have a debt as well as equity element. Hence, they are compound financial instruments. The IAS 32 guidelines for recognition of compound financial instruments will be followed:

Carrying amount of liability portion	Tshs'000
PV of principal: Tshs300,000 at end of 5 years discounted to PV (300,000 x 0.747*)	224,100
PV of interest: Tshs12,000 payable annually in arrears for next 5 years (12,000 x 4.212**)	50,544
Carrying amount of liability portion	274,644

* PV of Tshs1 at 6% after 5 years, taken from **discount tables**

** Annuity value of Tshs1 at 6% after 5 years, taken from **annuity tables**

	Tshs'000
Proceeds of the issue (3,000 debentures x Tshs100,000)	300,000
Less: Carrying amount of liability portion	(274,644)
Carrying amount of equity portion	25,356

Note: For the calculation of present values, a discount rate of 6% (the prevailing market rate for a similar debt which does not have a conversion right) is used.

Quick Quiz

1. How is a financial asset of one entity related to the assets / liabilities of another entity?
2. Why is proper classification of financial instruments necessary?
3. Financial instruments with credit balances can be either debt instruments or equity instruments. They cannot be both at the same time. True or false?
4. What is the difference between the basis for measurement of an equity issue and that of a debt issue?
5. What are the two categories under which financial liabilities can be classified?
6. How is the finance cost of equity instrument accounted in accordance with IAS 32?

Answers to Quick Quiz

1. A financial asset of one entity automatically gives rise to a financial liability or equity instrument of another entity.
2. Proper classification of financial instruments is necessary because misclassification will affect the financial statements.
3. False. There exist financial instruments which are compound in nature. They have both debt and equity characteristics. An example is convertible bonds.
4. Equity is valued at cost less any transaction costs directly attributable to the equity issue. Changes in fair value of an equity instrument are not recognised in the financial statements.

Debt is initially valued at fair value less any transaction costs directly attributable to the issue. If debt is not classified at fair value through profit or loss, then it is subsequently measured at amortised cost using the effective interest method.

5. The two categories under which financial liabilities can be classified are:
 - financial liabilities measured at fair value through profit or loss
 - financial liabilities measured at amortised cost
6. IAS 32 states that transaction costs of an equity transaction shall be accounted for as a deduction from equity, net of any related income tax benefit

Self-Examination Questions

Question 1

Determine whether the following is financial instruments or not:

Bear Co has entered into a future contract to purchase 2,000 shares from Tear Co for Tshs25 million after three months. This is a verbal agreement between the two entities.

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Question 2

Determine whether the following will be classified as debt or equity:

- (i) Super Inc is a software company. It has decided to issue warrants for 3,500 of its ordinary shares to its key employees. The holders of these warrants have the option to subscribe to these shares at a specified time.
- (ii) Past Inc has taken a loan from Present Inc. Past Inc has to pay annual interest of 4% on this loan. There is no repayment clause.

Question 3

What are the main requirements of IAS 32 for the issue and transaction costs of equity instruments?

Question 4

Lotus Ltd borrowed Tshs15 million on 1 January 20X8 from ABN Bank. They incurred transaction costs of Tshs100,000 to obtain the loan.

The terms of the loan provide that Lotus Ltd pays interest of Tshs900,000 on 31 December each year and the loan is repayable at a substantial premium on 31 December 20Y2. The effective annual interest rate associated with this loan is 10%. The annual interest was paid on 31 December 20X8 and Lotus intends to retain the loan until its repayment date.

The fair value of the loan on 31 December 20X8 was Tshs16 million.

Required:

Show how the financial instruments will be treated in the financial statements of Lotus Ltd for the year ended 31 December 20X8.

Answers to Self Examination Questions

Answer to SEQ 1

In order to determine whether an item is a financial instrument or not, it is necessary to check whether it fulfils all the conditions laid down in the definition of a financial instrument.

A **financial instruments** any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

The settlement of this contract will lead to the exchange of cash and shares between the two entities. Both these items are financial instruments. For the purpose of fulfilling the definition of financial instrument, IAS 32 states that a contract need not be in writing.

In this transaction the fair value of the 2,000 shares will keep fluctuating.

If the end of the reporting period falls before the end of the three-month period, then the entity will have to account for a gain or loss on account of the derivative contract.

If the fair value at the end of the reporting period exceeds Tshs25 million, Bear co has actually made a gain on account of this forward contract. Hence, a financial asset is created. Likewise, if it is less than Tshs25 million, the entity has acquired a financial liability.

Answer to SEQ 2

The classification of a financial instrument as debt or equity primarily depends upon whether there is an obligation on the issuer:

- To deliver cash or another financial asset to the other party; or

- To exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer; or
- To redeem the holder at a fixed or determinable future date.

If there is **no** such **obligation**, then the financial instrument is an **equity instrument**.

If there is such an **obligation**, then the financial instrument is a **debt instrument**.

The specified instruments should be classified according to these guidelines:

- (i) When the employees exercise their options, Super will not be obliged to deliver cash or any other financial asset to them. The ordinary shares are also not compulsorily redeemable at a fixed or determinable future date. Hence, these warrants are **equity instruments** of Super Inc.
- (ii) Past Inc is obliged to pay interest each year. Hence, even though there is no compulsory repayment clause in this loan agreement, it will be classified as a debt instrument.

Answer to SEQ 3

The main requirements of IAS 32 to the issue and finance costs of equity instruments are:

- (i) All transaction costs that can be directly attributed to the equity transaction and that otherwise would have been avoided are accounted for as a deduction from equity.
- (ii) The costs of an equity transaction that is abandoned are recognised as an expense.
- (iii) Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds.
- (iv) Transaction costs that relate jointly to more than one transaction are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.
- (v) The amount of transaction costs is accounted for as a deduction from equity in the period is disclosed separately under IAS 1 Presentation of Financial Statements.
- (vi) The related amount of income taxes recognised directly in equity is included in the aggregate amount of current and deferred income tax credited or charged to equity that is disclosed under IAS 12 Income Taxes.

Answer to SEQ 4

The loan will initially be included in the financial statements of Lotus Ltd under long term borrowings at its net proceeds of Tshs14,900,000 (Tshs15 million – Tshs100,000).

The finance cost for the year will be Tshs1,490,000 (10% x Tshs14,900,000). This will be charged to statement of comprehensive income and also added to the outstanding loan liability.

On 31 December 20X8 Lotus Ltd pays interest of Tshs900,000 and this will reduce the loan liability.

The closing loan liability will be Tshs14,900,000 + Tshs1,490,000 – Tshs900,000 = Tshs15,490,000.

The fair value of the loan is not relevant under IFRS 9 because the loan is a financial liability measured at amortised cost.

STUDY GUIDE B7: PROVISIONS, CONTINGENT ASSETS AND LIABILITIES

Get Through Intro

As a finance manager of a large company, you will have to determine which liabilities are to be provided for and reflected in the financial statements of your company. You will also have to identify the contingent liabilities and contingent assets to be disclosed in the notes to the accounts.

Any **error in judgement** on your part, besides meaning that the **requirements of IAS 37 have not been fulfilled**, would also lead to a **misrepresentation of facts in the financial statements**.

You should spend time understanding the principles and the underlying determination of liabilities, contingent liabilities and contingent assets. This will not only help you solve the questions in your examination correctly, but will also help you in your future professional life.

Learning Outcomes

- a) State when provisions may and may not be made, and how they should be accounted for.
- b) Describe the measurement of provisions in accordance with international accounting standards.
- c) Define:
 - i. Legal obligations
 - ii. Constructive obligations
 - iii. Restructuring provisions
- d) Account for contingent liabilities and contingent assets.
- e) Identify and account for:
 - i. Onerous contracts
 - ii. Environmental and similar provisions

1. State when provisions may and may not be made, and how they should be accounted for. [Learning Outcome a]

1.1 What is a provision?



Definition

Provisions are liabilities 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.

IAS 37 Para 10

1.2 When provisions may be made

A liability can be provided for only when **all the following conditions** (known as the **recognition criteria**) are fulfilled:

1. An entity has a **present obligation** (legal or constructive) **as a result of a past event**.



Example

Sure, a bookseller sells books with a guarantee that if the books sold by him are returned within one month of sale, then the amount paid by the buyer for the book will be returned – no questions will be asked.

In this case, Sure has a **present obligation** to return the amount paid by the buyer, within one month of sale. This obligation is a **result of a past event** (the sale of books).

2. It is **probable** (which means it is more likely to happen than not) that an **outflow of resources, embodying economic benefits will be required to settle the obligation**.



Example

In the above example of Sure, it is probable that some buyers will return the book within one month. As the terms state that no questions will be asked on return of books, Sure Co will have to return the amount to the buyer.

Settlement of the obligation by Sure Co, will obviously lead to an **outflow of resources embodying economic benefits** (i.e. cash returned to the buyer).

3. A **reliable estimate** can be made of the **amount of the obligation**.



Example

In the above example, Sure Co can make a **reliable estimate** of the **amount of the obligation**.

In order to make a reasonable estimate, it will rely on past records, to see what percentage of books have been returned.

In any case, the total provision will not exceed the total of the last month's sales figures.

**Tip**

The above mentioned conditions can be remembered with the help of the following mnemonic:

P³ + E

Where,

P = **P**resent obligation

P = as a result of **P**ast event

P = **P**robable that outflow of resources, embodying economic benefits will be required to settle the obligation E = reliable **E**stimate can be made of the amount of the obligation

1.3 When provisions may not be made

If there is a situation where **even one condition** of the recognition criteria **is not fulfilled**, then it **does not constitute a liability which has to be provided for**.

**Example**

Let us see what happens in the following situations:

(a) A company is planning to give training to its employees to improve their leadership skills.

In this case;

- An **outflow of resources embodying economic benefits will be required to settle the obligation** i.e. the training cost.
- A **reliable estimate can** be made of the **amount of the obligation**.

However:

This is not a present obligation based on a past event in the ordinary course of the business – the training has not started yet. Also, the company has not yet entered into a contract with any training provider. **Therefore, the training cost cannot be recognised as liability.**

**Test Yourself 1**

Skylark Cosmetics manufactures a brand of fairness creams. It promotes its sales by guaranteeing that if the benefits of the cream are not evident within seven days of use then the money paid for the purchase will be returned to the buyer, no questions asked, provided the customer returns the goods within one month of purchase.

Required:

Determine whether this liability has to be provided for or not.

1.4 Accounting for provisions

1. **The journal entry to account for a provision is:**

Dr Expense (Statement of profit or loss)	X	
Cr Provision for expense (Statement of financial position)		X
Being expense provided for		

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2. The journal entry to be made when actual payment is made is:

Dr Provision for expense (Statement of financial position)	X	
Cr Bank		X
Being payment made for an expense provided for earlier.		



Test Yourself 2

Samson Electronics needs to make a provision for warranty claims in the following way:

At the end of financial year one	Tshs5,000,000
At the end of financial year two	Tshs6,000,000

It settles warranty claims worth Tshs4,400,000 in year two.

Required:

Set out the journal entries that it should make in respect of these transactions.



Test Yourself 3

The new environmental norms set out by the government require the entities in the manufacturing sector to fit smoke filters in its factories by the last date of June 20Y1.

Required:

Would a provision be recognised in the financial statements if smoke filters have not been fitted as on the following two reporting dates?

- 31 December 20Y0
- 31 December 20Y1

1.5 Disclosure in the financial statements:

- The details of the change in the **carrying amount of the provision** during the year.
- A brief description of the **nature of the obligation**, the **uncertainties** and **expected timing of any resulting outflows** and an **indication of the uncertainties about the amount of those outflows**.
- The amount of any **expected reimbursement**.

The following is an extract from the notes to the group financial statements of Nokia for the year 20X5. It shows the information disclosed in Nokia's financial statements regarding provisions. Tables have been reformatted so as to show the relationship of numbers more clearly.

2. Describe the measurement of provisions in accordance with international accounting standards.

[Learning Outcome b]

2.1 The best estimate

According to Para 36 of IAS 37, the amount recognised as a provision shall be the **best estimate** of the expenditure required to settle the present obligation at the reporting date.

The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

The best estimate of the expenditure required to settle the present obligation is determined by any or all of the following ways together:

- (a) the judgement of the management of the entity;
- (b) experience of similar transactions;
- (c) reports from independent experts.

The standard provides guidance relating to measurement of provisions which are on account of uncertainties.

The best estimate of the provisions can be determined as follows:

- (i) **Expected value:** for the measurement of a large population of items
- (ii) **Most likely outcome:** for the measurement of a single obligation

Each of the above stated methods is explained below.

(i) Expected value: Statistical method of determining the best estimate

When the provision being measured involves large population of items, the 'expected value' method is used. Under this statistical method, all the possible outcomes are weighed by their respective probabilities and the amount of provision is estimated on that basis. Therefore, the amount of provision differs according to the probabilities of a loss. However, if there is continuous range of possible outcomes, the mid-point of the range is used to determine the amount of provision.

In extremely rare cases where a liability exists but cannot be recognised due to non-availability of reliable estimates, the liability is disclosed as a contingent liability.



Example

Perfect Fit, a shirt manufacturing company, gives a guarantee that if any shirt shrinks or fades within one month of sale, it will refund the amount paid for the shirt. The last month's sales for the year ending 31 December 20X6 are Tshs25 million. Past experience states that 5% of shirts will shrink and 10% of shirts will fade. The possibility of a shirt both shrinking and fading is nil. However, the management is of the opinion that, due to the new technology introduced in the business last year, the possibility of shirts fading will go down to 5%.

	Tshs'000
In this case, the amount which will be provided for will be: For shrinking of shirts (past experience) 5% of Tshs25,000	1,250
For fading of shirts (management judgement) 5% of Tshs25,000	1,250
Total amount of provision	2,500

(ii) Most likely outcome: measurement of a single obligation

Where a single obligation is being measured, the most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount.



Example

A court case for damages was pending against Cart House on 31 December 20X6 which is the reporting date. Cart House's lawyers estimated that:

- there is a 60% chance of Cart House incurring a liability of Tshs150 million
- there is a 40% chance of Cart House incurring a liability of Tshs120 million

Remember, 'most likely' means that the chance of a transfer of economic benefits is over 50%

Therefore, as the most likely outcome is Tshs150 million, the entity made a provision for this amount.



Test Yourself 4

Quality Ltd sells digital cameras with a warranty under which customers are covered for the cost of repairs or replacement of manufacturing defects found within first 12 months after purchase. Quality Ltd has estimated that if every product sold required minor repairs, the cost would be Tshs2 million. If the product was replaced, the cost would be Tshs5 million. Quality Ltd's past experience and future expectations indicates that 75% of all goods sold will have no defects, 15% will have minor defects and 10% will need replacing.

Required:

Calculate the amount of provision.

2.2 Reimbursements

If a company is virtually certain that another party will reimburse the expenditure required to settle the liability, then this amount of 'receivable reimbursement' is recognised in the financial statements in the following manner:

- ⓐ As a separate **asset in the statement of financial position**.
- ⓑ **Deducted from the amount of expense** and the **net amount of expense is transferred to the statement of profit or loss**

However, the amount recognised for reimbursement cannot be more than the amount of provision.



Test Yourself 5

Optimax, a television set manufacturing company gives a guarantee that it will correct all faults found in its television sets within six months of sale. Sales in the last six months were Tshs40 million. The company knows that if all sets sold had minor defects, the cost involved would be Tshs5 million and if all sets sold had major defects, the cost would be Tshs15 million. From past experience, it estimates that 60% of its sets will have no defects, 20% will have minor defects and 20% will have major defects. It has taken out an insurance policy, the terms of which state that the insurance company will reimburse half the amount the company pays by way of settling guarantee claims.

Required:

Calculate the amount of provision to be reflected in the financial statements of Optimax.

2.3 Changes in provisions

Provisions are **reassessed at the end of each reporting period** and **adjusted to reflect the current best estimate**.

If it is **no longer probable** that an **outflow of resources embodying economic benefits will be required to settle the obligation, the provision** has to be **reversed**.

 **Example**

Wine Co has signed a contract with its employees under which it has agreed to pay a long service incentive of Tshs5 million to employees who stay with the company for a period of more than three years.

On 31 December 20X8, four employees are eligible for this incentive and accordingly a provision of Tshs20 million is made in the accounts of that year.

In 20X9, all the four employees are accused of embezzling company funds and are fired.

As an **outflow of resources embodying economic benefits will probably not be required to settle the obligation**, the provision of Tshs20 million made earlier **will now be reversed**, and a **new provision will not be made**.

The accounting entries will be:

31 December 20X8

Dr	Employee costs	Tshs20m	
	Cr Provisions		Tshs20m

Being employee costs provided for

31 December 20X9

Dr	Provisions	Tshs20m	
	Cr Statement of profit or loss		Tshs20m

Being the provision made for the employee costs reversed

3. Define:

- i. Legal obligations
- ii. Constructive obligations
- iii. Restructuring provisions

[Learning Outcome c]

3.1 Legal obligations

A **legal obligation** is an obligation that a company derives because of:

1. A contract (through its explicit or implicit terms);
2. Legislation; or
3. Other operation of law.

1. Obligation derived because of contract

 **Example**

Florist Co enters into a contract to complete the landscaping work of Garden Hotels Inc and the entire amount of the contract has been collected in advance.

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The terms of the contract state that the work has to be completed according to the predetermined time schedule. If Florist Co does not finish the work on time, then it will be liable to pay 20% of the amount of the contract to Garden Hotels Inc.

This liability (the payment of 20% of the amount of the contract on non-completion of work in time) **is a legal obligation** which Florist Co has derived because of **a contract**, and **will result in an outflow of economic resources**.

A provision will have to be made for 20% of the amount of the contract, if it is likely that the work will not be finished on time.

2. Obligation as a result of legislation



Example

According to the terms of new legislation which has been passed, Amy Co is required to clear the contamination it has caused to the environment.

Amy Co has entered into a contract of Tshs23.5 million with Fire Inc for clearance of the contamination.

The liability of clearance of contamination **is a legal obligation**, which Amy Co has derived because of **legislation and will result in an outflow of economic resources**.

A provision will have to be made for Tshs23.5 million.

3. Obligation as a result of other operation of law



Example

The pollution control board of a region requires a company to pay a fine which equals an amount of 2.5% of the turnover of the month in which the pollution levels of smoke emitted by a company cross an established limit.

Pure Ltd finds that it has crossed the limits in November 20X9 but has not paid the fine up to the date of the statement of financial position (31 December 20X9). The turnover for the month of November 20X9 is Tshs424 million.

The pollution which has crossed the allowed limit is an event leading to a legal obligation, which Pure Co has derived because of another operation of law. It will lead to an economic outflow of Tshs10.6 million (Tshs424 million x 2.5%).

A provision will have to be made for Tshs10.6 million.

3.2 Constructive obligations



Definition

A constructive obligation is an obligation that a company derives because of an entity's actions, 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.



Example

House Providers Inc has been in the business of constructing houses for the last 20 years. Its practice has been to maintain the housing colonies it constructs for a period of one year after the date of handing them over. This policy is not written anywhere, nor does the company make such a commitment at the time of sale.

However, this liability has to be provided for, as it is a **constructive obligation** which House Providers Inc has derived **because of an established pattern of past practice**, which its customers expect with full certainty that it will discharge.



Test Yourself 6

Outline the differences between legal and constructive obligations.

There is **one point of similarity** between the legal obligations and constructive obligations:

Non-performance in both cases will lead to a **fall in the credibility of the company**, and may affect the business.

3.3 Restructuring provisions

Restructuring provisions were used by some companies to manipulate their results; therefore IAS 37 specifically lays down the accounting requirements in this area.



Definition

A **restructuring** is a programme that is planned and controlled by management, and materially changes either:

- (a) The scope of a business undertaken by an entity; or (b)
- The manner in which that business is conducted.

IAS 37 Para 10

In the absence of a standard, a **mere management decision to restructure the business** would be taken as a **basis for inclusion / non-inclusion of a provision**.

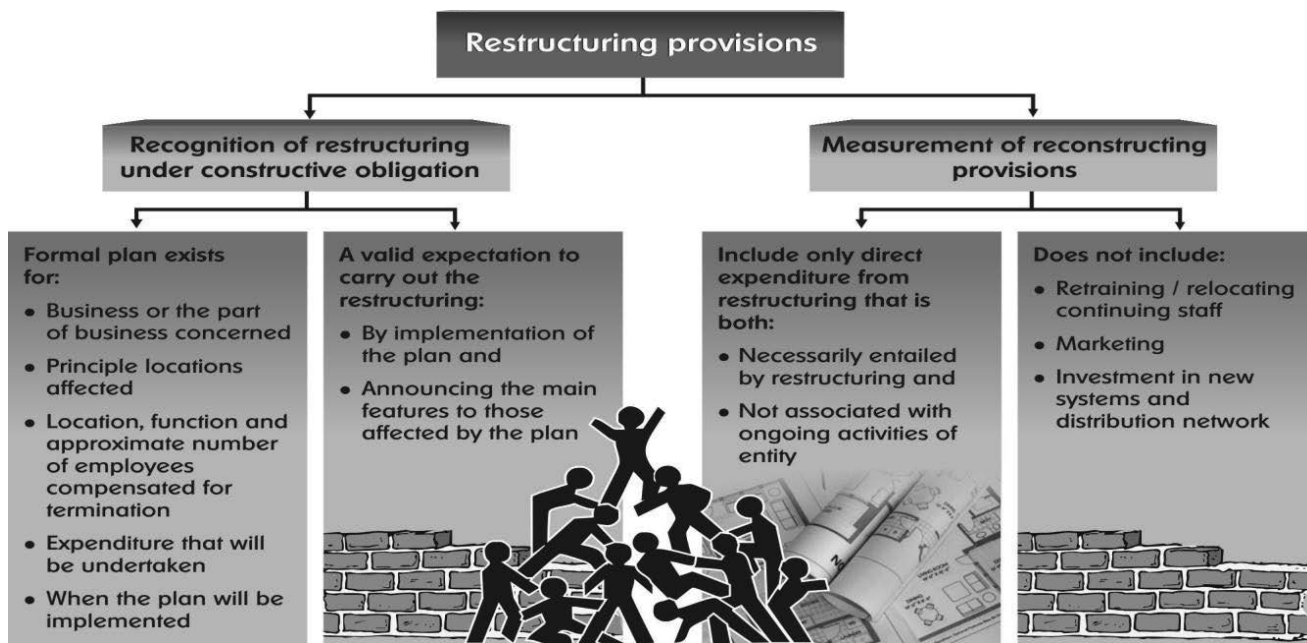
The following are examples of events that may fall under the definition of restructuring, as specified in the IAS:

- (a) sale or termination of a line of business
- (b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another
- (c) changes in management structure, for example, eliminating a layer of management
- (d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations

According to para 72 of IAS 37, an entity are required to recognise the constructive obligations for restructuring if the following conditions are satisfied:

- (a) a formal plan exists
- (b) a valid expectation that it will carry out the restructuring exists

Diagram 1: Restructuring provisions



Measurement of restructuring provisions

A restructuring provision **shall include** only the direct expenditure 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.

A restructuring provision **does not include** such costs as:

- retraining or relocating continuing staff;
- marketing; or
- investment in new systems and distribution networks.

This expenditure relates to the future conduct of the business and is not liabilities for restructuring at the end of the reporting period. Such expenditure are recognised on the same basis as if they arose independently of a restructuring.

Identifiable **future operating losses** up to the date of a restructuring are **not included** in a provision, unless they relate to an onerous contract.

Gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.



Test Yourself 7

Moneywell is a commercial bank having a large corporate client base. In order to expand its operations, it had started a money transfer facility 3 years ago. At the time of the half-yearly business review, the management noticed that the money transfer business is not delivering the expected profits.

The bank decided to reorganise the structure and prepared a formal plan for the restructuring which was approved by the board and communicated to the trade union representatives prior to the year end. The directors estimate the cost of the restructuring to be Tshs1,200 million. The restructuring has already commenced prior to the end of the year i.e. 31 March 20X9. However, a formal announcement to the general public for restructuring of the group was made after the year end on 5 April 20Y0.

Furthermore, the bank is also planning to spend Tshs200 million on retraining and Tshs300 million on new equipment.

Required:

Determine the amount of the restructuring provision.

4. Account for contingent liabilities and contingent assets.

[Learning Outcome d]

4.1 Contingent liability

1. Meaning

A **contingent liability** is derived when any of the following situations occur:

- (a) A **possible obligation** arises from **past events** and its **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**.



Example

Play Well Co has become a guarantor of a loan of Tshs50 million taken by its associate company Play Fine Co from the bank. The outstanding balance of the loan on the reporting date is Tshs25 million.

There is a **past event**: Play Well Co has given a guarantee.

However, the **possible obligation** will **arise** only if Play Fine Co **does not honour its commitment**. It is an **uncertain event not wholly within the control of Play Well Co**.

Hence, this is a **contingent liability**.

- (b) A **present obligation exists that arises from past events**, but it cannot be recognised because:

- (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or
- (ii) The amount of the obligation cannot be measured with sufficient reliability.

In other words, in the event of a present obligation arising from past event, the **amount of obligation can be measured with sufficient reliability**, it is a **provision**. However, when the amount **cannot be measured with sufficient reliability**, it is a **contingent liability**.



Test Yourself 8

During the screening of a new movie, the theatre building collapsed. The theatre owners believed that the material used for the construction was below the required standard, which resulted in poor construction quality. Therefore, they sued Star Construction Co, the company that had constructed the building.

Star's lawyers presented certain evidence contradicting this contention in the court and on that basis advised Star that the probability of losing the case is only 25%.

Required:

Determine whether this is a contingent liability for Star Construction.

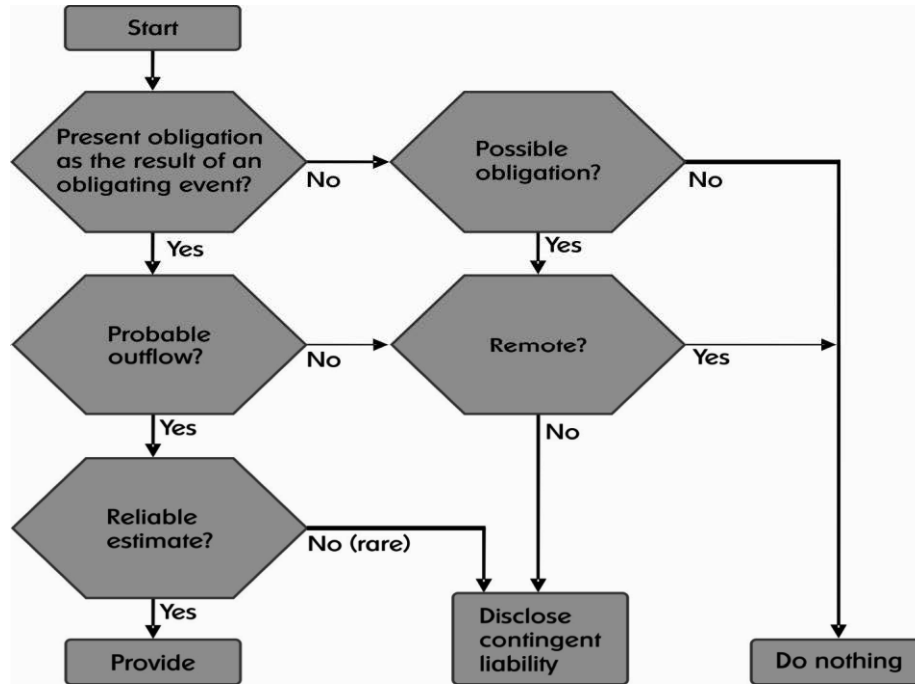
2. Accounting treatment

Contingent liabilities are **not provided for** in the accounts. This means that they are **not reflected** in the financial statements.

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In the case of a contingent liability, an entity should disclose a brief description of the nature of the contingent liability, along with an estimate of its financial effect, unless the possibility of a transfer of economic benefit is remote.

Diagram 2: Determination of contingent liability



4.2 Contingent asset

1. Meaning

A contingent asset is a **possible asset** 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.



Example

Amanda Co has filed a legal suit of Tshs3 million against Bermuda Ltd for Bermuda's non-performance of duties.

The entity received a favourable judgement and if Bermuda appeals against the judgement to a higher court, then Tshs3million will be disclosed in the financial statements as a contingent asset because

- There is a **past event** – Amanda received a favourable judgement.
- However, Amanda Co will be paid for this transaction only if an **uncertain future event occurs which is not wholly within the control of the entity** (the higher court needs to give a favourable judgement).

Hence, this is a **contingent asset**.

If Bermuda had not appealed to the high court, then Tshs3 million would be recognised in the financial statements as an accounts receivable.

2. Accounting treatment

Contingent assets are **not recognised** in the accounts as it may result in recognising income that may never actually be realised. This means that they are **not reflected** in the financial statements. However, if the entity is

virtually certain that income will be realised, then the related asset is no more a contingent asset. It is an actual asset **to be recognised in the financial statements**.

Where an **inflow of economic benefits is probable**, an entity shall disclose:

- (a) A brief description of the nature of the contingent assets on the end of the reporting period; and
- (b) If possible, an estimate of their financial effect on the financial statements of the entity.

5. Identify and account for:

- i. Onerous contracts
- ii. Environmental and similar provisions

[Learning Outcome e]

5.1 Onerous contracts

1. Identification

An **onerous contract** is a contract in which the **unavoidable costs of meeting the obligations** under the contract **exceed the economic benefit expected to be received** under the contract.

In simple terms, it means that the company will make a loss on the contract no matter what.

The liabilities derived from **onerous contracts** **have to be provided for** as onerous contracts **fulfil all the three conditions of the recognition criteria**.



Example

Alpha Ltd is a retailer of perfumes and is bound by the franchise agreement for a local brand that it has marketed for the past several years. Based on the market survey and a cost-benefit study, it decided to stop marketing the local brand and entered into a new agreement to market an international brand.

Although Alpha does not derive any economic benefit from the franchise agreement for the local brand, there is an obligation to pay a lump-sum amount to the franchiser under the franchise agreement for a period of two years.

Thus Alpha needs to make a provision for the charges under the franchise agreement. This is an onerous contract.



Definition

Executory contract is a contract under which either party (to the contract) has performed its obligations or both the parties (to the contract) have performed their obligations partially to an equal extent.

Multiple options: In the case of an onerous contract, there may be more than one option. All the options should be evaluated and a provision should be made for the lowest one. This is because the company is expected to exercise the option giving rise to minimum loss.



Example

Tweety Co, located in a ski resort, has entered into a contract to buy 200 meters of copper wire for the purpose of making souvenirs from Daffy Co every month for Tshs4,000 a meter. Each meter of wire makes a simple wall hanging which can be sold in the market for Tshs8,000 a piece. Labour and other costs incurred per wall hanging are Tshs2,000. As an alternative, the wire bought in its original form can be sold in the retail market for Tshs2,000 per meter. If Tweety decides to terminate the contract, it would have to pay a cancellation fee of Tshs250,000 for the next four months. Disturbances caused by some of the tourists have rendered the ski resort unpopular. The

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souvenirs are now being sold at Tshs5,000 a piece. As a result, Tweety Co is considering abandoning the production of the souvenirs.

Required:

Assess if a present obligation would arise and how much of provision Tweety Co has to make?

Answer

In this case, Tweety would have to pay a cancellation fee if it decides to terminate the contract. Hence, a **present obligation** would arise for which a provision would be required.

Tweety Co has following 3 alternatives:

Alternative 1: Honour the contract and sell the wire as it is

	Tshs'000
Revenue (Tshs2,000 x 4 months x 200 meters)	1,600
Cost (Tshs4,000 x 4 months x 200 meters)	(3,200)
Profit	(1,600)

Alternative 2: Cancel the contract

Unavoidable costs of penalty of Tshs250,000 x 4 months i.e. Tshs1,000,000 would be incurred.

Alternative 3: Continue with production

	Tshs'000
Revenue (Tshs5,000 x 4 months x 200 meters)	4,000
Cost of copper wire (Tshs4,000 x 4 months x 200 meters)	(3,200)
Labour and other expenses (Tshs2,000 x 4 months x 200 meters)	(1,600)
Profit	(800)

So unavoidable cost is lower of

Tshs1,600,000

(a) Tshs1,000,000

(b) Tshs800,000

Therefore Tweety Co has to make a provision for Tshs800,000.



Test Yourself 9

Arc Co entered in to a three-year lease contract at Tshs5 million per month for the use of the premises of an old building. As at 31 December 20X9, when two years of the lease contract remained, Arc Co was taken over by Noah Co. One of the conditions of the takeover was that all of Arc's offices and assets would be relocated to Noah's premises. As a result, Arc's old premises are now vacant. The lessor of the premises refused to terminate the lease contract and due to this reason, a sub-lessee was appointed for the rest of the lease term at Tshs2 million per month.

Required:

Would Noah recognise a provision in respect of the lease and if it would how would this information be presented in Noah's financial statements for the year ended 31 December 20X9 and 20Y0?

5.2 Environmental and similar provisions

(1) Identification

Liabilities from environmental and similar provisions fulfil all three recognition criteria, **as soon as an entity performs any operation affected by these laws**. Hence, they have to be provided for as soon as such operations begin.



Example

On 1 January 20X9, a mining company signs a contract with the government in which it is given the permission to carry out its excavating operations for five years. At the end of this period, the mine has to be filled up again and the entire land has to be landscaped. The present value of the cost of such landscaping is expected to be Tshs2 million.

The liability of Tshs2 million has to be provided for in the first year itself, when the mining company begins its excavation work.

It cannot be provided for gradually over the five years of the mining operations, or in the fifth year (that is, at the end of the excavation work), because a liability has to be recognised as soon as the entity performs any operation affected by these environmental laws.



Tip

In the above example, note that a provision will be recognised only when the company begins the excavation work, NOT when it signs the contract. (The present obligation on the basis of a past event occurs only when the actual work starts).

(2) Accounting treatment

The accounting treatment can be explained by reference to the above example.



Example

Continuing with the above example of the mining company

At the time of making the provision, on 1 January 20X9:

Dr	Mine Account	Tshs2m	
	(Reflected in the statement of financial position)		
	Cr	Provision for landscape work	Tshs2m

Being provision made for the cost of landscaping work

The Mine account will be amortised over a period of five years. As the benefits to be received from the mine will flow to the entity over a period of more than one financial year, it is reflected as an asset in the statement of financial position.

The journal entry made every year for amortisation of mine account is:

Dr	Mine Amortisation Expense	Tshs0.4 million	
	(Reflected in the statement of profit or loss)		
	Cr	Mine Account	Tshs0.4 million

Being amortisation for the year (Tshs2 million/5 years)

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Assuming the finance cost as 8%, the unwinding of discount will be done as follows:

Statement of unwinding of discount			
Year	Opening balance	Finance cost @10%	Closing balance
	Tshs	Tshs	Tshs
1	2,000,000	160,000	2,160,000
2	2,160,000	172,800	2,332,800
3	2,332,800	186,624	2,519,424
4	2,519,424	201,554	2,720,978
5	2,720,978	217,678	2,938,656

While recording the unwinding of discount:

Entry for year 1

Dr	Finance cost	Tshs0.16 million
	Cr Provision for landscape work	Tshs0.16 million

Being provisions made for landscape work

These entries will be repeated every year till the time the closing balance reaches Tshs2.938 million.

When the actual landscape work is done:

Dr	Provision for landscape work	Tshs2.938 million
	Cr Bank	Tshs2.938 million

Being amount paid for landscaping work (this will be including the compounded interest)



Test Yourself 10

Bright has to pay a certain amount to the local board for the damage it causes to the environment by its production activity. The payment will be due at the end of the next three years. The present value of the amount to be paid is Tshs300 million. It decides to provide for this amount at the end of the third year.

Required:

Comment on the appropriate accounting treatment.

Answers to Test Yourself

Answer to TY 1

Skylark has a present obligation, based on a past event as there is a probability that some buyers will return the fairness cream after seven days. Total provision from its sale. Should not exceed the total of the last **An outflow of resources embodying economic benefits will be required to** month's sales figure **settle the obligation as** in case a customer returns the cream after seven in any case. Days the customer will have to be reimbursed.

Furthermore, **Skylark can make a reliable estimate of the amount of the obligation by using its past records**, to determine the percentage of cream which has been returned.

Therefore it satisfies all the three recognition criteria of liability and so Skylark will have to make a provision for the guarantee given to buyers.

Answer to TY 2

(Amounts in Tshs'000)

The accounting entries to be passed are: **(Amounts in Tshs'000)**

	Tshs'000	Tshs'000
At the end of year 1:		
Dr Warranty claims	5,000	
Cr Provision for warranty claims		5,000
Being provision made for warranty claims		
(Balance in provision account, after this entry, is Tshs5,000)		

For settling warranty claims in year 2:

Dr Provision for warranty claims	4,400	
Cr Bank		4,400
Being warranty claims provided for earlier and now settled.		
(The balance in the provision account, after this entry, is Tshs600)		

At the end of year 2:

Dr Warranty claims	5,400	
Cr Provision for warranty claims		5,400
Being warranty claims provided for earlier and now settled		
(The balance in the provision account, after this entry, is Tshs6,000)		

Answer to TY 3

In the statement of financial position dated 31 December 20Y0

The date by which the smoke filters would be fitted is 30 June 20Y1. As a result, in the statement of financial position dated 31 December 20Y0, there is no obligating event arising from the fitting of smoke filters or fines arising from non-compliance. Hence no provision would be required.

In the statement of financial position dated 31 December 20Y1

Since the date for fitting the smoke filters has already passed, an obligation in respect of the cost of fitting smoke filters as well as in respect of the fines incurred for not complying with the new legislation has already arisen. As a result, a provision in respect of the expenses incurred as well as the fines estimated to be paid would need to be made. However, the capital equipment yet to be acquired will not be recorded.

Answer to TY 4

	Tshs
Calculation of the provision	300,000
For minor defects 15% x Tshs2 million	
For replacements 10% x Tshs5 million	500,000
Total amount of provision	800,000

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Answer to TY 5

In this case, the amount which will be provided for the liability will be:

	Tshs'000	Tshs'000
For minor defects	20% x 5,000	1,000
For major defects	20% x 15,000	3,000
Total amount of provision (reflected as provision in statement of financial position)		4,000

Receivable reimbursement from insurance company

	Tshs'000
(reflected as asset in statement of financial position) 50% x Tshs4,000 This assumes that the reimbursement is virtually certain	2,000

Expenses (reflected in statement of profit and loss)

	Tshs'000
Amount of provision	4,000
Less: Receivable reimbursement	(2,000)
Expenses	2,000

Answer to TY 6

	Legal obligations	Constructive obligations
Meaning	Arises because a company is required to perform such acts under any law or because it has signed a contract with others	Arises because of established past practice of the company or because of voluntary schemes / policies by the company
Discharge of obligations	1. Compulsory 2. Company can be compelled to discharge the obligation	1. Not compulsory 2. In certain situations, it may not be possible to compel the company to discharge the obligation
Non-performance of obligations	May lead to a lawsuit being filed; judgement would normally be unfavourable to the company	May lead to a lawsuit being filed; judgement would normally be favourable to the company
Other parties	Are sure the company will discharge the obligation	Are reasonably sure the company will discharge the obligation

Answer to TY 7

The general recognition criteria for a provision are set out in IAS 37 Provisions, Contingent Liabilities and Contingent Assets. An obligating event must have arisen in the case of restructuring provisions. Before a constructive obligation for restructuring exists, specific conditions have to be met.

These conditions are:

- (i) a detailed formal plan for the restructuring exists; and
- (ii) the entity has raised a valid expectation to the affected stakeholders that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Moneywell bank has approved the restructuring and communicated it to the employees via the trade unions and also commenced the restructuring effectively before the end of the financial year. Also, the bank started implementing the plan and made those affected by it aware of its main features before the year end and so that is a valid expectation and is provided for.

The restructuring provision will be Tshs1,200 million. The accounting entry as on 31 March 20X9 will be:

Dr	Restructuring costs (SOPL)	Tshs1,200 million	
	Cr Provisions (SOFP)		Tshs1,200 million
	Being reconstruction cost provided for		

The retraining cost and the cost of new equipment are specifically excluded from the restructuring costs. These costs will be expensed as and when incurred.

Answer to TY 8

The existence of obligation in this case depends upon the decision of Court. Thus it is an uncertain event not wholly within the control Star Construction Co. Furthermore, the outflow does not seem to be probable. Hence this is a contingent liability.

Answer to TY 9

An onerous contract would arise in this case because Arc would have to make payments on the lease in spite of whether or not it makes use of the premises. This would give rise to a legal obligation on the part of Noah to pay (24 months x Tshs5 million) i.e. Tshs120 million to the landlord. In this case, a provision would be required.

In addition to this, there would be a recoverable amount of (Tshs2 million x 24 months) i.e. Tshs48 million from the sub-lessee. Both of these amounts can be netted of against each other in the current year's statement of financial position as below:

Statement of profit or loss (extract)

	Tshs'000	
	20X9	20Y0
Provision for onerous contract (Tshs120,000 - Tshs48,000) (Tshs60,000 - ,Tshs24,000)	72,000	36,000

Answer to TY 10

Any liability derived from environmental provisions has to be provided for as soon as the act which will lead to these provisions being enforced begins.

In this case:

Bright will have to make a provision for environmental damage immediately – that is, as soon as it starts its production activity.

This is because, if the provision is made only at the end of the three-year period, then the financial statements of the preceding two years will be misleading.

The company's obligation to pay Tshs300 million to the local board for the damage it is causing to the environment is not being reflected anywhere.

Hence, Bright is not justified in making such a provision at the end of the third year.

Quick Quiz

1. Why is an accounting standard on provisions necessary?
2. When can a liability be provided for?
3. How are the provisions measured?
4. What is the main difference between constructive obligations and legal obligations?
5. What is the main characteristic of a contingent liability?
6. Can a provision be made for liabilities derived from onerous contracts?

Answers to Quick Quiz

1. Companies would otherwise be able to manipulate their financial results. In the absence of checks on the provisions made in the accounts, the **financial statements would be able to depict a misleading picture of the financial position** of an entity.
2. A liability can be provided for if it satisfies the following three conditions:
 - There exists a **present obligation, based on a past event**.
 - An **outflow of resources embodying economic benefits will be required to settle the obligation**. A **reliable estimate** can be made of the **amount of the obligation**.
3. The amount recognised as a provision shall be the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period.
4. The **main difference** is that **constructive** obligations are **voluntary** in nature and **legal** obligations are **compulsory** in nature.
5. The main characteristic of a contingent liability is that it is a **present or possible obligation that may, but probably won't, require an outflow of resources**.
6. Yes, because an onerous contract fulfils all the three conditions of the recognition criteria.

Self Examination Questions

Question 1

Excellent Courses is a computer training institute. It guarantees a full refund of fees to its students if they do not get a job within six months of completing their training.

Required:

Determine, with reasons, whether this liability has to be provided for.

Question 2

Footwear Co, an enterprise which sells shoes, gives a guarantee that it will refund 50% of the amount for major defects in shoes, and 25% of the amount for minor faults in the shoes, within six months of sale. The sales figure for the last six months is Tshs15 million. From past experience, Footwear Co estimates that 25% of the shoes sold will have minor defects and 15% will have major defects. It has made a deal with the manufacturers of the shoes, who have agreed to reimburse 20% of any such claims which Footwear Co might have to entertain.

Required:

Determine the amount which has to be provided for.

Question 3

Determine the nature of the following obligation:

Perfect Gems Co has announced a scheme by which a lucky buyer to be selected by a lottery will be given a gift voucher of Tshs5 million. On the end of the reporting period, this lucky draw has not yet taken place.

Question 4

What is the difference between the accounting treatment given to a liability and that given to a contingent liability?

Answers to Self Examination Questions

Answer to SEQ 1

In this case:

- There exists a past event – training given to students.
- There exists a present obligation – guarantee of full refund of fees if the students do not get a job within six months of completion of training.
- An outflow of resources embodying economic benefits will be required to settle the obligation – Excellent Courses will have to refund the fees it charges.
- A reliable estimate can be made of the amount of the obligation – to do this, Excellent Courses will rely on past records showing take-up by students.

This liability has to be provided for as it satisfies all the conditions required for making a provision.

Answer to SEQ 2

In this case, the amount which will be provided for the liability will be:

	Tshs'000	Tshs'000
Cost of shoes with minor defects	25% x 15,000	3,750.00
Cost of shoes with major defects	15% x 15,000	2,250.00
Probable amount of claims:		
For minor defects	25% x 3,750	937.50
For major defects	50% x 2,250	1,125.00
Total amount of provision		2,062.50
(reflected as liability in statement of financial position)		
Receivable reimbursement		
from the manufacturer of shoes 20% x Tshs2,062.50		412.50
(Reflected as asset in statement of financial position)		412.50
Expenses (reflected in statement of profit or loss)		
Amount of provision		2,062.50
Less: Receivable reimbursement		(412.50)
Expenses		1,650.00

Answer to SEQ 3

In this case:

- This scheme has been announced **voluntarily** by Perfect Gems Co.
- Perfect Gems Co is **not required to announce it under any law, nor has it signed any contract with its customers.**
- The buyers are **reasonably sure** that Perfect Gems Co will discharge its obligations.
- If Perfect Co does not have the lucky draw and does not choose a lucky winner, some disgruntled customer may **file a lawsuit**. However, there are chances that the judgement will be in favour of Perfect Gems Co.
- In certain situations, it may not be possible to **compel the company to perform the acts.**

Hence, the scheme announced by Perfect Gems is a **constructive obligation**.

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Answer to SEQ 4

The difference between the accounting treatment for a liability and a contingent liability is:

(i) A **provision** is made for a **liability** and the provision is accounted for by passing the following journal entry:

Dr	Expense		X	
	Cr	Liability / Provision for expense		X

The **expense is reflected in the statement of profit or loss** and the liability / **provision is reflected in the statement of financial position.**

The following information is also disclosed in the financial statements:

- the details of the change **in the carrying amount of the provision**, during the year;
- a brief description of the **nature of the obligation**, the **uncertainties** and **expected timing of any resulting outflows** and an **indication of the uncertainties about the amount of those outflows; and**
- the amount of any **expected reimbursement.**

(ii) On the other hand, a **contingent liability** is not provided for. This means that it is not accounted for and that it is not reflected in the statement of financial position.

If there is a **possible obligation** or a **present obligation** that **may**, but **probably won't, require an outflow of resources**, then the entity has to disclose a brief description of the nature of the contingent liability, along with;

- an estimate of its financial effect;
- an indication of uncertainties relating to the amount or timing of any outflow; and
- the possibility of any reimbursement.

If the possibility of outflow of resources is remote, then there is no need to disclose any information in the financial statements.

STUDY GUIDE B8: INVENTORIES

Get Through Intro

Inventory means the goods-in-hand at the end of an accounting period.

Inventory can be valued in a number of ways. Each method gives a different value for inventory. For example: Playful Cars has a closing inventory of 30 cars. The value of the cars under the last in first out (LIFO) method is Tshs3 million and under the average cost (AVCO) method is Tshs3.5 million.

Inventory is included in the cost of sales which means that it directly affects the profitability of the entity. In the above example the profitability of Playful Cars will increase by Tshs0.5 million (Tshs3.5 million - Tshs3.0 million) if it uses the average cost method, to value its closing inventory.

An accountant has to be familiar with all aspects of inventory accounting and valuation. He will be asked to help decide the method of inventory valuation which affects the reported profits of the company. This is a huge responsibility as the amounts tied up in inventory can also be very high!

Learning Outcomes

- a) Understand and apply the principles of inventory valuation in accordance with International Accounting Standard on inventory.

1. Understand and apply the principles of inventory valuation in accordance with International Accounting Standard on inventory.

[Learning Outcome a]



Case Study

The following figures are from the financial statements of Midas Group, a major player in the world consumer electronics industry, for the year ending 31 December 20X2:

Extracts from the statement of profit or loss and other comprehensive income

	Tshs million	% to sales
Net sales	6,635	
Cost of sales	3,439	
Gross profit	3,197	48.2%
Operating profit	707	10.7%

Extracts from the statement of financial position

	Tshs million
Inventories	1,230
Total current assets	4,367

Statement of financial position ratios

Current asset intensity of investments 75.9%
 Working capital turnover 2.6

Imagine inventories above to be understated by Tshs100 million. The operating profit amount and percentage would be Tshs607m and 9.2% only, and the statement of financial position ratios would change. These variations would mislead management, tax authorities, lenders, investors and other users of the financial statements.

In this Study Guide, you will learn the principles for determining the cost of inventories, their carrying amount recognition as expenses / losses, and related issues.

1.1 Measurement of inventories

Having seen the importance of inventories to the final accounts, the next questions that arise are (i) how to ensure that the amounts disclosed are true and fair?; and (ii) how to measure them, i.e. how to determine the values to be recognised in the financial statements?



Important

Inventories shall be measured at the lower of cost and net realisable value.

IAS 2 Para 9

There is a need to understand how to calculate cost and net realisable value.

Cost of inventories

This includes:

1. Costs of purchase;
2. Costs of conversions; and
3. Other costs incurred in bringing the inventories to their present location and condition.

The above costs are discussed in detail below:

1. **Costs of purchase** include the following:

(a) **purchase price**

(b) **import duties and other taxes**, excluding those subsequently recoverable from the taxation authorities

(c) transport, handling and other **costs directly attributable** to the acquisition of materials, finished goods and services

Trade discounts / rebates are **deducted** if not already deducted from the purchase price.



Example

Saliburtan Ltd purchased raw materials for Tshs125 million less a rebate of 2%. It paid Tshs25 million as import duty, including Tshs10 million towards countervailing duty. According to local tax laws, it will get a credit of the amount paid towards countervailing duty, while determining its excise duty liability. It spent ocean freight of Tshs3 million, clearing agent's charges of Tshs2 million, Tshs4 million on warehouse rent and Tshs1.5 million on the watchman's salary.

Cost of the materials will be determined as:

	Tshs	Tshs
Purchase price		125,000
Less: Rebate (2%)		(2,500)
		122,500
Add: Import duty		25,000
Less: Countervailing duty (to be refunded)		(10,000)
Net duty		137,500
Add: Ocean freight	3,000	
Add: Clearing agent's charges	2,000	5,000
Total		142,500

The rent and watchman's salary are not included as they are not incurred in acquiring the inventory.

2. Costs of conversion

Conversion refers to the change in condition of the material into a finished or saleable product. Conversion costs can be discussed under two broad headings:

(a) **Costs directly related to the units of production** e.g. a worker spent 6 hours on completing the article; the wages paid to the worker for the time can be directly related to the units of production.

(b) **Allocation of production overheads: fixed or variable**

(i) **Fixed production overheads**

- Allocation is based on normal capacity.
- Normal capacity is the expected average over a number of periods, after taking into account the loss of capacity due to normal maintenance.
- If there is a low production, overhead allocated to each unit is not increased.
- Unallocated overheads are recognised as an expense in the period in which they are incurred.



Example

Zanzy Co's normal capacity is 100,000 units per annum. Budgeted fixed production overheads are Tshs200,000 per annum. Raw material and wages per unit are Tshs15.

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Actual production is 98,000 units and actual fixed overheads are Tshs203,000.

The fixed overheads allocation rate will be $Tshs200,000/100,000 \text{ units} = Tshs2 \text{ per unit}$.

Total overheads allocated will be $98,000 \text{ units} \times Tshs2 = Tshs196,000$.

Unallocated overheads will be $Tshs203,000 - Tshs196,000 = Tshs7,000$. This amount will be recognised as expenses.

The inventory will be valued at $Tshs15 \text{ (raw material + wages)} + Tshs2 \text{ (overheads)} = Tshs17 \text{ per unit}$ i.e. in total $98,000 \times Tshs17 = Tshs1,666,000$.

(ii) Variable production overheads

Allocation of these overheads is based on the actual use of the production facilities.



Example

At Benjini's Restaurant, the fuel consumed for cooking is a variable overhead (indirect material). For every 100 meals, Benjini needs fuel of Tshs50,000. Thus, per meal overhead cost is Tshs500.

Benjini uses raw material of Tshs15,000 and pays wages of Tshs100 per unit.

The total variable cost (excluding absorption of fixed overheads) of the product is $Tshs15,000 \text{ raw material} + Tshs100 \text{ wages} + Tshs500 \text{ variable overheads} = Tshs15,600$.

3. Other costs

Other costs are included in the cost of inventories to the extent that they are incurred for bringing the inventories to their **present location and condition**.



Example

A product is manufactured according to the specifications given by the customer.

Material cost is Tshs300 million and wages are Tshs130 million. Professional fees of Tshs25 million are paid for having the product designed.

The fees of Tshs25 million, being 'other' costs, are to be added to cost of the product manufactured. The total costs are: $Tshs300 \text{ million} + Tshs130 \text{ million} + Tshs25 \text{ million} = Tshs455 \text{ million}$.

4. Costs excluded from the cost of inventory

Costs that do not satisfy the above conditions are not included, but are recognised as expenses in the period in which they are incurred. Some instances are:

1. **Abnormal costs** such as abnormal wastage of material, labour, and other costs e.g. loss of material by fire, idle time of workers due to machine breakdown.
2. **Storage costs** except those that are necessary in the production process before the further production stage.



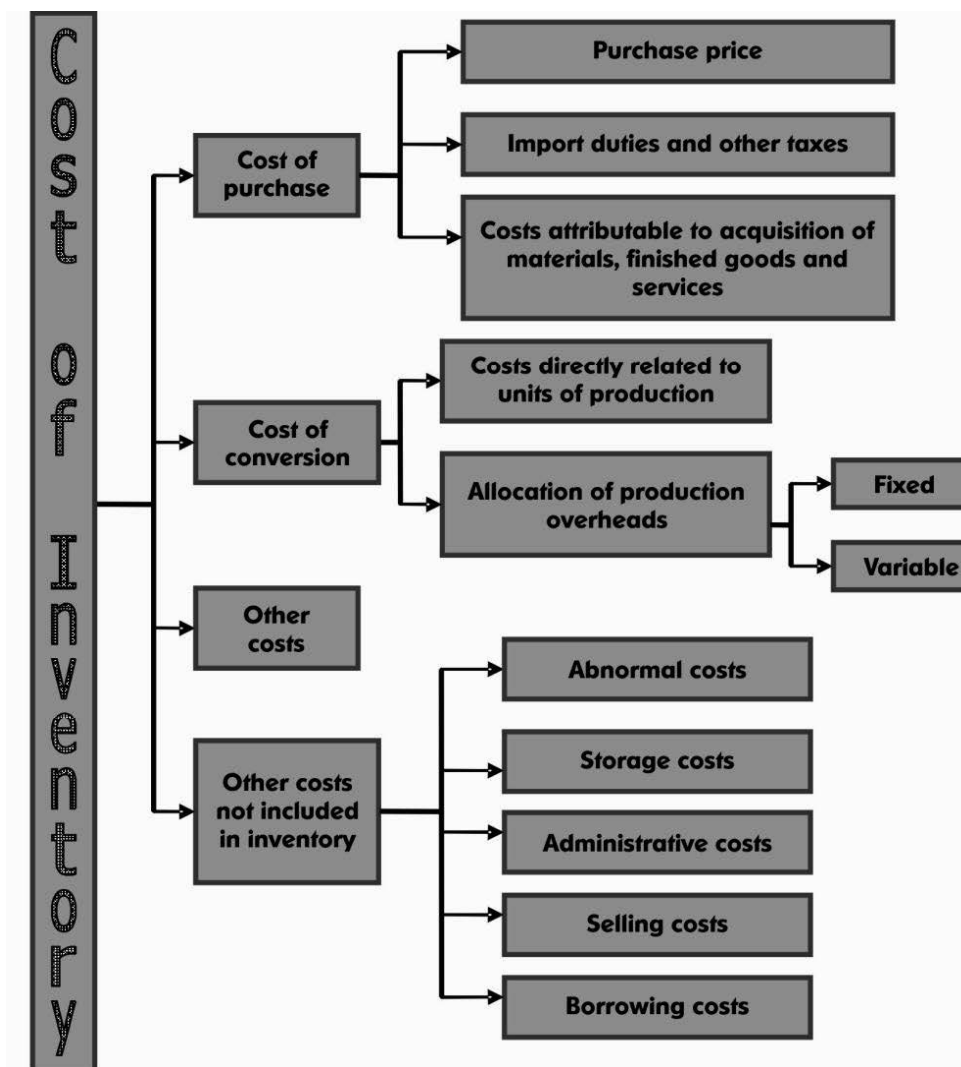
Example

Rent for a warehouse where goods are kept is not included in cost of inventory.

However, in brewery, if particular liquor is to be matured by storing it in a special container for a specific period of time, then the cost of that storage may be added to the cost of inventory.

3. **Administrative overheads**, except those that are incurred for bringing the inventories to their present location and condition. For example, salaries of office staff are not added to the cost of inventory, but salaries of the production accountant can be added, as he is needed for production to occur.
4. **Selling costs**, for example, commission paid to salesmen is not added to the cost of inventory.
5. **Borrowing costs**, except to the extent permitted by IAS 23 Borrowing Costs.

Diagram 1: Components of Cost of Inventory



1.2 Cost formula

A cost formula is required to determine the value of material issued and material remaining in inventory. The selection of the correct cost formula depends upon the nature of the items.

1. Specific identification method

This method is applied to items that are **not ordinarily interchangeable** and goods and services produced and segregated for **specific projects**. **Specific costs are attributed** to the items of inventory.



Example

For special made-to-order furniture, specific costs of material and labour used therein are identified and included in the cost.

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2. Other methods allowable under IAS 2

Either of the following two methods is to be used for items not covered under the specific identification method above. This means that the two methods are for ordinarily interchangeable goods and services.

- (a) **First In First Out (FIFO):** This method assumes that the item which came first into inventory (by way of purchase or production) went out first (as sales or consumption). This means that the items remaining in hand are those which were purchased the last.

This is an assumption for the purpose of determining the cost, and the actual movement of the goods may or may not be in that manner. However, generally, the storekeepers ensure that the oldest items are moved out first.

- (b) **Weighted Average:** Total cost of material (opening inventory plus subsequent purchases) is divided by the total quantity (opening inventory plus subsequent purchases). This is done either after every purchase or periodically.

Weighted average =	$\frac{\text{Total cost of material}}{\text{Total quantity of material}}$
--------------------	---

It is to be noted that the **Last In First Out method (LIFO) is not permitted by IAS 2.**



Example

The following details are available from Bakers Point Ltd:

Date	Details	Quantity	Rate (Tshs)
01/4/20X2	Opening inventory	500	20,000
04/4/20X2	Purchase	150	22,000
08/4/20X2	Issue	200	

Determine the value of the inventory as at 8 April 20X2 under the FIFO and Weighted Average methods.

Answer

1. FIFO method

Date		Quantity opening	Quantity purchased
01/04/20X2	Opening inventory	500	
04/04/20X2	Purchase		150
08/04/20X2	Issue	(200)	
08/04/20X2	Closing inventory	300	150

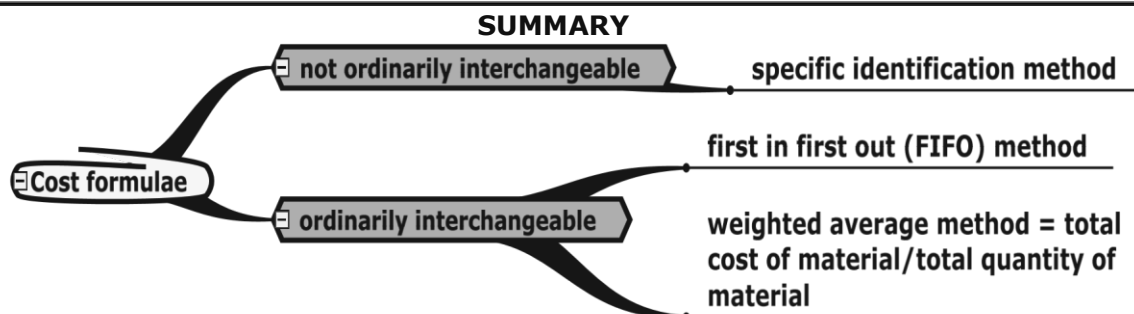
Date		Quantity opening	Quantity purchased
01/04/20X2	Opening inventory	500	
04/04/20X2	Purchase		150
08/04/20X2	Issue	(200)	
08/04/20X2	Closing inventory	300	150

Value of inventory will be Tshs9,300,000 (300 x Tshs20,000 + 150 x Tshs22,000)

2. Weighted Average method

Date		Qty	Tshs	Tshs
01/04/20X2	Opening inventory	500	20,000	10,000,000
04/04/20X2	Purchase	150	22,000	3,300,000
		650	20,460*	13,300,000
08/04/20X2	Issue	200	20,460	4,092,000
08/04/20X2	Closing inventory	450	20,460	9,208,000

$$* \frac{10,000,000 + 3,300,000}{500 + 150} = \text{Tshs}20,460(\text{roundedoff})$$



Test Yourself 1

Thomson Traders Plc gives the following details:

Date		Quantity	Rate (Tshs)
1 Jan 20X2	Opening inventory	100	5,000
3 Jan 20X2	Purchase	50	6,000
5 Jan 20X2	Issue	125	

Required:

Value inventory on 5 January 20X2 under the FIFO and weighted average methods.

1.3 Approximation techniques for the measurement of costs

As seen above, normally cost is to be determined for the measurement of inventories. However, the IAS provides for some alternatives where, instead of actual costs, some alternative amounts may be used. These are called approximation 'techniques' and are discussed below:

If **the results approximate cost, techniques** for measurement of cost **may be used** e.g. the standard cost method or retail method.

- Standard cost method:** standards based on the normal level are decided for the elements of cost such as materials, labour and overheads. The standard costs are used for the valuation of inventories and the issues of materials.
- Retail method:** retailers sometimes use this method if there are **large numbers of rapidly-changing items with similar margins for which it is impracticable to use other costing methods**. Sales value is taken as a starting-point, and the gross margin percentage is deducted from that, to arrive at the value of inventory.



Example

XLS Inc, a dealer in garments, has thousands of items in inventory. It applies the retail method. Its average gross margin is 20%. The sales price of a carton of 10 shirts is Tshs130,000.

Each carton will be valued at Tshs104,000 (Tshs130,000 – 20%); each shirt at Tshs10,400 (Tshs104,000 / 10).

1.4 Net realisable value



Definition

Net realisable value is the estimated selling price in the ordinary course of business, less estimated costs of completion and estimated costs necessary to make the sale.

IAS 2 Para 6

Costs are compared with the realisable value, since the inventories are to be measured at the lower of the two. This is based on the view that assets should not be carried at a value which is in excess of their realisable value.



Example

			All amounts in Tshs'000			
Group	Item	Quantity	Cost per unit	Sales price per unit	Costs to completion	Selling costs
P	1	500	2	5	2	1
Q	2	280	5	8	2	4
P	3	320	3	9	2	3
P	4	170	4	8	2	4
Q	5	460	2	7	2	2

(Amounts in Tshs'000)

Group	Item	Quantity	Cost per unit	Total cost	NRV* per unit	Total NRV	Lower individual	Lower subtotals	Note No.
P	1	500	2	1,000	2	1,000	1,000		3
P	3	320	3	960	4	1,280	960		3
P	4	170	4	680	2	340	340		3
Subtotal P				2,640		2,620		2,620	2
Q	2	280	5	1,400	2	560	560		3
Q	5	460	2	920	3	1,380	1,380		3
Subtotal Q				2,320		1,940		1,940	2
Grand total (P + Q)				4,960		4,560		4,560	1

*NRV = Sales price – Costs to complete – Selling costs

Notes: (Amounts in Tshs'000)

- At a time any **ONE** method of comparison is used. The above presentation gives all of them together only for the purpose of understanding.
- A global comparison should not be done, i.e. you cannot compare the grand totals and decide to take the lower of the two i.e. **Tshs4,560** as the value of inventory.
- Comparing subtotals of P and Q can be done assuming that the similar or related items are grouped together. Therefore, the value of inventory will be Tshs2,620 + Tshs1,940 = **Tshs4,560**.
- Comparing each item separately is the recommended method. Total by this method will be Tshs1,000 + Tshs960 + Tshs340 + Tshs560 + Tshs1,380 = **Tshs4,240**, ignoring the subtotal comparison.



Test Yourself 2

The cost of an electronic component is Tshs15,000 per unit. However, its net realisable value is Tshs13,000 only. Why might the realisable value of an item be lower than its cost?

The **comparison** between cost and net realisable value is to be done **item by item**. However, it may be appropriate to group similar or related items together.



Test Yourself 3

Group	Item	Quantity	Cost per unit	Sales price per unit	Costs to completion	Selling costs
			Tshs'000	Tshs'000	Tshs'000	Tshs'000
A	1	10	100	111	14	2
B	2	25	80	97	11	4
A	3	8	90	104	12	2
A	4	15	110	132	15	2
B	5	6	125	130	13	5

Required:

Value the inventory at the lower of cost and net realisable value.

Considerations in computing NRV

Net realisable values are determined after taking into consideration

- The most reliable estimates available.
- Fluctuations after the end of the reporting period, to the extent that they confirm the conditions existing on the end of the reporting period. (Remember IAS 10)
- The purpose for which the inventory is held.

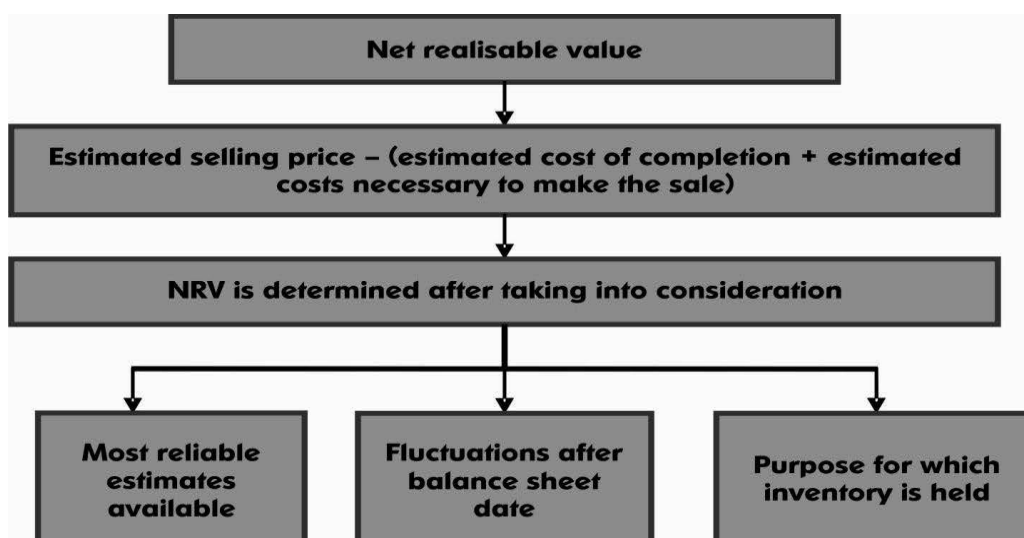


Example

Bolton Inc specifically manufactured an item for a firm sales order, with a cost of Tshs90 million to date. Order value is Tshs100 million. Costs to completion are expected to be Tshs14 million.

Net realisable value is Tshs100 million – Tshs14 million = Tshs86 million. Cost to date is Tshs90 million. A write-down is required of Tshs90 million – Tshs86 million = Tshs4 million.

Diagram 2: Net realisable value (NRV)



Raw materials and other supplies held for use in production need not be written below cost if the finished goods in which they are going to be used are likely to fetch a price higher than the total cost.

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A fresh assessment is made in each subsequent period. If the situation has changed, the amount of the **writedown may be reversed**. The new carrying amount will be the lower of the new net realisable value and the new cost.

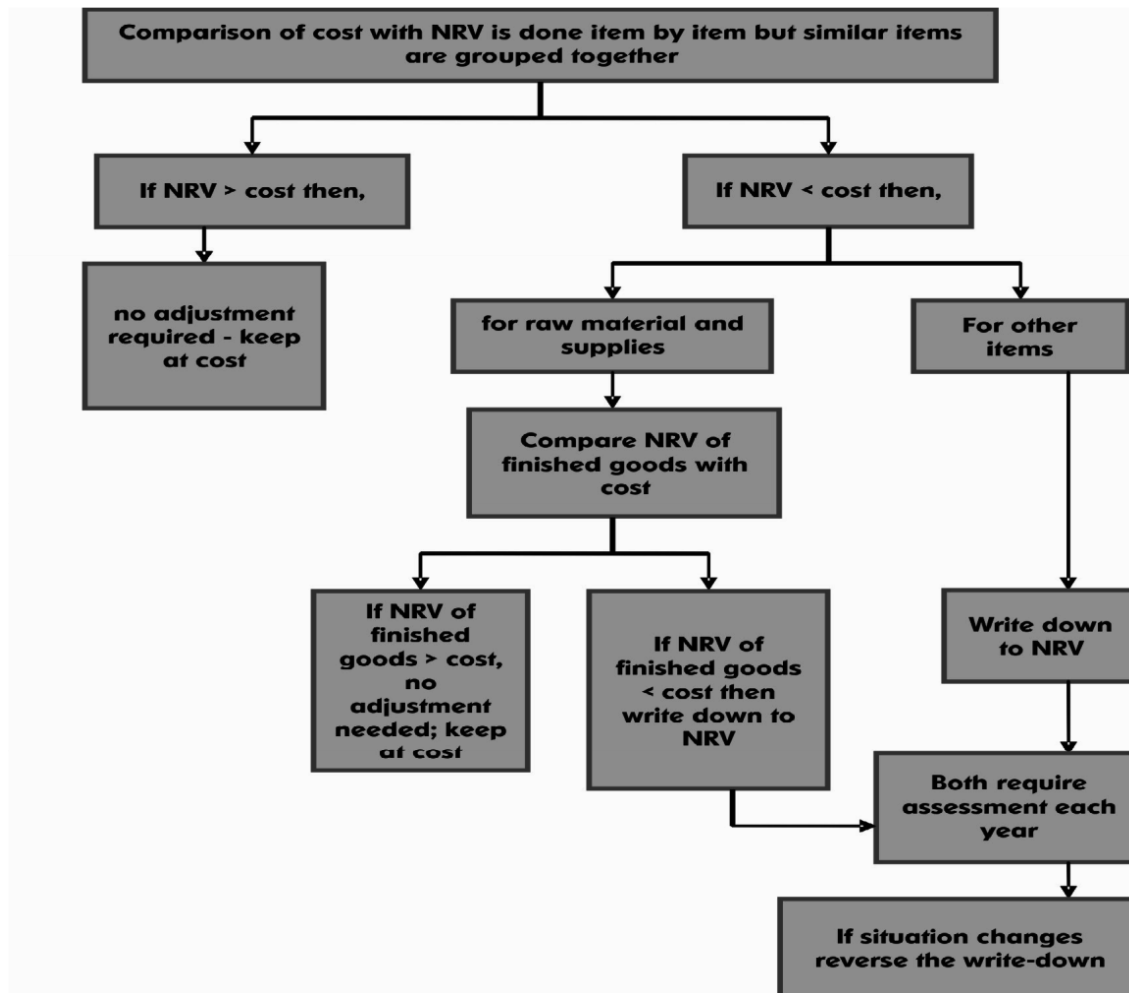


Example

Continuing with the Bolton's example above

In the next period, if the item is fully completed with a cost of Tshs101 million and is still in hand (against contract price of Tshs100 million), the expected loss and required write-down is Tshs1 million only. However, Tshs4 million has already been written down. The excess of Tshs3 million can be written back to the statement of profit and loss.

Diagram 3: Comparison of cost with NRV



1.5 Recognition as an expense

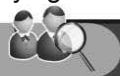
Inventory may be recognised as an expense when:

1. Inventory is sold, its carrying amount is recognised as an expense.
2. Write-downs to net realisable value are needed (as discussed above).
3. Losses of inventory e.g. loss by fire or theft

1.6 Disclosures

The IAS requires the financial statements to disclose the following:

1. the **accounting policies** adopted and **cost formula** used;
2. **the carrying amount of inventories:** the total amount and the amount in classifications appropriate to the entity;
3. the **carrying amount** of inventories carried at **fair value less costs** to sell;
4. the amount of **inventories recognised as an expense** during the period;
5. any **write-down of inventories** recognised as an expense in the period;
6. any **reversal of any write-down** recognised as a reduction in the amount of inventories recognised as an expense in the period;
7. the **circumstances or events** that led to the reversal of a write-down of inventories;
8. the carrying amount of inventories **pledged as security** for liabilities.



Example

Extracts from the financial statements pertaining to inventory

Extracts from the notes to accounts: accounting policies

Inventories are valued at lower of cost or net realisable value. Cost is determined under FIFO.

Extracts from the statement of financial position

	Tshs'000
Current assets	
Inventories according to schedule X	500,000
Schedule X – inventories	
Raw materials	200,000
Finished goods	250,000
Consumables	50,000
Total	500,000

Note- the above figure includes an amount of Tshs75 million towards inventories carried at fair values less costs to sell.

Extracts from statement of profit or loss

	Tshs'000
Cost of materials and consumables used	3,000,000
Write-downs of inventories	55,000
Less: Reversal of write-down of inventories	(25,000)
	3,030,000



Test Yourself 4

The details of transactions on account of material Z are given below:

Date		Quantity	Rate Tshs'000
01/01/20X1	Opening Inventory	Nil	
01/01/20X1	Purchases	200	45
15/01/20X1	Issued for consumption	100	
01/02/20X1	Purchases	400	60
01/05/20X1	Issued for consumption	200	
20/02/20X1	Issued for consumption	200	
01/03/20X1	Purchases	300	75
15/03/20X1	Issued for consumption	200	

Calculate the value of inventory at 31 March 20X1 by using:

- FIFO
- The Weighted Average method

Answers to Test Yourself

Answer to TY 1

1. FIFO method

Date		Quantity Opening	Quantity Purchased
01/01/20X2	Opening inventory	100	
03/01/20X2	Purchase		50
05/01/20X2	Issue	(100)	(25)
05/01/20X2	Closing inventory	Nil	25

Value 25 x Tshs6,000 = Tshs150,000

2. Weighted Average method

		Qty	Tshs	Tshs
01/01/20X2	Opening inventory	100	5,000	500,000
03/01/20X2	Purchase	50	6,000	300,000
03/01/20X2	Closing inventory	150	*5,333	800,000
05/01/20X2	Issue	125	5,333	(667,000)
05/01/20X2	Closing inventory	25	5,333	133,000

$$* \frac{500,000 + 300,000}{100 + 50} = \text{Tshs}5,333$$

Answer to TY 2

The net realisable value may be lower than the cost due to any of the following reasons:

- damage
- obsolescence
- decline in the selling price
- increase in costs of completion or costs of sale

Answer to TY 3

Group	Item	Quantity	Cost per unit	Total cost	NRV* per unit	Total NRV	Lower individual	Lower totals	Note No.
			Tshs000	Tshs000	Tshs000	Tshs000	Tshs000	Tshs000	
A	1	10	100	1,000	95	950	950		3
A	3	8	90	720	90	720	720		3
A	4	15	110	1,650	115	1,725	1,650		3
Subtotal A				3,370		3,395		3,370	2
B	2	25	80	2,000	82	2,050	2,000		3
B	5	6	125	750	112	672	672		3
Subtotal B				2,750		2,722		2,722	2
Grand total (A + B)				6,120		6,117		6,092	1

*NRV = sales price – costs to complete – selling costs

Notes (Amounts in Tshs'000)

1. A global comparison is not to be done, i.e. you cannot compare the grand totals and decide to take the lower of the two i.e. Tshs6,117 as the value of inventory.
2. Comparing subtotals of A and B can be done assuming that the similar or related items are grouped together. Thus, the value of inventory will be Tshs3,370 + Tshs2,722 = Tshs6,092.
3. Comparing each item separately is the recommended method. Total by this method will be Tshs950 + Tshs720 + Tshs1,650 + Tshs2,000 + Tshs672 = Tshs5,992, ignoring the subtotal comparison.

Answer to TY 4

FIFO

Date	Receipts			Issues			Balance		
	Qty	Rate	Value	Qty	Rate	Value	Qty	Rate	Value
		Tshs'000	Tshs'000		Tshs'000	Tshs'000		Tshs'000	Tshs'000
01/01/20X1							Nil		Nil
01/01/20X1	200	45	9,000						
15/01/20X1				100	45	4,500	100	45	4,500
01/02/20X1	400	60	24,000				100	45	4,500
							400	60	24,000
15/02/20X1				100	45	4,500			
				100	60	6,000	300	60	18,000
20/02/20X1				200	60	12,000	100	60	6,000
01/03/20X1	300	75	22,500				100	60	6,000
							300	75	22,500
15/03/20X1				100	60	6,000			
				100	75	7,500	200	75	15,000

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Value of inventory using Weighted Average method

Date	Receipts			Issues			Balance		
	Qty	Rate	Value	Qty	Rate	Value	Qty	Rate	Value
		Tshs'000	Tshs'000		Tshs'000	Tshs'000		Tshs'000	Tshs'000
01/01/20X1			-				Nil		Nil
01/01/20X1	200	45	9,000				200	45	9,000
15/01/20X1			-	100	45	4,500	100	45	4,500
01/02/20X1	400	60	24,000				500	57*	28,500
15/02/20X1			-	200	57	11,400	300	57	17,100
20/02/20X1			-	200	57	11,400	100	57	5,700
01/03/20X1	300	75	22,500				400	70.5**	28,200
15/03/20X1			-	200	70.5	14,100	200	70.5	14,100

$$* \frac{4,500,000 + 24,000,000}{100 + 400} = \text{Tshs}57,000$$

$$** \frac{5,700,000 + 22,500,000}{100 + 300} = \text{Tshs}70,500$$

Quick Quiz

1. An entity paid Tshs100 million as a purchase price and Tshs2.5 million as freight for the material. It incurred Tshs3 million as a salary to the warehouse keeper. What is the cost of inventory?
2. "Under the FIFO method, the cost of material in hand will tend to be based on the latest prices." True or false?
3. A company manufactured special equipment as per the specifications given by the customer. There is no other equipment similar to this. Out of FIFO and Weighted Average, which cost formula will be used to determine the cost of this inventory item?
4. A retailer has a large number of rapidly changing and similar items with similar margins. Its auditor is insisting that it must follow either the specific identification or the FIFO / Weighted Average formulae. The retailer approaches you to help, explaining that it is impracticable to use these methods. Advice.
5. An item of raw material inventory costing Tshs10 million has NRV of Tshs9.5 million. The finished goods in which the item is to be used is expected to have a cost of Tshs25 million and NRV of Tshs27 million. What should be the write-down of the raw material item?

Answers to Quick Quiz

1. The cost of inventory is Tshs102.5 million. Salary of the warehouse keeper is a storage cost not to be added.
2. True.
3. Since it is an item not ordinarily interchangeable, the specific identification method should be used. (FIFO and Weighted Average are not relevant).

4. The retailer can use the retail method. Under this, sales value is taken as the starting-point, and the gross margin percentage is deducted from that, to arrive at the value of inventory.
5. Since the finished goods in which the raw material is to be used has NRV higher than cost, no write-down is required.

Self Examination Questions

Question 1

From the following details provided, find out the cost of inventory of job no. 101, compare it with the NRV, and advise on the accounting treatment.

		Tshs'000
a)	Cost of raw material (gross)	55,000
b)	Discounts	1,200
c)	Duties and taxes on the above material	8,800
d)	Duties (included above) deductible from the duty payable on sales	3,000
e)	Transport	1,500
f)	Raw material purchased for the job, but lost by fire (not included in (i) above)	4,500
g)	Wages of the workmen (250 hours)	5,100
h)	Wages for the hours lost by fire	600
i)	Salesman's commission	650
j)	Production overheads (fixed, per month)	80,000
k)	Normal man hours per month	20,000 hrs
l)	Production overheads (variable, for the job)	4,000
m)	Net realisable value	70,000

Question 2

Tea & Cup Traders have incurred the following transactions:

- 1 January 20X2 purchased raw material 500 units for Tshs5,000,000
- 2 January 20X2 purchased raw material 200 units for Tshs2,400,000
- 3 January 20X2 issued 600 units for production
- 15 October 20X2 purchased raw material 300 units for Tshs4,500,000
- 30 October 20X2 purchased raw material 200 units for Tshs2,500,000 1 November 20X2 issued raw material 250 units

Required:

Calculate the quantity and value of inventory on 31 December 20X2 using the FIFO method.

Answers to Self-Examination Questions

Answer to SEQ 1

Cost of inventory (job no. 101)	Tshs'000	Tshs'000
Purchases	55,000	
Less: Discounts	(1,200)	
Add: Duties excluding refundable part (8,800 – 3,000)	5,800	
Add: Transport	1,500	61,100
Add: Wages		5,100
Add: Production overheads:		
- Variable	4,000	
- Fixed (80,000/20,000 x 250)*	1,000	5,000
Total cost		71,200
Net realisable value (NRV)		70,000
Abnormal loss of material (due to fire)		4,500
Abnormal loss of wages (due to fire)		600
Salesman's commission		650
This will be expensed out and not added to cost of inventory		5,750

* Fixed overheads = $\frac{\text{Production overheads}}{\text{Normal man hours per}} \times \text{hours worked for the job}$

Answer to SEQ 2

(Amounts in Tshs'000)

Tea & Cup Traders										
Raw material ledger card (FIFO method)										
Date		Receipts			Issues			Balance		
		Qty	Rate	Tshs	Qty	Rate	Tshs	Qty	Rate	Tshs
01/01/20X2	Purchases	500	10	5,000	-		-	500	10	5,000
										5,000
02/01/20X2	Purchases	200	12	2,400	-		-	500	10	5,000
								200	12	2,400
										7,400
03/01/20X2	Used in production	-			500	10	5,000	100	12	1,200
					100	12	1,200			1,200
							(note1)			
15/10/20X2	Purchases	300	15	4,500	-		-	100	12	1,200
								300	15	4,500
										5,700
30/10/20X2	Purchases	200	12.5	2,500	-		-	100	12	1,200
								300	15	4,500
								200	12.5	2,500
										8,200
01/11/20X2	Used in production	-			100	12	1,200	150	15	2,250
					150	15	2,250	200	12.5	2,500
				14,400			9,650	350		4,750

The inventory on 31 December 20X2 consists of 350 units with the valuation of 2250 for 150 units and 2,500 for 200 units.

Notes

1. Under the FIFO method it is assumed that the units which are purchased first are consumed first.
2. Issues mean material taken out of the stores. Issues can either be for production or sale out of the entity.

Valuation as per the FIFO method is **Tshs4,750,000**.

Note

This value is compared with the net realisable value of these units. Closing inventory will be valued at the lower of these two amounts.

STUDY GUIDE B9: TAXATION IN FINANCIAL STATEMENTS

Get Through Intro

Benjamin Franklin once said “in this world, nothing is certain but death and taxes“! Tax is indeed very certain for most profitable businesses. It is important that you understand how to calculate tax for financial statements, as an incorrect figure could change the meaning of financial statements. Tax reported in financial statements typically comprises not only the amount due for the year being reported (‘current tax’) but also deferred tax.

Deferred tax is actually a very simple concept. For example you record interest income that is due in the current year financial statements. However, you do not actually receive the interest until the following year. You will therefore actually pay tax on the interest in the following year. While recognising the interest income in the current year, you should also recognise the tax that will have to be paid on that income. Deferred tax is a way of ensuring that tax is accounted for on items recognised in the financial statements. It is not a tax that you actually pay it is simply in the financial statements for matching purposes.

This Study Guide will ensure you do not forget about the tax implications of recognising assets and liabilities in the financial statements!

Learning Outcomes

- a) Define the terms such as tax expense, current tax, losses carried back and losses carried forward in accordance with international accounting standards.
- b) Account for deferred tax in accordance with international accounting standards.
- c) Measure and record deferred tax liabilities and assets in the financial statements.

1. Define the terms such as tax expense, current tax, losses carried back and losses carried forward in accordance with international accounting standards.

[Learning Outcome a]

1.1 Definitions

1. Tax expense



Definition

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

IAS 12 Para 5

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

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



2. Current tax



Definition

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

IAS 12, Para 5

The definition above shows that current tax:

- is actually **payable or receivable** (as opposed to **deferred taxation**, a matching accounting tool to reduce distortions, discussed in more detail later in this Study Guide).
- is calculated on the taxable profit or tax loss for a period. Although it relates to the **current period**, any adjustments required to **prior period tax** also form part of current tax.

1.2 Recognition

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



Example

An entity determines total tax payable at Tshs50 million. Tshs40 million of the tax relates to business income and Tshs10 million relates to a receipt, which is credited directly to equity.

The tax expense of Tshs40 million will be reflected in the statement of profit or loss. The balance of Tshs10 million will be recorded directly under equity (i.e. through other comprehensive income part of statement of profit or loss and OCI) and not in the statement of profit or loss.

1.3 Liabilities or assets

If the tax expense and the provision at the end of the year are greater than the payment, the **shortfall in the payment will be disclosed as a current tax liability**.

If the tax expense and the provision at the end of the year are lower than the payment, the **excess payment will be disclosed as a current tax asset**.

1.4 Measurement

Current tax liabilities or assets are measured:

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



Example

A company's taxable income for the year 20X9 is Tshs800 million. The tax rate applicable to the company is 30%. For 20X8, the company had provided Tshs200 million for income tax. The actual liability for 20X8 was decided at Tshs215 million and paid in 20X9.

	Tshs'000
Tax due for 20X9 (Tshs800,000 x 30%)	240,000
Short provision for 20X8 (Tshs215,000 – Tshs200,000)	15,000
Current tax expense and liability	255,000

In the statement of financial position, Tshs240,000 will be shown as a current tax liability.



Test Yourself 1

Heltron Co has a taxable income of Tshs500 million for 20X7. The tax rate enacted, as applicable to the company, is 30%. For 20X6, the company had provided Tshs100 million for income tax. The actual liability for 20X6 was decided at Tshs108 million and paid.

Required:

Advise the company on the required presentation in the financial statements.

Would your answer be different if the actual liability for 20X6 was Tshs95 million?

1.5 Accounting entries

1. When advance tax is paid

Dr Advance tax (SOFP)	X	
Cr Bank / cash		X
Being advance tax paid		

2. When expense is recognised

Dr Current tax expense (IS)	X	
Cr Current tax liability (SOFP)		X
Being tax expenses recognised		

When the current tax asset and liability are adjusted against each other

Dr	Current tax liability	X	
	Cr Advance tax		X
	Cr Bank / cash		

Being the current tax asset and current tax liability adjusted against each other

If tax liability is more than the advance tax



Test Yourself 2

Show the entries related to the following transactions

Tshs'000

Advance tax paid	30,000
Current tax payable	37,500

1.6 Tax losses carried back and carried forward

In some jurisdictions, tax losses can be **carried back** to earlier periods to recover the current tax of those periods. However, some jurisdictions only allow the losses to be **carried forward**.

1. Tax losses carried back

The losses that are allowed to be carried backward can be recognised as an asset, since they satisfy the criteria of the framework, i.e. the benefits can be reliably measured, and it is probable that they will flow to the entity.



Example

Black & Co had provided for and paid a tax liability of Tshs100 million for 20X6. The actual liability as assessed by the authorities is Tshs125 million, i.e. an additional amount of Tshs25 million is payable.

During 20X7, the company incurred a tax loss of Tshs70 million. The local tax laws permit carrying back of tax loss. The tax rate is 30%.

The tax impact of the loss for 20X7 is Tshs70 million x 30% = Tshs21 million.

This can be recovered against the additional amount payable for 20X6. Therefore, it can be recognised as an asset. The company will have to pay a net amount of Tshs4 million (Tshs25 million – Tshs21 million).

The journal entries for the example of Black & Co given above would be as follows: (Amounts in Tshs'000)

(a) When the additional tax becomes payable (Tshs125,000 - Tshs100,000)

Dr	Current tax expense	Tshs25,000	
	Cr	Current tax liability	Tshs25,000

Being the entry to record the additional tax liability for 20X6

(b) When the tax benefit is recognised

Dr	Tax receivable (SOFP)	Tshs21,000	
	Cr	Tax repayment (income)	
		(SOPL – part of tax expense)	Tshs21,000

Being the current tax receivable in respect of the loss for the year 20X7

(c) When the tax receivable is adjusted against the tax liability

Dr	Current tax liability (SOFP)	Tshs21,000	
	Cr	Tax receivable (SOFP)	Tshs21,000

Being the Adjustment of current tax receivable for 20X7 (Tshs21,000) against the tax payable for 20X6 (Tshs25,000), leaving a net payable of Tshs4,000

(d) When the net amount is paid

Dr	Current tax liability	Tshs4,000	
	Cr	Cash / bank	Tshs4,000

Being the entry to record payment of current tax

The balance, if any, in the tax receivable account will be disclosed in the statement of financial position as an asset and the tax repayment as income, in the statement of profit or loss.



Example

Continuing with previous example of Black & Co

Assume the tax losses of Tshs90 million, therefore the tax receivables will be Tshs27 million. This will be adjusted as follows: (Amounts in Tshs'000)

Dr	Current tax liabilities	Tshs25,000
	Cr Tax receivable	Tshs25,000

The remaining Tshs2 million will be shown as a current asset.

2. Tax losses carried forward

This case falls under deferred tax asset which is discussed later in this Study Guide.

Diagram 1: Tax losses



2. Account for deferred tax in accordance with international accounting standards.

[Learning Outcome b]

2.1 Principles of accounting for deferred tax

IAS 12 deals with taxes on income (current as well as deferred tax). Current tax is tax related to the current year whereas deferred tax is a matching accounting tool, used for taxes related to other than current year.

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



Example

Polo Ltd has a building with carrying value of Tshs200 million. The current tax rate is 20%. The entity decides to revalue the building to a fair value of Tshs500 million. Now, by doing so, the entity is recognising that in the future it is likely to be able to sell the asset for Tshs500 million. It is also likely to have to pay tax on this sale. If Polo knows that it will have to pay this additional tax later on, then it should account for it in some manner. Therefore deferred tax on Tshs300 million (Tshs500 million - Tshs200 million) should be recognised in the current year.

Some items are recognised in the statement of financial position at a time different from the time when they are considered for taxation, giving rise to temporary difference. Such as, in some countries, statutory payments payable are allowed for tax purpose only in the year when they are paid.



Example

Gile Ltd recognised a sales tax of Tshs20 million payable in 20X7 but it was paid in 20X8. For accounting purposes, it will be deducted from the profits of 20X7; however, for taxation purposes it is deductible in 20X8. Therefore this will give rise to a temporary difference (i.e. reversible in future) of Tshs20 million.

2.2 Temporary difference



Definition

- **Temporary differences** are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.
- The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.
- **Taxable profit (tax loss)** is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).
- **Accounting profit** is profit or loss for a period before deducting tax expense.

IAS 12, Para 5

The carrying amount is the amount appearing in the statement of financial position. The concept of tax base is discussed below.

The carrying amount of assets and liabilities in the financial statements may be different from the related 'tax bases' for a temporary period. In the future, depending upon the tax laws, such differences would be eliminated. These differences are called temporary differences.



Example

The cost of an asset is Tshs100 million. For the first year, the accounting depreciation is Tshs16 million whereas the depreciation according to tax laws is Tshs25 million. The carrying value of the asset is Tshs84 million (Tshs100 million - Tshs16 million) and tax base is Tshs75 million (Tshs100 million - Tshs25 million).

Assuming that the asset will be written down to zero both for accounts and tax purposes, this difference will be reversed in the future, (0 – 0) i.e. it is temporary. Therefore temporary difference is Tshs9 million (Tshs25 million - Tshs16 million) i.e. difference between carrying amount and tax base of the asset.



Example

Peanut Co incurred development costs during the year and recognised them as an intangible asset. They are to be amortised in the accounts over 10 years. However, for tax purposes, they are deducted fully when incurred. Since the timing of recognition is different, it gives rise to temporary difference.

Permanent differences (Zero temporary difference)

Many local GAAPs use the term permanent difference when the difference in the carrying amount and tax base does not get eliminated in the future. However the term is not used in IAS 12.



Example

Big Co has paid a penalty of Tshs8 million which is treated as an expense for accounting profits. However, according to the local laws, a penalty is not a deductible expense when calculating tax profit and therefore there is a difference between the accounting and tax profits which will not be reversed in the future. This is a permanent difference.

Temporary difference is for a temporary period and gets reversed in the future.



Tip

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

2.3 How to calculate tax base

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

1. For assets

When economic benefits are taxable

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

The carrying amount of an asset can be recovered by using the asset or selling it.



Example

For an asset costing Tshs120 million, if Tshs45 million is already deducted for tax purpose, in future, the entity can either:

- (i) deduct tax depreciation from taxable profits to the extent of Tshs75 million (Tshs120 million - Tshs45 million) if it uses the asset or
 - (ii) deduct the cost of Tshs75 million from sale proceeds if it sells the asset
- In either case, it is said that the **entity recovers the carrying amount**.
Since Tshs75 million is deductible for future tax purposes, tax base is Tshs75 million.

In this case, the economic benefits are taxable as revenue generated by using the asset or sales proceeds earned by selling the asset are taxable.



Test Yourself 3

In the books of Wise Co, an amount of Tshs25 million is recorded as rent paid in advance. However for income tax purpose the amount is deductible on accrual basis.

Required:

Determine the tax base

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



Example

Nice Co has recorded interest receivable Tshs15 million. According to the local laws, the amount is taxable on receipt basis. In this case, amount **not taxable in future is nil as Tshs15 million is taxable in future**. Therefore, the tax base is NIL.

In this case, the economic benefits are taxable as the interest amount is taxable.

When economic benefits are not taxable

(c) If the economic benefits are **not taxable in future**, the tax base of the asset is equal to its carrying amount.

 **Example**

Wise Co has also recorded dividends of Tshs10 million receivable from a subsidiary. The dividend is exempt from tax. In this case, the entire carrying amount will be treated as the tax base, as it will never be taxable.

In this case, the economic benefit is not taxable as dividend amount is not taxable.

Since the amount is never deductible, it gives rise to zero temporary difference. Therefore carrying amount = tax base.

2. For liabilities

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

 **Example**

A current liability with a carrying value of Tshs50 million that is **allowable fully** under tax laws as a deduction on a payment basis. The tax base in this case will be nil (the carrying amount Tshs50 million amount deductible in future Tshs50 million).

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

 **Example**

Rent received in advance of Tshs5 million has already been taxed on a receipts basis under local tax law (i.e. tax has already been paid). Therefore, the full amount will not be taxed again in future. Therefore the tax base is nil (the carrying amount Tshs5 million the amount not taxable Tshs5 million).

3. Items not recognised as an asset or liability

Some items are not recognised as assets or liabilities, but may still have a tax base.

 **Example**

Delta Co has incurred research costs of Tshs50 million during the year. This amount is charged to the statement of profit or loss for accounting purpose. For tax purpose the deduction is permitted only after satisfying certain conditions and only to the extent of Tshs30 million.

In this case, no asset or liability will be recognised therefore carrying amount will be nil and the amount deductible in future i.e. Tshs30 million will be the tax base.

Types of temporary differences

Temporary differences may be of two types:

 **Definition**

Taxable temporary differences 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 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.

IAS 12 Para 5

2.4 Taxable temporary differences (TTD)

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

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

1. Assets

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



Example

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

The carrying amount of an asset is Tshs84 million. **In future**, the entity will **earn taxable income and recover this carrying amount**. When it does so, for tax purposes it can deduct only Tshs75 million (Tshs100 million – Tshs25 million), the tax base, on which depreciation is yet to be allowed. On the difference of Tshs9 million, it will have to pay tax, i.e. it is a taxable difference.

2. Liabilities

If a particular liability has already been allowed as a deduction for tax purposes but has not been deducted in the accounts, a taxable temporary difference occurs.

This situation is seen less frequently in real life.



Example

Continuing the example of Peanut Co

For tax purposes, the development costs are deducted fully when incurred.

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

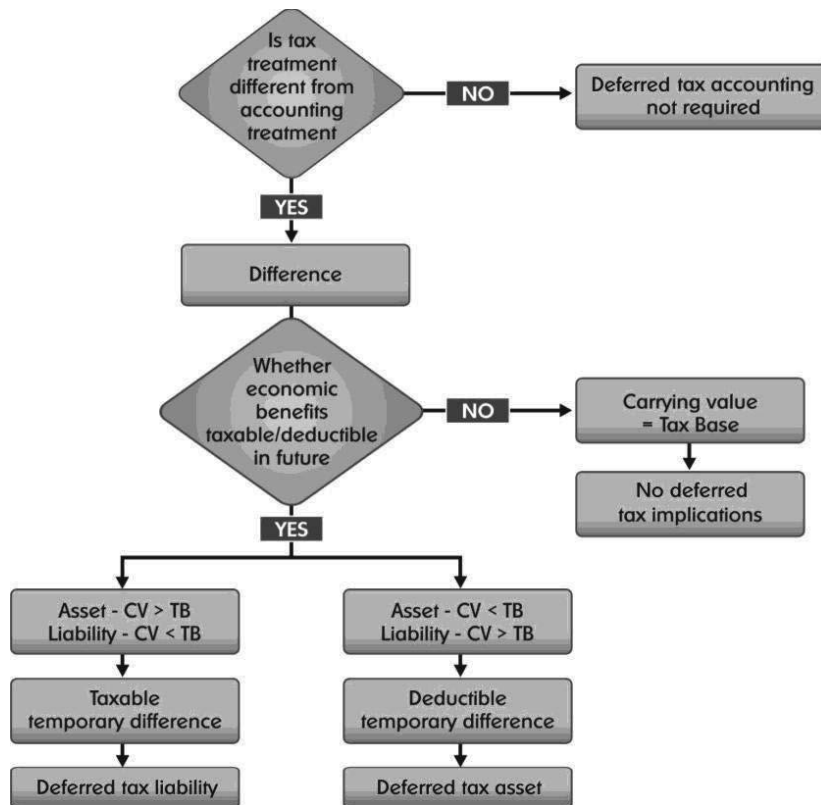
An entity records a loan at the proceeds received, net of transaction costs. The transaction costs are deducted in the first period to calculate taxable profits. They are amortised gradually in accounts, thereby increasing the carrying amount of the loan.

2.5 Deductible temporary differences

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

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

Diagram 2: Determination of deferred tax asset and liability



Example

A company had accrued product warranty costs of Tshs10 million in its accounts, in respect of claims made by customers against warranties. The taxation laws do not permit the deduction until the company actually pays the claims.

Its taxable profits for the current period will be higher by Tshs10 million. In future, it will be lower. Therefore, this is a **deductible difference**.



Test Yourself 4

In the first year of operation, the depreciation on an asset for tax purposes is Tshs10 million higher than that for accounting purposes.

In future, the tax authorities will not allow the deduction again. Therefore, the aggregate taxable profits in future will be Tshs10 million higher than the accounting profits. Assuming a tax rate of 25%, the tax effect will be 25% of Tshs10 million i.e. Tshs2.5 million.

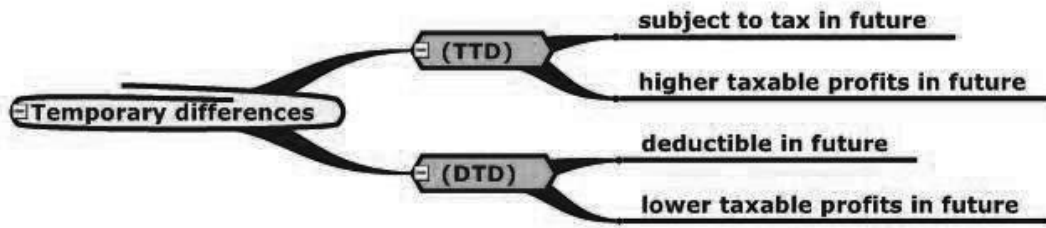
The entity will recognise a deferred tax liability of Tshs2.5 million.

Required:

State, in a tabular form, the situation in the financial statements if the deferred tax liability

- (i) is not recognised and
- (ii) it is recognised.

SUMMARY



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

This means that if for a transaction, both effects are on statement of profit or loss related accounts, then there is no impact on net profit or loss and therefore there will not be temporary differences.



Test Yourself 5

Determine the tax base and temporary differences (whether taxable or temporary) for the following. Give reasons for your answers:

- (a) Local tax laws allow a deduction of 125% of the cost incurred for employing persons with special needs, as certified by the specified authorities. An entity incurs Tshs10 million as a cost of employees with special needs.
- (b) The carrying value of the provision for municipal taxes is Tshs12 million. The tax laws allow the deduction on a cash basis.
- (c) Rent received in advance is Tshs18 million. The amount is taxed on cash basis.
- (d) Rent receivable taxable on a receipts basis is Tshs6 million.

The relationship between the carrying amount and tax bases of assets and liabilities and the resulting deferred tax asset and liabilities that arise are summarized as follows:

Relationship	For assets	For liabilities
Carrying amount is more than the tax base	Taxable temporary Difference Deferred tax liability (DTL)	Deductible temporary Difference Deferred tax asset (DTA)
Carrying amount is less than the tax base	Deductible temporary Difference Deferred tax asset (DTA)	Taxable temporary Difference Deferred tax liability (DTL)
Carrying amount = tax base	None	None

3. Measure and record deferred tax liabilities and assets in the financial statements. [Learning Outcome c]

The temporary difference gives rise to recognition of deferred tax asset / liability depending on whether the difference is deductible or taxable.



Definition

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

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

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

IAS 12, Para 5

3.1 Deferred tax liabilities / assets

As the above definition indicates, deferred tax liabilities are closely related to taxable temporary differences and deferred tax assets are linked to deductible temporary differences. In fact, **all taxable temporary differences give rise to deferred tax liabilities and all deductible temporary differences give rise to deferred tax assets.**

1. The initial recognition of goodwill
2. The initial recognition of an asset or liability in a transaction which
 - (a) Is not a business combination; and
 - (b) At the time of the transaction affects neither accounting nor taxable profit (tax loss).

This means that deferred tax accounting is required when the identifiable assets acquired (excluding goodwill) and liabilities assumed in a business combination are recognised at their fair values in accordance with IFRS 3 Business Combinations, but no equivalent adjustment is made for tax purposes.

However, a deferred tax asset (DTA) shall be recognised for all deductible temporary differences **to the extent it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.**

IAS 12 does not permit the recognition of the deferred tax liability resulting from the initial recognition of goodwill because goodwill is measured as a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill.



Example

Tip Co acquired Top Co for Tshs500 million. The fair value of net assets of Top on the acquisition date was Tshs300 million. Therefore goodwill of Tshs200 million is recognised in the business combination. Since goodwill is an asset acquired as a result of acquisition and the tax authorities do not allow reduction in goodwill as a deductible expense while determining taxable profits, deferred tax liability (DTL) may be required to be recognised. However, IFRS 3 prohibits recognition of DTL against such goodwill as goodwill itself is a residual amount (i.e. balance after allocating consideration to the fair values of net assets of a subsidiary).

3.2 Measurement of deferred tax assets and liabilities

1. Measurement shall be **at the tax rates expected to apply** to the period when the asset is realised or liability is settled.
2. The rates used shall be those **enacted or substantially enacted by the end of the reporting period.**
3. Measurement **depends upon the expectations about the manner** in which the recovery of tax asset or settlement of tax liability will take place.



Example

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

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

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

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



Test Yourself 6

An accrued warranty liability of Tshs10 million is created in the current year. For tax purposes, it will be allowed in future years when the claims are actually settled. Assume a tax rate of 30%.

This is a deductible temporary difference. Its tax effect is Tshs10 million \times 30% = Tshs3 million, which will be recognised as a deferred tax asset.

Required:

State in a tabular form the situation in the financial statements if the deferred tax asset

- (i) is not recognised and
- (ii) if it is recognised



Example

The following are some of the transactions related to Lagan Co.

The following details for the year ended 31 December 20X6, being the end of the reporting period, are given:

1. Interest receivable of Tshs100 million is included in the statement of financial position. This will be included in the taxable profit when cash is collected.
2. Development costs of Tshs200 million were incurred. They are capitalised and are to be amortised over future periods when determining the accounting profit. However, the amount is deducted when determining the taxable profit for the year 20X6.
3. The cost of retirement benefits provided for (unpaid at the end of the reporting period) of Tshs50 million while determining accounting profits. However, the amount is deductible for tax purposes only when contributions are paid into a fund.
4. Research costs worth Tshs30 million are recognised as an expense while determining the accounting profits. According to local tax laws, the amount is permitted as a deduction in the future on the fulfilment of certain conditions.

Required:

Show the effect of these transactions on the financial statements of Lagan Co.

Answer Step 1: Calculate Tax base

1. The carrying value per the accounts is Tshs100 million. The related interest revenue will be taxed on a cash basis, so the tax base of the interest receivable is nil.
2. The development costs have a tax base of nil as they have already been deducted for tax purposes. The carrying value per the statement of financial position is Tshs100 million.
3. The tax base of retirement benefits is nil (Carrying amount Tshs50 million amount deductible in the future Tshs50 million). The carrying value per the statement of financial position is Tshs50 million.

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- The tax base of the research costs is the amount the taxation authorities will permit as a deduction in future periods. The carrying value is 0 as they have already been expenses.

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

- Tshs100 million — Nil = Tshs100 million taxable temporary difference
- Tshs200 million — Nil = Tshs200 million taxable temporary difference
- Tshs50 million — Nil = Tshs50 million deductible temporary difference
- Nil — Tshs30 million = Tshs30 million deductible temporary difference

Step 3: Calculate deferred tax asset / liability:

- Tshs30 million (i.e. Tshs100 million x 30%) Deferred tax liability
- Tshs60 million (i.e. Tshs200 million x 30%) Deferred tax liability
- Tshs15 million (i.e. Tshs50 million x 30%) Deferred tax asset
- Tshs9 million (i.e. Tshs30 million x 30%) Deferred tax asset

Step 4: Accounting entries

Dr Deferred tax expense Tshs90 million
 Cr Deferred tax liability Tshs90 million
 Being the entry to record the deferred liability on the taxable temporary differences

Dr Deferred tax asset Tshs24 million
 Cr Deferred tax income Tshs24 million
 Being the entry to record the deferred asset on the deductible temporary differences

Step 5 Presentation in the financial statements Extract from statement of financial position

	Tshs'000
Assets	
Non-current asset	
Deferred tax asset	24,000
Equity and liabilities Non-current	
liability	
Deferred tax liability	90,000

Extract from statement of profit or loss

	Tshs'000	Tshs'000
Tax expenses		
Deferred tax liability	90,000	
	(24,000)	66,000

Deferred tax asset / liability are recognised only for temporary period and will be reversed in future. The following example is given to show how the differences reverse fully.

It would be interesting to see how the reversible differences actually reverse, and what the impact on the income and the tax is. Let us take an example of accelerated depreciation and the resultant deferred tax assets.

For simplification, it is assumed that the entity has only the transactions given in the example.



Example

Depreciable assets

Murphy Ltd purchases machinery worth Tshs6,000 million. The expected useful life of the machinery is five years and Murphy decides to depreciate it on a straight line basis. The machinery is depreciated at 25% p.a. on a straight line basis for tax purposes. The tax losses can be set off against the taxable profits of the five years. Murphy's taxable profit in year 0 is Tshs3,000 million with the tax rate being 40%.

The carrying amount of the machinery would be recovered by manufacturing goods for resale. The current tax calculation of Murphy Ltd is as follows:

	Year				
	1	2	3	4	5
	Tshs'm	Tshs'm	Tshs'm	Tshs'm	Tshs'm
Depreciation for accounts purpose	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)
Depreciation for tax purposes	(1,500)	(1,500)	(1,500)	(1,500)	-
Taxable profit (tax loss)	(300)	(300)	(300)	(300)	1,200
Current tax expense (income) at 40%	(120)	(120)	(120)	(120)	480

As Murphy recovers the benefit of tax loss against the taxable profit of year 0, it recognises the current tax asset at the ends of years 1 to 4.

The temporary differences associated with the machinery and the resulting deferred tax asset and liability and deferred tax expense and income are as follows:

	Year				
	1	2	3	4	5
	Tshs'm	Tshs'm	Tshs'm	Tshs'm	Tshs'm
Carrying amount	4,800	3,600	2,400	1,200	-
Tax base	4,500	3,000	1,500	-	-
Taxable temporary difference	300	600	900	1,200	-
Opening deferred tax liability	-	120	240	360	480
Deferred tax expense (income)	120	120	120	120	(480)
Closing deferred tax liability	120	240	360	480	-

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The reversal of the temporary taxable difference will create taxable income in the subsequent years. In this example, a taxable income amounting to Tshs1,200 million arises in year 5, so Murphy will recognise the deferred tax liability in years 1 to 4. Murphy's statement of profit or loss is as follows:

	Year				
	1	2	3	4	5
	Tshs'm	Tshs'm	Tshs'm	Tshs'm	Tshs'm
Income	1,200	1,200	1,200	1,200	1,200
Depreciation	1,200	1,200	1,200	1,200	1,200
Profit before tax	-	-	-	-	-
Current tax expense (income)	(120)	(120)	(120)	(120)	480
Deferred tax expense (income)	120	120	120	120	(480)
Total tax expense (income)	-	-	-	-	-
Net profit for the period	-	-	-	-	-

3.3 Recognition of current and deferred tax

The recognition provision for current tax is also applicable to deferred tax.

The amount is to be recognised in Profit or Loss. However, in the following cases, it should not be recognised in the statement of profit or Loss.

1. Current tax and deferred tax that relates to items that are recognised, in the same or a different period in other comprehensive income, shall be recognised in other comprehensive income part of the statement of profit or loss and OCI.



Example

Revaluation gains on property and exchange differences arising on the translation of the financial statements of a foreign operation are presented in the 'other comprehensive income' section of statement of profit or loss and other comprehensive income. Tax related to these items is also recognized in the same section.

2. Current tax and deferred tax that relates to items that are recognised, in the same or a different period directly in equity, shall be recognised directly in equity.



Example

When there is a change in accounting policy that is applied retrospectively or the correction of an error, an adjustment to the opening balance of retained earnings is made. Similarly, on initial recognition of a compound financial instrument, a part of the amount is recognized in equity.

The tax effects of these items are also recognized directly in equity.

Deferred tax liability / asset for a Business combination On initial recognition of assets and liabilities

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



Example

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

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

Fair values of the assets and liability as on the acquisition date are more by Tshs25,000 million. This gives rise to deferred tax as for income tax purposes the values will remain Tshs160,000 million. Since carrying values are more by Tshs25,000 million, a deferred tax liability will be recognised on acquisition.

Assuming the tax rate to be 20%, deferred tax liability will be Tshs5,000 million.

Intra group transactions

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



Example

The parent company sold an inventory costing Tshs1 million after adding a profit of Tshs0.10 million to the subsidiary, which held the inventory at the reporting date. This unrealised profit will be eliminated in the consolidated financial statements. However, tax authorities would not make such adjustments. This creates a deductible difference. Assuming the tax rate as 30%, a deferred tax asset of Tshs30,000 (Tshs100,000 x 30%) is created.

3.4 Deferred tax assets against unused tax losses and unused credits

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

1. the carry forward of unused tax losses and
2. the carry forward of unused tax credits

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

From the profits earned in future, the amounts of unused tax losses and unused tax credits will be deducted in the calculation of taxable profits. Therefore, the possible **taxable profits to be earned in future will be reduced** because of the tax benefits of unused losses and credits. Therefore we can recognise tax assets which can be settled in future. It is as if we have a **tax asset today** that will be set off against the future tax liability. Similar is the case with the unused tax credits. Therefore this is also recognised as a deferred tax asset.



Example

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

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It can recognise a deferred tax asset for Tshs90 million (Tshs300 million x 30%) only if there is evidence that future taxable profits will be available to offset the loss. Not only this, but it will also have to disclose the nature of the evidence in the financial statements.

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

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

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



Example

Continuing with the previous example of Zorium

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

3.5 Reassessment of unrecognised tax assets

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

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

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

3.6 Presentation

Current tax

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

Deferred tax

1. Deferred tax assets and deferred tax liabilities shall be disclosed **separately. They are not classified as current assets or current liabilities**.
2. **Offset** of deferred tax assets and liabilities against each other **is permitted if and only if**:
 - (a) The entity has a legally enforceable right to set off the amounts
 - (b) Both relate to income taxes levied by the same taxation authority
 - (i) either on the same taxable entity; or;
 - (ii) on different entities that intend to settle the net amount or to realise / settle the asset / liability at the same time.

3. **Tax expense:** the tax expense or income related to profit or loss from **ordinary activities** shall be **presented in profit and loss**.



Example

Continuing the example of Zorium Tempo Co

In addition to the deferred tax assets of Tshs90 million mentioned above, Zorium Tempo Co has deferred tax liabilities of Tshs110 million.

It can disclose the net amount as Tshs20 million (Tshs110 million – Tshs90 million) in the statement of financial position only if it has a legally enforceable right to set off the amounts.

3.7 Disclosures: IAS 12 requires the following disclosures

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

- (a) **Current tax expense or income**.
- (b) Any adjustments to **current tax for prior years** recognised during the reporting period.
- (c) **Deferred tax expense (income)** relating to origination or reversal of **temporary differences**.
- (d) **Deferred tax expense (income)** resulting from **changes in tax rates and imposition of new taxes**.
- (e) **Benefit arising from previously unrecognised** tax loss, tax credit or temporary difference of a prior period that is used to reduce:
 - ⁽ⁱ⁾ Current tax expense; or
 - ⁽ⁱⁱ⁾ Deferred tax expense
- (f) **Deferred tax expense** resulting from **write down** or reversal of previous write down of a deferred tax asset.
- (g) Tax expense or income resulting from **changes in accounting policies and errors** that is included in profit or loss in accordance with IAS 8.

2. Additional disclosures

- (a) Aggregate of current or deferred tax recorded directly in equity.
- (b) Explanation of the relationship between tax expense or income with accounting profit:
 - (i) Numerical reconciliation between **tax expense (income)** and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) calculated; or
 - (ii) Numerical reconciliation between the average effective **tax rate** and the applicable tax rate, disclosing also the basis on which the applicable tax rate is calculated.
- (c) Explanation of changes in the applicable tax rate(s) in comparison with the rate in previous accounting period.
- (d) Amount (and expiry date, if any) of deductible temporary differences, unused tax losses, and unused tax credits **for which no deferred tax asset is recognised in the statement of financial position**;
- (e) In respect of each type of temporary difference, and in respect of each type of unused tax losses and unused tax credits:
 - (i) The amount of deferred tax assets and liabilities recognised in the statement of financial position for each period presented.
 - (ii) The amount of deferred tax income or expense recognised in the profit or loss, if this is not apparent from changes in the amounts recognised in the statement of financial position.

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- (f) In respect of discontinued operations, the tax expense relating to:
- (i) The gain or loss on discontinuance.
 - (ii) The profit or loss from ordinary activities of the discontinued operation for the period, together with the corresponding amounts for each prior period presented.

The income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements.



Example

A company declares a dividend of Tshs500 million. There is a tax on dividend distribution at 10%, amounting to $500,000 \times 10\% = 50,000$.

If this amount of Tshs50 million is not recognised as a liability, the fact is to be disclosed.

-
- (g) if a business combination in which the entity is the acquirer causes a change in the amount recognised for its pre-acquisition deferred tax asset, the amount of that change; and
 - (h) if the deferred tax benefits acquired in a business combination are not recognised at the acquisition date but are recognised after the acquisition date, a description of the event or change in circumstances that caused the deferred tax benefits to be recognised.

3. Separate disclosures for deferred tax asset

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

- (a) The utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences.
- (b) The entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.



Case Study

Extract showing disclosure of taxation

9 Taxation

	2009 £ million	2008 £ million
Current tax		
Corporation tax on profits for the year	43.4	96.9
Adjustment for prior years	1.3	0.6
Total current tax	<u>44.7</u>	<u>97.5</u>
Deferred tax		
Origination and reversal of temporary differences	33.4	(16.3)
Changes in tax rates and laws	-	(0.1)
Recognition of previously unrecognised deferred tax assets	(0.7)	(0.5)
Adjustment to estimated recoverable amount of deferred tax assets arising in prior years	(0.7)	(3.4)
Total deferred tax	<u>32.0</u>	<u>(20.3)</u>
Income tax expense – continuing operations	<u>76.7</u>	<u>77.2</u>

The tax charge for the year can be reconciled to the profit per the income statement as follows:

	2009 £ million	2008 £ million
Profit before tax	<u>249.4</u>	<u>262.3</u>
Tax expense at UK corporation tax rate of 28% (2008 30%)	69.8	78.7
Effects of:		
Overseas tax rates	6.1	3.3
Expenses not deductible for tax purposes	1.1	1.0
Net utilisation of tax losses and tax holidays	0.5	(1.7)
Adjustments for prior years	0.6	(2.8)
Research and development credits	(4.4)	(3.3)
Other	3.0	2.0
Tax expense for the year	<u>76.7</u>	<u>77.2</u>

Source: Johnson Matthey Annual Reports and Accounts 2008



Tip

- ⑩ Do not segregate DTL and DTA as current and non-current. It should always be shown under non-current category.
- ⑩ DTA and DTL should never be discounted. The reason for this is generally because it is difficult to accurately predict the timing of the reversal of each temporary difference



Tip

Tips for preparation of answers

- (1) Current tax
 - (a) Current tax calculations and entries are easier than those for deferred tax so should be tackled first.
 - (b) Calculate and record the tax liability.
 - (c) Show the tax as an expense in the statement of profit or loss (unless the related item is recognised as a change in equity).
 - (d) Check the tax amount with the payment made:
 - If the tax provision is higher than the payment, show the net amount as a current liability.
 - If the tax payment is higher than the provision, show the net amount as a current asset.
- (2) If there is a carry back of a loss, then create a current tax asset.
- (3) Deferred tax
 - (a) Calculate the tax base of the assets and liabilities.
 - (b) Calculate the amount and the type of the temporary differences.
 - (c) Unless the item falls under the exceptions mentioned above, calculate the deferred tax liabilities for all taxable temporary differences, and recognise them.
 - (d) Check if it is probable that taxable profit will be available against which the deductible temporary difference can be used. Calculate the deferred tax assets for all deductible temporary differences that satisfy the condition mentioned above.
- (4) Present the deferred tax assets and liabilities separately from the current assets and liabilities.

Answers to Test Yourself

Answer to TY 1 Case 1: Actual liability for 20X6 Tshs10 million Statement of profit or loss

	Tshs'000
Tax due for 20X7 (Tshs500,000 x 30%)	150,000
Under provision for 20X6 (Tshs108,000 – Tshs100,000)	8,000
Current tax expense	158,000

Statement of financial position

	Tshs'000
Tax due for 20X7 (Tshs500,000 x 30%)	150,000
Under provision for 20X6 (Tshs108,000 – Tshs100,000)	8,000
Add: provision in the previous year Total provision	100,000
	258,000
Less: amount paid	(108,000)
Current tax liability	150,000

Case 2: Actual liability for 20X6 Tshs95 million Statement of profit or loss

	Tshs'000
Tax due for 20X7 (Tshs500,000 x 30%)	150,000
Over provision for 20X6 (Tshs100,000 – Tshs95,000)	(5,000)
Current tax expense	145,000

Statement of financial position

	Tshs'000
Tax due for 20X7 (Tshs500,000 x 30%)	150,000
Over provision for 20X6 (Tshs100,000 – Tshs95,000)	(5,000)
Add: provision in the previous year	100,000
Total provision	245,000
Less: amount paid	(95,000)
Current tax liability	150,000

**Answer to TY 2
(Amounts in Tshs'000)**

(1) When advance tax is paid:

Dr Advance tax	Tshs30,000	
Cr Bank / cash		Tshs30,000
Being payment of advance tax		

(2) When expense is recognised:

Dr Current tax expense	Tshs37,500	
Cr Current tax liability		Tshs37,500
Being the current tax payable		

(3) When the current tax asset and liability are adjusted against each other:

Dr Current tax liability	Tshs30,000	
Cr Advance tax		Tshs30,000
Being the transfer of advance tax amount to current tax liability account		

Net current tax liability is Tshs7,500 (37,500 - 30,000) when paid will be

Dr Current tax liability	Tshs7,500	
Cr Cash		Tshs7,500

Or

Dr Current tax liability	Tshs37,500	
Cr Advance tax		Tshs30,000
Cr Cash		Tshs7,500
Being net outstanding current tax paid		

Answer to TY 3

Amount deductible in future is Tshs25 million therefore tax base is Tshs25 million.

Answer to TY 4

Since depreciation allowed for tax purposes is higher, the tax base of the asset is Tshs10 million lower than its carrying value. When the entity recovers this amount in the future by way of using or selling the asset, it will not get the deduction again. There is an associated tax liability of Tshs2.5 million (Tshs10 million x 25%).

The following table shows the **situation in the financial statements** if (i) the deferred tax liability is not recognised and (ii) if it is.

	If liability is not recognised		If liability is recognised	
	Current year	Future years	Current year	Future years
	Tshs'000	Tshs'000	Tshs'000	Tshs'000

Answer to TY 6

The following table shows the **situation in the financial statements** if the deferred tax asset (i) is not recognised and (ii) if it is.

	If asset is not recognised		If asset is recognised	
	Current year	Future years	Current year	Future years
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Deductible difference		10,000	10,000	-
Less: Tax asset Net amount	(3,000)		(3,000)	-
	(3,000)	10,000	7,000	-

If a deferred tax asset is created, the net tax expense for the year will be nil (deferred tax expense Tshs3 million less current tax income Tshs3 million).

Only the second of these where deferred tax is recognised – satisfies the matching principle.

Accounting entries: deferred tax asset

From the above example, in the current period, the accounting entry to recognise the deferred tax asset will be:

Dr	Deferred tax asset	Tshs3 million
	Cr	Deferred tax income
		Tshs3 million

Being deferred tax asset recognised

In future, when the profit is recognised, the tax expense also will be recognised by the following entry:

Dr	Deferred tax expense	Tshs3 million	Add to tax expenses
	Cr	Deferred tax asset	

Being tax expenses recognised

Hence the deferred tax asset is derecognised from the statement of financial position and the deferred tax expense is disclosed in the statement of profit or loss.

Quick Quiz

1. What is current tax?
2. Is current tax always presented in the profit or loss?
3. An entity has incurred a tax loss of Tshs50 million for a period. It wants to recognise the tax benefit of the loss as an asset. Can it do so? If yes, what will the value of the tax asset be at a 35% tax rate?

Answers to Quick Quiz

1. Current tax is the amount of income taxes payable or recoverable in respect of the taxable profits (tax loss) for a period.
2. Normally current tax is presented in profit or loss. However, there are two exceptions:
 - (a) If it relates to items credited or charged to equity or OCI, the tax also shall be recorded directly in equity.
 - (b) If the tax arises from business combination.

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3. Subject to being allowed from a tax point of view, it can do so:
 - (a) If the entity wants to carry it back to earlier periods to recover the current loss of those periods, it can recognise the tax benefit as a current tax asset. The value will be Tshs50 million \times 35% = Tshs17.5 million.
 - (b) If the entity wants to carry it forward for offset against future taxable income, it can recognise the tax benefit of Tshs17.5 million as a deferred tax asset. However, it should be probable that future taxable profit will be available against which the unused tax losses can be used.

Self Examination Questions

Question 1

Please go through the following information:

1. Assets

- (a) A machine has a carrying value of Tshs1,000 million for accounts purposes and Tshs700 million for tax purposes.
- (b) Interest receivable of Tshs1,000 million has been recorded in the accounts but it is taxable on a receipts basis.
- (c) Trade receivables have a carrying value of Tshs1,000 million. The related sales have also been recognised for tax purposes.
- (d) The entity has a loan receivable with a carrying value of Tshs1,000 million. The receipts against the loan will have no tax effects.

2. Liabilities

- (a) Current liabilities include interest payable with a carrying value of Tshs1,000 million, deductible for tax purposes on a payment basis.
- (b) Current liabilities include telephone expenses payable with a carrying amount of Tshs1,000 million. This expense has already been allowed as a deduction for tax purposes.
- (c) Fines payable have a carrying value of Tshs1,000 million, but they are not deductible for tax purposes.
- (d) A loan payable has a carrying value of Tshs1,000 million. Its repayment does not affect taxation. (e) Interest received in advance with a carrying value Tshs1,000 million. It is taxed on a cash basis.

3. Other items

Research costs of Tshs1,000 million are included in profit or loss for accounting purposes, but deductible for tax purposes in future.

Required:

- (a) Determine the tax base, the taxable temporary differences and deductible temporary differences (if any)
- (b) For the temporary differences above, determine the deferred tax assets and liabilities at a 30% tax rate and set out the required accounting entries.

Question 2

Gold Line Transports has an accounting profit of Tshs100 million for the year 20X6. The following additional information is available:

1. Depreciation allowable under income tax rules is Tshs10 million higher than accounting depreciation.
2. A penalty of Tshs6 million for the infringement of local laws is charged as an expense in the accounts, but never allowable under income tax.
3. A provision of Tshs8 million for expenses recorded in the accounts is allowable on a cash basis for tax purposes.

The applicable rate of tax is 25%.

Required:

Determine the accounting entries for current tax and deferred tax.

Question 3

The following information relates to Zeta Ltd for the year ended 31 March 20X3.

The balance in the deferred tax provision account as on 1 April 20X2 was Tshs70 million. This amount was computed on a cumulative time difference of Tshs200 million by applying a tax rate of 35%.

Capital allowances (tax depreciation) and depreciation for the year ended 31 March 20X3 is as follows:

	Capital allowances	Depreciation
	Tshs'000	Tshs'000
20X3 actual	200,000	180,000

The income tax rate for 20X3 is 30% and is expected to remain at this level for the foreseeable future.

Required:

Account for deferred tax in accordance with IAS 12 for the year ended 31 March 20X3.

Question 4

Creative Ltd, is a wholly owned subsidiary of Crafts Ltd and also satisfies the criteria of a cash generating unit in accordance with IAS 36 Impairment of assets. The value of the property, plant and equipment of Creative Ltd on 31 October 20X2 was Tshs12 million and purchased goodwill was Tshs2 million before any impairment loss. Apart from the property, plant and equipment, Creative did not own or owe any other assets or liabilities.

On 31 October 20X2, Crafts Ltd tested Creative Ltd for impairment and an impairment loss of Tshs3.6 million had occurred. The tax base of the property, plant and equipment of Creative Ltd was Tshs8 million as at 31 October 20X2. The directors wish to know how the impairment loss will affect the deferred tax provision for the year. In the jurisdictions in which Crafts Ltd operates, Impairment losses are not an allowable expense for taxation purposes. Assume a tax rate of 30%.

Required:

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

Answers to Self-Examination Questions

Answer to SEQ 1

(All amounts in Tshs 'million)

1. Assets

		Carrying value	Tax base	Temp. diff.	Nature of temp. diff.
(a)	Machine	1,000	700	300	taxable
(b)	Interest receivable, taxed on receipts basis	1,000	-	1,000	taxable
(c)	Trade receivables	1,000	1,000	-	n/a
(d)	Loan receivable	1,000	1,000	-	n/a

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2. Liabilities

		Carrying value	Tax base	Temp. diff.	Nature of temp. diff.
(a)	Current liabilities, allowable on cash basis	1,000	-	1,000	deductible
(b)	Accrued expense, already deducted for tax	1,000	1,000	-	n/a
(c)	Accrued fines and penalties	1,000	1,000	-	n/a
(d)	Loan payable	1,000	1,000	-	n/a
(e)	Interest received in advance, taxed on cash basis	1,000	-	1,000	deductible

3. Other items

		Carrying value	Tax base	Temp. diff.	Nature of temp. diff.
(a)	Research costs	-	1,000	1,000	deductible



Tip

In future, when the difference will cause:

- ⑩ higher taxable profits than accounting profits, it is treated as a taxable temporary difference;
- ⑩ lower taxable profits than accounting profits, it is treated as a deductible temporary difference.

(a) (All amounts in Tshs 'million)

		Temp. diff.	Nature of temp. diff.	Tax at 30%	
1a)	Machine	300	taxable	90	Deferred tax liability
1b)	Interest receivable, taxable on receipts basis	1,000	taxable	300	
	Sub total			390	
2a)	Current liabilities allowable on cash basis	1,000	deductible	300	Deferred tax asset
2e)	Interest received in advance, taxed on cash basis	1,000	deductible	300	
3a)	Research costs	1,000	deductible	300	
	Sub total			900	



Tip

The asset is to be recognised only to the extent it is probable that taxable profit will be available. It is assumed that taxable profit will be available in future against which DTA can be used.

Entries to record the deferred tax asset and liabilities are as below:

Dr	Deferred tax expense	Tshs390	
	Cr	Deferred tax liability	Tshs390

Being deferred tax liability recorded

Dr	Deferred tax asset	Tshs900	
	Cr	Deferred tax income	Tshs900

Being deferred tax asset recorded

Answer to SEQ 2 (a) Current tax

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

The accounting entry is

Dr	Current tax expense	Tshs26 million	
	Cr	Current tax liability	Tshs26 million

(b) Deferred tax

- (1) Extra depreciation allowed will be reversed in future, when the depreciation deduction will be less and the taxable profits more. This is a taxable difference, leading to a deferred tax liability of Tshs10 million x 25% = Tshs2.5 million.

The accounting entry is:

Dr	Deferred tax expense	Tshs2.5 million	
	Cr	Deferred tax liability	Tshs2.5 million

- (2) The penalty is permanently disallowed. It does not create any deferred tax assets or liabilities.
- (3) Provision for expenses has been charged in the current period accounts, but will be deducted for tax purposes in future. This is a deductible difference, leading to a tax asset of Tshs8 million x 25% = Tshs2 million, to be recognised if the entity expects to earn profits in future to offset the tax liability against it. The accounting entry is:

Dr	Deferred tax asset	Tshs2 million	
	Cr	Deferred tax income	Tshs2 million

Answer to SEQ 3 Timing difference as at 31 March 20X3

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

The above difference is termed as a taxable temporary difference and deferred tax liability on above will Tshs220 million x 30% = Tshs66 million. This amount will be disclosed in the statement of financial position.

The decrease in provision (Tshs70 million - Tshs66 million = Tshs4 million) will reduce the tax expense for the year.

Answer to SEQ 4

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

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

	Goodwill	Property, plant and equipment
	Tshs'000	Tshs'000
Balance 31 October 20X2	2,000	12,000
Impairment loss	(2,000)	(16,000)
	-	4,000

Tax base of the PPE is Tshs8 million.

DTL (before the impairment loss) = (Tshs12 million – Tshs8 million) x 30% = Tshs1.2 million. DTL (after the impairment loss) = (Tshs10.4 million – Tshs8 million) x 30% = Tshs0.72 million

The statement of financial position will show a DTL of Tshs0.72 million and the statement of profit or loss will need to be credited by Tshs0.48 million to reduce tax expense.

STUDY GUIDE C1: REGULATORY REQUIREMENT RELATING TO THE PREPARATION OF FINANCIAL STATEMENTS

Get Through Intro

Cooking food well is a job half done. The food will not serve its true purpose unless it is well laid out, to make it appear appetising. Similarly, performing day to day accounting well is a job half done. It will not serve its purpose, unless the results are presented in a proper format, with the required content.

The end result of the accounting process is financial reporting. Unless the report contains true and fair information, and its structure and presentation is understandable and consistent, its utility to the users will be substantially reduced.

Accounting is said to be the language of business. The person receiving the information should understand the statements in the manner the person giving the information intended it to. Similarly, the presenter of the information should give information that is sufficient for the user to make informed decisions.

Unless there are some standards, there may be intentional or unintentional errors in the financial statements. Misleading information will lead to wrong decisions. For example investors may wrongly decide to buy or sell their investments; management may take wrong decisions involving the future of the business.

In future, you will be responsible for ensuring compliance with IFRSs, therefore it is essential for you to master the principles.

Learning Outcomes

- a) State the objectives of international accounting standards governing presentation of financial statements.
- b) Identify and state the laws, regulations accounting standards and other requirements that govern the production of financial statements of public and private sector entities.
- c) Assess the circumstances in which the use of IFRSs for companies and IPSASs for public sector entities may be required.
- d) Draft and compile financial statements, or extracts of financial statements, of an entity in accordance with its chosen policies and IFRSs.
- e) Evaluate, judge and advise on the appropriateness of chosen accounting policies with regard to compliance with IFRSs.
- f) Draft and compile financial statements, or extracts of financial statements, of an entity in accordance with its chosen policies and IPSASs.

1. State the objectives of international accounting standards governing presentation of financial statements. [Learning Outcome a]

1.1 The broad objectives of the IASB have been spelled out in Para 6 of the preface to IFRS, as follows:

- (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 financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions;
- (b) **to promote** the use and rigorous application of those standards; and
- (c) **to work actively with national standard setters to bring about convergence** of national accounting standards and IFRSs to high quality solutions.

In a single sentence, we can state that the **objective of international accounting standards** is to ensure that the financial statements prepared are dependable for decision making.

The objectives of international accounting standards outlined in the preface are as follows:

- 1. International accounting standards should be applied to general purpose financial statements and other financial reporting. The objective of financial statements is to **provide information about the financial position, performance and cash flows** of an entity that is **useful to users** in making economic decisions.
- 2. The prime objective of international accounting standards is to provide standards and guidance to ensure that the financial information in the financial statements is:
 - (i) **High quality** (based on the set principles)
 - (ii) **Transparent**
 - (iii) **Comparable**
- 3. These **qualities** make the **financial statements dependable** for the purpose of making important economic decisions.
- 4. IFRSs set out **recognition, measurement, presentation and disclosure requirements** dealing with transactions and events that are important in general purpose financial statements.
- 5. IFRSs may set out the requirements as applicable to specific industries, in addition to the general requirements.
- 6. IFRSs are designed to **apply to all profit oriented entities**. Although IFRSs are not designed to apply to not for profit activities in the private sector, public sector or government, entities with such activities may find them appropriate.

One more **objectives of financial statements** as mentioned in the framework is to ensure the **stewardship of management**, or the accountability of management for the resources entrusted to it. Unless the financial statements comply with the accounting standards, they cannot be relied upon for assessing whether this objective is fulfilled.

 **Test Yourself 1**

What will happen if managers are given remuneration based on the profits earned, and also a free hand to prepare the financial statements without having to comply with IFRSs?

2. Identify and state the laws, regulations accounting standards and other requirements that govern the production of financial statements of public sector and private sector entities.
3. Assess the circumstances in which the use of IFRSs for companies and IPSAS for public sector entities may be required. [Learning Outcomes b and c]

2.1 Public sector entities

Framework and accounting standards for not-for profit entities (NFPs)

Typically, the IASs and IFRSs usually followed by private sector entities are not suitable for public sector entities and NFPs. This is because NFPs and public sector entities are required to report financial information that is different from that reported by profit-making entities. The users of this information look at the information from a different perspective.

Although some countries have set specific standards for NFPs and public sector entities to follow (e.g. Statements of Recommended Practice in the UK), or the guidelines to be followed by these entities are prescribed by the legal framework, most entities use their own accounting techniques and methods; sometimes, even the cash basis of accounting is followed. However, in recent times, many public sector enterprises follow IASs and IFRSs where possible, so as to bring about uniformity in their accounts.

The **IASB** and the **FASB** are currently developing a framework for reporting by not-for-profit entities in the public and private sector. The project is titled 'The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information', and is part of the joint project between the IASB and the FASB to develop a common conceptual framework, to be addressed under Phase G. Currently, Phase G is inactive.

In addition, **the International Public Sector Accounting Standards Board (IPSASB)**, a body of the International Federation of Accountants (IFAC), regulates public not-for-profit entities and public sector enterprises. IFAC is a global organisation for the accountancy profession and comprises over 160 members and associates. This Board has so far issued 30 **International Public Sector Accounting Standards (IPSAS)**, loosely based on IFRSs. Each IPSAS is based on a particular related IASs / IFRSs and follows the accrual method of accounting, a move designed to encourage NFPs to switch over from the cash basis they have so far been following.

IPSAS standards

The IPSAS developed by the IFAC are standards modelled on the IFRSs / IASs issued by the IASB. The use of IPSAS also ensures that financial statements are comparable for organisations that adopt them. The application of the IPSAS gives bodies incorporated under public law greater significance through comparability with general and internationally recognised regulations for submitting accounts. This facilitates dealing with financiers and simplifies communication with the general public.

The following is a list of IPSAS issued till date. These are given for reference, and need not be memorised.

IPSAS 15	Financial Instruments: Disclosure and Presentation - superseded by IPSAS 28 and IPSAS 30	IAS 39
IPSAS 16	Investment Property	IAS 40
IPSAS 17	Property, Plant and Equipment	IAS 16
IPSAS 18	Segment Reporting	IFRS 8
IPSAS 19	Provisions, Contingent Liabilities, Contingent Assets	IAS 37
IPSAS 20	Related Party Disclosures	IAS 24
IPSAS 21	Impairment of Non-cash-generating Assets	IAS 36
IPSAS 22	Disclosure of Financial Information About the General Government Sector	NA
IPSAS 23	Revenue from Non-Exchange Transactions (Taxes and Transfers)	NA
IPSAS 24	Presentation of Budget Information in Financial Statements	NA
IPSAS 25	Employee Benefits	IAS 19
IPSAS 26	Impairment of Cash-Generating Assets	IAS 36
IPSAS 27	Agriculture	IAS 41
IPSAS 28	Financial Instruments: Presentation	IAS 32
IPSAS 29	Financial Instruments: Recognition and Measurement	IFRS 9
IPSAS 30	Financial Instruments: Disclosures	IFRS 7
IPSAS 31	Intangible Assets	IAS 38
IPSAS 32	Service Concession Arrangements: Grantor	IFRIC 12

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In Tanzania, public sector entities include ministries, regional governments, government departments, agencies and local government.

IFRSs / IASs specify the types of financial statements to be prepared. Public Authorities in Tanzania are required to prepare their financial statements in compliance with the International Financial Reporting Standards (IFRSs) or the International Public Sector Accounting Standards (IPSASs) depending on the nature and objectives of the Public Authorities in question. This is in line with the decision taken by the National Board of Accountants and Auditors (NBAA) and endorsed by the Government that effective from 1 July, 2004, reporting entities in Tanzania shall embrace the International Financial Reporting Standards framework and shall also be guided by standards and guidelines issued from time to time by the National Board of Accountants and Auditors (NBAA).

2.2 Private sector entities

Since 1 July, 2004, the National Board of Accountants and Auditors adopted the International Financial Reporting Standards (IFRSs) and International Accounting Standards, issued by the International Accounting Standards Board (IASB), and International Standards of Auditing (ISAs), issued by the International Federation of Accountants (IFAC), as Tanzanian standards.

At the same time, the NBAA continued in force the following Tanzania Financial Accounting Standards (TFASs) and Tanzania Statements of Recommended Practice (TSRPs) that do not have counterpart International standards:

Tanzania Financial Accounting Standards (TFASs)

- TFAS No. 12 Director's Report
- TFAS No. 16 Accounting for Extractive Industries
- TFAS No. 23 Accounting for Value Added Tax (VAT)
- TFAS No. 24 Public Sector Accounting

Tanzania Statements of Recommended Practice (TSRPs)

TSRP 2 Accounting for Non-Governmental Organizations

TSRP 3 Governance in the Public Sector - An Accounting Officer's Perspective

Note: TFAS No. 12 Directors Report has now been superseded by TFRS No.1 Directors Report.

2.3 Circumstances when IFRSs and IPSASs are to be adopted

All domestic companies whose securities are publicly traded are required to use IFRSs. The public sector entities are allowed to use IPSAS. IFRSs and IPSASs issued by IASB and IFAC are adopted / endorsed by NBAA as and when they are issued.

IFRSs automatically have the force of law, without need for endorsement of individual standards, because the use of IFRSs is incorporated into regulations of various governmental regulatory bodies, including the Bank of Tanzania (BoT), Tanzania Insurance Regulatory Authority (TIRA), Dar-es Salaam Stock Exchange (DSE), Capital Market and Securities Authority (CMSA), and the NBAA technical pronouncement adopting IFRSs.



Important

Refer to Study Guide A1 to understand applicability of IFRSs and IPSASs to various categories of entities.

3. Draft and compile financial statements, or extracts of financial statements, of an entity in accordance with its chosen policies and IFRSs.

5. Evaluate, judge and advise on the appropriateness of chosen accounting policies with regard to compliance with IFRSs.

[Learning Outcomes d and e]

IAS 1 Presentation of Financial Statements deals with format and content of financial statements.

Before we go into details about the structure and content of financial statements, it will be useful first to understand what financial statements are and what their purpose is.

3.1 Components of financial statements



Definition

A complete set of financial statements comprises of:

- (a) a statement of financial position (SOFP) as at end of the period
- (b) a statement of profit or loss and other comprehensive income (SOPL and OCI)
- (c) a statement of changes in equity for the period (SOCIE)
- (d) a statement of cash flow for the period;
- (e) notes, comprising a summary of significant accounting policies and other explanatory information
- (f) comparative information in respect of the preceding period (at least one year's comparative financial statements); and
- (g) a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements

IAS 1 Para 10

In Tanzania, the Director's Report is one of the required 'components' of financial statements and must be prepared in accordance with TFRS No.1 Director's Report

The entity shall give equal prominence to all the components of financial statements. A complete set of financial statements includes all the above components.

An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

3.2 Purpose

General purpose financial statements meet the needs of users who are not in a position to demand reports tailored to meet their particular information needs.

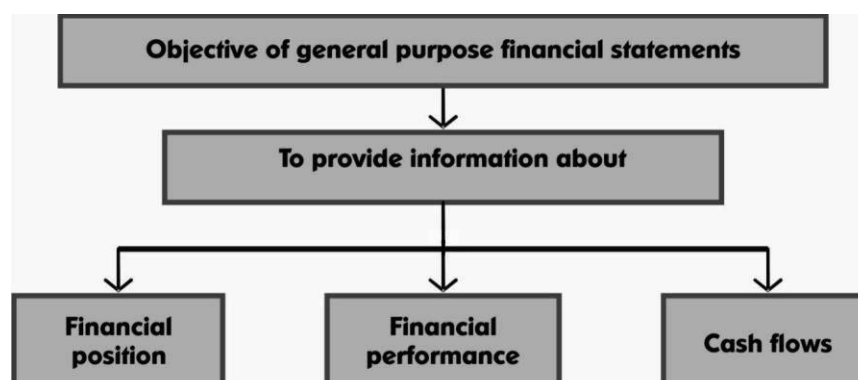
As you have seen earlier, the objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity. The information contained in the statements is used by a wide range of users in making economic decisions.



Example

Investors may use the statements to decide about investing in the company or divesting their shares. Banks may use them to decide about whether to lend to the entity or not. Governments may levy taxes based on the statements and so on.

Diagram 1: Objective of financial statements



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3.3 Information in financial statements

The following information is to be displayed prominently and repeated when necessary

1. **Name** of the reporting entity or any other means of identification (e.g. logo), and any changes therein from the end of preceding period.
2. Whether the statements cover an **individual entity or group of entities**.
3. The end date of the end of the reporting period or period covered by financial statements.
4. **Presentation currency** (e.g. Euro, US\$, Tshs).
5. **Level of rounding** off used in presenting amounts (e.g. to the nearest thousand).



Example

When the report is in a physical printed form, the above information can be included as titles on each page.

3.4 The period to be covered

The financial statements are to be presented **at least annually**. If the reporting date is changed, and the financial statements are presented for a period **longer or shorter than one year**, they should disclose:

1. The **period covered**.
2. The **reasons for using a longer or shorter period**.
3. The fact that the **prior-period amounts** for the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows are **not entirely comparable** as they have been prepared for periods with varying lengths.



Example

Allen Co normally presents its financial statements to 31 December each year. The last set of statements was prepared for the year ended 31 December 20X5. Local laws were amended in 20X6 to require all entities to follow a uniform accounting year ending on 31 March. Allen will prepare its next financial statements for the period from 1 January 20X6 to 31 March 20X7, and will disclose in the financial statements the fact that the end of the reporting period is of 15 months.

3.5 Statement of financial position: current / non-current distinction

Traditionally, accountants have arranged the assets and liabilities of an entity either on the basis of whether they are current or non-current or on the basis of their liquidity.

1. IAS 1 gives **first preference to the current / non-current presentation**. However, it **permits a presentation based on liquidity** if this provides information that is reliable and more relevant.

We will first understand how assets and liabilities are split into current and non-current.

2. Current assets and current liabilities



Definition

An asset should be **classified as current when it satisfies any** of the following criteria:

- (a) It is expected to be realised in, or is intended for sale or consumption in, the entity's normal **operating cycle**;
- (b) It is **held primarily** for the purpose of **trading**;
- (c) It is expected to be realised **within twelve months** after the reporting period; or
- (d) It is **cash or a cash equivalent** (as defined in IAS 7 Statement of cash flows), unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

All other assets should be classified as non-current.



Definition

A liability should be **classified as current** when it satisfies **any** of the following criteria:

- (a) It is expected to be settled in the entity's normal **operating cycle**;
- (b) It is **held primarily** for the purpose of trading;
- (c) It is due to be settled **within twelve months** after the reporting period; or
- (d) The entity does not have an **unconditional right to defer settlement of the liability for at least twelve months** after the reporting period.

All **other liabilities** should be classified as **non-current**.

IAS 1 Para 69

3. The point to be noted is that if **any ONE of the criteria** is satisfied, the asset or liability is "current".
4. If we study the above definitions, we find a general theme: current assets and liabilities are respectively those assets and liabilities which are expected to be realised and settled in the entity's **normal trading cycle** or in the near future, for example **within the next twelve months**.



Example

Trade receivables, inventories are current assets, but buildings and machines are non-current assets. This is because trade receivables are likely to be settled within 3 months: and most entities like to turn over their inventory as quickly as possible, preferably within one year.

Similarly, trade payables, bills payables are current liabilities, whereas debentures issued are non-current liabilities. This is because trade payables are usually settled within 3 months, but debentures are often repaid years later.

Normally both rules (part of the normal trading cycle, time limit of 12 months) are satisfied by a particular item at the same time. However, in some cases, they may not be.

5. For entities operating within a **clearly identifiable operating cycle**, presentation of current assets and liabilities separately in the SOFP provides useful information. Assets used for the entity's long-term operations are separated from the **net assets continuously circulating as working capital**.



Example

Property, plant and equipment are expected to be held for a company's long-term operations (non-current assets). Inventories and trade receivables are current assets. It is useful to group all current assets together; so as to know how much has been invested in working capital.

When banks consider a proposal to lend money for working capital, they need to analyse the composition of working capital. Showing current assets together helps this analysis.

The operating cycle is the time between acquiring the assets for processing and their final sale and realisation of the sale through the receipt of cash or cash equivalents.

Entities supplying goods and services are likely to be operating within an operating cycle as described above.



Example

Zedex Co's operations proceed in this order

1. Purchases raw materials
2. Converts them into finished goods
3. Holds them in the inventory
4. Sells the finished goods on credit
5. Realises cash
6. Pays cash to account payables and again buys raw materials

This process takes four months, and is known as an operating cycle.

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6. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve months.



Example

An entity's trial balance discloses the following figures:

	Tshs'000	Tshs'000
Share capital	200,000	
Retained earnings	80,000	
Long-term secured loans	100,000	
Property plant and equipment		350,000
Trade receivables		170,000
Inventories		60,000
Long-term unsecured loans	50,000	
Trade payables	150,000	
	580,000	580,000

Going by the discussions so far, we can identify the following as current assets and current liabilities:

	Tshs'000
Current assets	
Trade receivables	170,000
Inventories	60,000
	230,000
Current liabilities	
Trade payables	(150,000)
Net current assets	80,000

This gives very meaningful and useful information. It helps management in knowing how much has been invested in net working capital. In fact, if you approach a bank for working capital finance, it is very likely that the bank will ask for this information. The bank's analysis, including working capital ratios, is possible only if this information is readily available.

On the other hand, let us consider the long-term items.

	Tshs'000
Non-current assets	
Property plant and equipment	350,000
Non-current liabilities	
Share capital	200,000
Retained earnings	80,000
Long-term secured loans	100,000
Long-term unsecured loans	50,000
	430,000

It may be management's finance policy that the non-current assets should be financed entirely from non-current sources. The above information confirms that this policy has been correctly implemented as non-current assets are less than non-current liabilities, showing that the non-current assets are effectively financed by the non-current liabilities.

Thus what initially appears to be a mundane debit / credit accounting exercise takes such a useful and interesting form if the financial statements are prepared properly.

3.6 Presentation based on liquidity (as an alternative to current / non-current method)

IAS 1 prefers the current / non-current classification of assets and liabilities, but it permits a presentation based on **liquidity if it provides information that is reliable and more relevant.**

Which entities could fall under this category?



Important

For some entities, **such as financial institutions**, a presentation of assets and liabilities in increasing or decreasing order of liquidity provides information that is reliable and is more relevant than a current / non-current presentation because the entity **does not supply goods or services within a clearly identifiable operating cycle.**

IAS 1 Para 63

Consider the case of a bank. It accepts deposits from depositors, for periods varying from a few days to a few years. Similarly, it lends to borrowers for different periods. Some loans may be repayable in instalments over a period of many years, whilst others may be repayable within a few days.

In this case, the current / non-current classification may not be useful. A more useful presentation will be the one based on liquidity.



Example

Liquidity-Based Arrangement

If we start from most liquid asset and go in the order of decreasing liquidity, the order could be:

1. Cash
2. Money at call (money available in the near future within e.g. 3 months)
3. Investments
4. Bills discounted
5. Working capital finance
6. Short-term loans
7. Long-term loans
8. Property, plant and equipment

It should be noted that within current and non-current categories, the assets and liabilities line items can still be arranged in order of liquidity.

Combined Items (current plus non-current amounts included in one line item)

If a line item of asset combines amounts expected to be recovered

- (a) within twelve months; and
- (b) more than twelve months after the end of the reporting period,

The entity discloses the amounts **expected to be recovered more than twelve months after the end of the reporting period separately.**

If a line item of liability combines amounts expected to be settled

- (a) within twelve months; and
- (b) more than twelve months after the end of the reporting period,

The entity discloses the amounts **expected to be settled more than twelve months after the end of the reporting period separately.**

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Current portion of long-term liabilities

A typical implementation of the above principle is seen in the presentation of a long-term loan.

Term loans are basically non-current liabilities. However, the total amount of the instalments of the principal amount due within 12 months after the end of the reporting period is separated from the remaining repayments due after one year and disclosed as a current liability.



Example

The total balance payable of a term loan is Tshs100 million. Instalments due within 12 months of the end of the reporting period total Tshs12 million.

The entity will present Tshs12 million as a current liability and Tshs88 million as a non-current liability.

This disclosure is required **whichever method of presentation** is adopted (current / non-current or liquiditybased).

3.7 Information to be presented in the statement of financial position

1. After studying the methods of classification, it is now essential to see which items must be disclosed in the statement of financial position. It is to be noted that these items can be classified by using either of the methods discussed above.



Definition

As a minimum, the face of the statement of financial position should include line items that present the following amounts:

- (a) Property, plant and equipment;
- (b) Investment property;
- (c) Intangible assets;
- (d) Financial assets (excluding amounts shown under (e), (h) and (i));
- (e) Investments accounted for using the equity method;
- (f) Biological assets;
- (g) Inventories;
- (h) Trade and other receivables;
- (i) Cash and cash equivalents;
- (j) Total assets classified as held for sale in accordance with IFRS 5
- (k) Trade and other payables;
- (l) Provisions;
- (m) Financial liabilities (excluding amounts shown under (k) and (l));
- (n) Liabilities and assets for current tax, as defined in IAS 12 Income Taxes;
- (o) Deferred tax liabilities and deferred tax assets, as defined in IAS 12;
- (p) Liabilities included in disposal group classified as held for sale under IFRS 5
- (q) Non-controlling interest, presented within equity; and
- (r) Issued capital and reserves attributable to owners of the parent.

IAS 1 Para 54

2. Held for sale and disposal groups:

The following items are also to be disclosed in the statement of financial position:

- (a) the total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5;
- (b) liabilities included in disposal groups classified as held for sale in accordance with IFRS 5.

3. **Additional line items, headings and subtotals:** when relevant to an understanding of the entity's financial position, additional line items, headings and subtotals may be presented in the statement of financial position.

A proforma of the Statement of financial position is given below:

XYZ Group – Statement of financial position as at 31 December 20X7 (in thousands of currency units)

	20X7 Tshs	20X6 Tshs
Assets		
Non-current assets		
Property, plant and equipment	XX	XX
Goodwill	XX	XX
Other intangible assets	XX	XX
Investments in associates	XX	XX
Total Non-current Assets	XXX	XXX
Current assets		
Inventories	XX	XX
Trade receivables	XX	XX
Other current assets	XX	XX
Cash and cash equivalents	XX	XX
Total Current Assets	XXX	XXX
Total assets	XXX	XXX
Equity and liability		
Share capital	XX	XX
Retained earnings	XX	XX
Other components of equity	XX	XX
	XXX	XXX
Non-controlling interest	XX	XX
Total equity	XXX	XXX
Non-current liabilities Long-term		
borrowings	XX	XX
Deferred tax	XX	XX
Long-term provisions	XX	XX
Total non-current liabilities	XXX	XXX
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	XXX	XXX
Total liabilities	XXX	XXX
Total equity and liabilities	XXX	XXX

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3.8 Information to be presented either in the statement of financial position or in the notes



Definition

As a minimum, the face of the statement of financial position should include line items that present the following amounts:

1. For each class of share capital:
 - (a) the number of shares authorised;
 - (b) the number of shares issued and fully paid, and issued but not fully paid;
 - (c) par value per share, or that the shares have no par value;
 - (d) a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
 - (e) the rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
 - (f) shares in the entity held by its subsidiaries or associates; and
 - (g) shares reserved for issue under options, including terms and amounts.
2. Nature and purpose of each reserve in the equity.

IAS 1 Para 79

The sub classification of line item should be classified in a manner appropriate to the entity's operations. This subclassification can be either disclosed in statement of financial position or in the notes. For example:

- (a) Classification of items of property, plant and equipment according to IAS 16;
- (b) Classification of receivables into trade receivables, related party receivables, prepayments and other amounts;
- (c) Classification of inventories according to IAS 2, such as merchandise, production supplies, materials, work in progress and finished goods;
- (d) Classification of provisions for employee benefits and other items; and
- (e) Classification of equity capital and reserves disaggregated into various classes, such as paid-in capital, share premium and reserves.

Assets and liabilities, and income and expenses, **should not be offset unless required or permitted by a Standard or an Interpretation.**

Figures for assets and liabilities, as well as income and expenses, are disclosed separately.



Example

The trade payables control account shows a balance of Tshs100 million. There are credit balances in the accounts of individual parties totalling Tshs115 million, and debit balances of Tshs15 million representing advances given to suppliers. The two are disclosed separately as assets (Tshs15 million) and liabilities (Tshs115 million) respectively.

3.9 Statement of profit or loss and other comprehensive income

IAS 1 gives a choice to entities to present profit or loss and other comprehensive income in either:

1. a single statement of statement of profit or loss and other comprehensive income; or
2. two statements: a statement displaying components of profit or loss (referred to as statement of profit or loss), and a second statement beginning with profit or loss and displaying the components of OCI (referred to as statement of profit or loss and other comprehensive income).

Further a statement of profit or loss and other comprehensive income can be prepared under two formats:

Based on the function of expenses Based on
the nature of expenses

The formats under both these methods are given below for reference.

**Tip**

An entity may use titles for the income statement other than those used in IAS 1 Presentation of financial statements. For example, an entity may use the title 'statement of comprehensive income' instead of 'statement of profit or loss and other comprehensive income'.

A proforma of statement of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by function is given below:

XYZ Group – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7

	20X7 Tshs	20X6 Tshs
Revenue	XX	XX
Cost of sales	(XX)	(XX)
Gross profit	XXX	XXX
Other income	XX	XX
Distribution costs	(XX)	(XX)
Administrative expenses	(XX)	(XX)
Other expenses	(XX)	(XX)
Finance costs	(XX)	(XX)
Share of profit of associates	(XX) / XX	(XX) / XX
Profit before tax	XXX	XXX
Income tax expense	(X)	(X)
Profit for the year from continuing operations	X	X
Loss for the year from discontinued operations	-	(X)
PROFIT FOR THE YEAR	XXX	XXX
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	XX	XX
Actuarial gains (losses) on defined benefit pension plans	(XX)	XX
Gain on investment in Equity instruments	XX	XX
Share of other comprehensive income of associates	XX	(XX)
Income tax relating to items that will not be reclassified	(XX)	(XX)
Items that may be reclassified to profit or loss		
Exchange differences on translating foreign operations	XX	XX
Cash flow hedges	(XX)	(XX)
Income tax relating to items that will may be reclassified	(XX)	(XX)
Other comprehensive income for the year, net of tax	(XXX)	XXX
Total comprehensive income for the year	XXX	XXX
Profit attributable to:		
Owners of the parent	X	X
Minority interest	X	X
	X	X
Total comprehensive income attributable to:		
Owners of the parent	X	X
Minority interest	X	X
	X	X
Earnings per share (in currency units)		
Basic and diluted	X	X

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A proforma of statement of profit or loss and other comprehensive income in one statement and the classification of expenses within profit by nature of expenses is given below:

XYZ Group – Statement o profit or loss for the year ended 31 December 20X7

	20X7 Tshs	20X6 Tshs
Revenue	XX	XX
Other income	XX	XX
Changes in inventories of finished goods and work in progress	(XX)	(XX)
Work performed by the entity and capitalised	XX	XX
Raw material and consumables used	(XX)	(XX)
Employee benefits expense	(XX)	(XX)
Depreciation and amortisation expense	(XX)	(XX)
Impairment of property, plant and equipment	(XX)	-
Other expenses	(XX)	(XX)
Finance costs	(XX)	(XX)
Share of profit of associates	XX	XX
Profit before tax	XXX	XXX
Income tax expense	(XX)	(XX)
Profit for the year from continuing operations	XXX	X
Loss for the year from discontinued operations	-	(XX)
Profit for the year	XXX	XXX

The other comprehensive part of the statement of profit or loss and other comprehensive remains same irrespective of the nature of expense or function of expense format being adopted and hence it is not repeated again in the nature of expenses profoma.



Important

The statement of profit or loss and other comprehensive income based on function of expenses and nature of expenses can be presented in two statements format in accordance with IAS1. This can be done by separating

- the profit or loss part and referring it as statement of profit or loss and
- other comprehensive income part and referring it as statement of profit or loss and other comprehensive income

Information to be presented in the statement of profit or loss and OCI

IAS requires particular information to be presented in the statement of profit or loss and OCI



Definition

Information to be presented in the profit or loss section of statement of profit or loss and other comprehensive income

In addition to items required by other IFRS, the profit or loss section shall include line items that present the following amounts for the period:

- Revenue;
- Finance costs;
- Share of the profit or loss of associates and joint ventures accounted for using the equity method;
- Tax expense;
- A single amount for the total of discontinued operations (see IFRS 5);

An entity shall present the following items, in addition to the profit or loss and other comprehensive income sections, as allocation of profit or loss and other comprehensive income for the period:

- i. **Profit or loss for the period attributable to** non-controlling interests, and owners of the parent.
- ii. **Comprehensive income for the period attributable to**
 - non-controlling interests, and
 - owners of the parent

Information to be presented in the other comprehensive income section

The component of other comprehensive income includes:

OCI items that can be reclassified into profit or loss

- Foreign exchange gains or losses arising from translating the financial statements of a foreign operation (see IAS 21 The Effects of Changes in Foreign Exchange Rates);
- Effective portion of gains and losses on hedging instruments in a cash flow hedge (see IAS 39 Financial Instruments: Recognition and Measurement);

OCI items that cannot be reclassified into profit or loss

- changes in revaluation surplus (see IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets);
- measurements of plan assets and defined benefit obligations under IAS 19 Employee benefits
- gains and losses from equity instruments measured at fair value through other comprehensive income
- for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of IFRS 9)

Additional line items, headings and subtotals should be presented in the statement of profit or loss and OCI when such presentation is relevant to an understanding of the entity's financial performance.

IAS 1 Para 7, 81A, 81B 82, 83, 84



Important

Total Comprehensive income = Profit for the period + Other comprehensive income

Other issues

(a) Profit or loss for the period

All items of **income and expense recognised** in a period **are included in the statement of profit or loss to determine profit for the period**, except where a Standard or Interpretation requires otherwise.



Example

IAS 8 specifies two circumstances, the correction of errors and the effect of changes in accounting policies. These items are recognised directly as changes in the equity.

(b) Changes to the presentation of other comprehensive income

In June 2011, IASB has made some minor amendments to IAS 1 regarding the change in grouping of items presented in other comprehensive income. The OCI items have to be categorised in two sections:

- Items that can be reclassified (or 'recycled') to profit or loss at a future point in time
- Items that cannot be reclassified (or 'recycled') to profit or loss at a future point in time

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The amendments do not change the nature of the items that are currently recognised in OCI, nor does it impact the determination as to whether items in OCI are reclassified through profit or loss in future periods.

The reason for this amendment is to assist users in a better understanding of the financial performance achieved and in making projections of future financial performance.

(c) Reclassification adjustment



Definition

Reclassification adjustments are amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or previous periods.

IAS 1, Para 7

Amounts previously recognised in other comprehensive income are reclassified as profit or loss according to the requirements of respective IFRSs. It is necessary to remove those items from other comprehensive income, so as to avoid including them in total comprehensive income twice.

This kind of presentation will be very useful since it separates the unrealised gain from the realised gain.

An entity may present reclassification adjustments in the statement of profit or loss and OCI or in the notes. An entity presenting reclassification adjustments in the notes presents the components of other comprehensive income after any related reclassification adjustments.

Reclassification adjustments arise, for example, on disposal of a foreign operation (see IAS 21), on derecognition of investment in equity instruments financial assets (see IFRS 9) and when a hedged forecast transaction affects profit or loss (see paragraph 100 of IFRS 9 in relation to cash flow hedges).

Reclassification adjustments do not arise on changes in revaluation surplus recognised in accordance with IAS 16 or IAS 38 or on actuarial gains and losses on defined benefit plans recognised in accordance with paragraph 93A of IAS 19. These components are recognised in other comprehensive income and are not reclassified to profit or loss in subsequent periods.

Extraordinary items

The original version of IAS 8, then entitled Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies, required extraordinary items to be disclosed in the statement of profit or loss and OCI.

The requirement has been withdrawn now. An entity **should not present** any income or expense as an **extraordinary item**, either in the statement of profit or loss and OCI or in the notes.



Example

A loss caused by fire was agreed at Tshs50 million. This loss used to be separately disclosed and called an extraordinary item. Now it will not be called an extraordinary item. However, if management is of the opinion that the amount is material, separate disclosure may be made either in the financial statements or in the notes, without calling it an extraordinary item.



Test Yourself 2

Barney PLC has the following items in its trial balance for the year ended 30 September 20X9

- Gain on valuation of Investment in equity instruments financial assets
- Interest expense
- Exchange differences on translating foreign operations
- Administrative expenses
- Gains on property revaluation
- Revenue
- Remeasurement of defined benefit obligation

- Cost of sales
- Distribution costs
- Share of profit of associates
- Income tax expense

Required:

Where should each of these items be shown in the statement of profit or loss and OCI according to IAS 1?



Example

The following trial balance relates to Zapak Technologies, a publicly listed company, at 30 September 20X8

	Tshs'000	Tshs'000
Ordinary share capital		300,000
Retained profits at 1 October 20X7		243,000
6% Loan note (issued in 20X6)		75,000
Trade receivables	72,000	
Inventory 1 October 20X7	53,250	
Land and Building: at valuation (Note 3)	195,000	
Bank	634,500	
Investment in equity instruments financial asset	37,500	
Defined benefits plan assets	30,000	
Long term borrowings		30,000
Defined benefits plan liabilities		37,500
Trade payables		67,500
Revenue		444,750
Purchases	117,750	
Operating expenses	43,500	
Loan interest paid	2,250	
Interim dividend	12,000	
	1,197,750	1,197,750

The following notes are relevant:

- At 30 September 20X8, the inventory amounted to Tshs57.75 million at cost.
- The directors have estimated the provision for income tax for the year to 30 September 20X8 at Tshs33 million.
- On 1 October 20X7, Zapak Technologies revalued its land and buildings.

The details are:

	Cost 01/07/ 20X2 Tshs'000	Valuation 01/10/20X7 Tshs'000
Land	30,000	37,500
Building	120,000	157,500

The building had an estimated life of 40 years when it was acquired and this has not changed as a result of the revaluation. Depreciation is on a straight line basis. The revaluation surplus has been added to the revaluation surplus; no other movements on the revaluation surplus have been recorded.

- Investment in equity instruments was valued at Tshs45 million at the reporting date.

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- The company decides to recognise the actuarial losses on defined benefit pension plan obligations amounting to Tshs750,000.
- The income tax rate is 30%.

Required:

Prepare a statement of profit or loss and other comprehensive income for the year to 30 September 20X8.

Answer

Statement of profit or loss and other comprehensive income for the year ended 30 September 20X8

	Tshs'000
Revenue	444,750
Cost of sales (W1)	(117,750)
Gross profit	327,000
Operating expenses	(43,500)
Profit from operations	283,500
Finance costs (W2)	(4,500)
Profit before tax	279,000
Tax expense	(33,000)
Profit for the year	246,000
Other comprehensive income – Not reclassified subsequently	
Gain on investment in equity (Tshs45,000 - Tshs37,500)	7,500
Gain/(loss) on property revaluations – land & buildings (W3)	60,000
Actuarial loss on defined benefit pension plans	(750)
Income tax relating to components of other comprehensive income (Tshs7,500 + Tshs60,000 – Tshs750) x 30%	(20,025)
Other comprehensive income for the year	46,725
Total comprehensive income for the year (Tshs246,000 + Tshs46,725)	292,725

Workings

W1 Cost of sales

	Tshs'000	Tshs'000
Opening inventory	53,250	
Purchases	117,750	
Closing inventory Cost of materials	(57,750)	113,250
Depreciation on building (W3)		4,500
		117,750

W2 Finance costs

	Tshs'000
Loan interest paid	2,250
Accrued ((Tshs75,000 x 6%) – Tshs2,250))	2,250
	4,500

W3 Land and building

	Land Tshs'000	Building Tshs'000	Total Tshs'000
Value at 1 September 20X2	30,000	120,000	150,000
Depreciation (120,000/40 x 5)	-	(15,000)	(15,000)
Carrying value at date of revaluation (1 September 20X7)	30,000	105,000	135,000
Valuation 1 September 20X7	37,500	157,500	195,000
Revaluation surplus	7,500	52,500	60,000

Note: (Amounts in Tshs'000)

The trial balance contains the revalued total balance of Tshs195,000, which means that the revaluation has been accounted for.

Depreciation = Revised value / Balance life = Tshs157,500 / (40 – 5) = Tshs4,500 (taken to W1)

**Test Yourself 3**

By making use of the following information, prepare the statement of profit or loss and other comprehensive income using both the methods of classification of expenses:

	Tshs'000
Purchases	92,000
Opening inventory	35,000
Closing inventory	5,000
Revenue	250,000
Administrative wages	50,000
Factory wages	23,000
Distribution staff wages	25,000
Depreciation -Factory	14,000
Depreciation –Administration section	7,500
Other income	81,000
Other expenses	37,500

**Tip**

All the items in other comprehensive income are unrealised gains or losses; however, all unrealised gains or losses may not necessarily be a part of other comprehensive income example- Investment property gain when fair value model is followed.

3.10 Information to be presented in the statement of change in equity

The statement of changes in equity presents all changes in all components of equity.

IAS 1 stipulates that certain details are to be disclosed in the statement of changes in equity, whereas others are to be disclosed either in the statement of changes in equity or in the notes.



Important

An entity shall show the following **in the statement of changes in equity**:

- (a) Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interest;
- (b) For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with IAS 8.
- (c) For each component of equity, reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:
 - (i) profit or loss;
 - (ii) each item of other comprehensive income: and
 - (iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control

IAS 1 Para 106

The statement of changes in equity presents all changes in all components of equity. Components of equity include each class of contributed equity, the accumulated balance of each class of other comprehensive income and retained earnings.

IAS 1 requires an entity to present dividends recognised as distributions to owners during the period and related amounts per share in the statement of changes in equity or in the notes.

Possible reasons for changes in equity are:

1. profit or loss for the period;
2. other comprehensive income during the period; and
3. **other transactions** between the entity and the shareholders or owners (for example, equity contributions and withdrawals, buyback of shares, dividends distributed, and the transaction costs directly related to such transactions).

Statement of changes in Equity

A pro forma (based on the format presented at the end of revised IAS 1)

(All figures in Tshs)
XYZ group- Statement of changes in equity for the year ended 31 December 20X7

	Other components of equity				Total
	Share capital	Retained earnings	Revaluation surplus	Cash flow hedges	
	Tshs	Tshs	Tshs	Tshs	Tshs
Balance at 1 Jan 20X7	X	X	X	X	X
Issue of share capital	X	-	-	-	X
Dividend	-	(X)	-	-	(X)
Total comprehensive income for the year	-	X	X	X	X
Transfer to retained earnings	-	X	(X)	-	-
Balance at 31 Dec 20X7	X	X	X	X	X



Test Yourself 4

Ramco earned profit of Tshs1.6m during 20X7, and distributed dividends of Tshs0.4m.

During the year, it issued 500,000 shares of Tshs1 each at a premium of 25%.

It revalued its property of Tshs2.4m to Tshs3.0m. The deferred tax liability due to the revaluation is Tshs0.12m.

The difference between depreciation on original cost and depreciation on the revalued amount was Tshs30,000, which was to be transferred to realised profit according to the company's accounting policy.

	Tshs'000
Balances at 01/01/20X7	
- Retained profits	2,100
- Revaluation reserve	400
- Ordinary shares	1,000
- Share premium	50

Required:

Present a statement of changes in equity for Ramco for the year ended 31 December 20X7

3.11 Statement of cash flows

The discussion on statement of cash flows has already been covered in Paper A3: Accounting. Students are advised to refer to the same to understand the preparation of statement of cash flows in accordance with IAS 7 Statement of Cash Flows.

To summarise

The statement of financial position and statement of profit or loss and other comprehensive income are prepared under the rules of accrual accounting. The concept of accrual however does not show the actual movement of cash into and out of the company. For example, credit sale and credit purchases are accounted for by the accrual system of accounting. However, the users of financial statements also need information on the liquidity of the entity, as there needs to be sufficient cash to pay the liabilities as they become due.

The statement of cash flows shows the movement of cash under three distinct sections of the cash flow cycle and allows users to assess the cash flows and their sources.

1. Cash flow from operating activity
2. Cash flow from investing activity
3. Cash flow from financing activity

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A proforma of a cash flow statement with imaginary figures is given below for your reference (Indirect method)

Indirect method statement of cash flows (with imaginary figures)		
	Tshs'000	Tshs'000
Cash flows from operating activities		
Profit before taxation	640	
Adjustments for		
Depreciation	90	
Loss on sale of non-current assets	30	
Investment income	(20)	
Interest expense	200	
	940	
Decrease / (Increase) in trade and other receivables	(70)	
Decrease / (Increase) in inventories	80	
Increase / (Decrease) in trade payables	50	
Cash generated from operations	1,000	
Interest paid	(200)	
Income taxes paid	(250)	
Net cash from operating activities		550
Cash flows from investing activities		
Purchase of property, plant and equipment	(300)	
Proceeds from sale of equipment	40	
Interest received	30	
Dividends received	20	
Net cash received from / (used in) investing activities		(210)
Cash flows from financing activities		
Proceeds from issue of share capital	700	
Proceeds from / (repayments of) long-term borrowings	(300)	
Payment of finance lease liabilities	(200)	
Dividends paid	(400)	
Net cash received from / (used in) financing activities		(200)
Net increase / (decrease) in cash and cash equivalents (Tshs550 – Tshs210 – Tshs200)		140
Cash and cash equivalents at beginning of period		50
Cash and cash equivalents at end of period		190

A statement of cash flow can also be prepared under the direct method in accordance with IAS 7 Statement of Cash flows

3.12 Notes to financial statements

The topic 'notes to the financial statements' will be discussed in detail below, under the following subheadings:

- Structure
- Disclosure of accounting policies
- Key sources of estimation uncertainty
- Capital
- Other disclosures

1. Structure



Definition

The notes shall:

- Present information about the basis of preparation of the financial statements and the specific accounting policies.
- Disclose the information required by IFRSs that is not presented elsewhere in the financial statements.
- Provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of them.

Notes should, as far as practicable, be presented in a systematic manner. Each item in the statement of financial position, statement of profit or loss and OCI, statement of changes in equity and statement of cash flow **should be cross-referenced to any related information in the notes.**

IAS 1 Para 112-113

Notes are normally presented in the **following order**:

- (a) A statement of compliance with IFRS.
- (b) A summary of significant accounting policies applied.
- (c) Supporting information for items presented in the statements of financial position and of statement of profit or loss or OCI and in the statements of changes in equity and of cash flows, in the order in which each statement and each line item is presented; and (d) Other disclosures including:
 - (i) Contingent liabilities; and
 - (ii) Non-financial disclosures.

Sometimes, it may be convenient to vary the order and combine two disclosures at one place.



Example

Information on changes in the fair value of financial instruments recognised in the statement of profit or loss and information about their maturity dates may be disclosed together.

2. Disclosure of accounting policies

Disclosure of accounting policies is so important for the understanding of the financial statements that IAS 1 states that an entity may present these as a separate component of the financial statements.

In accordance with IAS 1, an entity should disclose in the summary of significant accounting policies:

- (a) The measurement basis (or bases) used in preparing the financial statements; and
- (b) The other accounting policies used that are relevant to an understanding of the financial statements.

(a) Disclosure regarding the measurement basis

Under this disclosure it is essential to disclose:

- the basis for measurement i.e. under historical cost or current cost or net realisable value
- whether going concern status has been assumed
- compliance with the accrual basis of accounting
- whether policies are in accordance with IFRSs (International Financial Reporting Standards)



Example

Historical cost, current cost, net realisable value, fair value, or recoverable amount may be used for measuring a particular item. It is essential that the user of the financial statements is informed of the basis selected.

(b) Other relevant accounting policies used

Normally, all transactions of entities fall within the purview of the relevant accounting standards. Therefore disclosures in the financial statements, with respect to accounting policies are to be made in accordance with the relevant accounting standards.

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An extract on disclosure of accounting policy is given below for reference.



Example

Zentel Ltd – Extract of notes to financial statements for the year ended 31 December 20X1.

1. Property, Plant and Equipment:

- Property plant and equipment are initially recorded at cost Direct costs are capitalized until the assets are ready for use. The assets are carried at cost, less accumulated depreciation and impairments, if any.
- Property, plant and equipment are depreciated on a straight line basis over their estimated useful lives. The Management estimates the useful lives of the assets as follows:

Buildings	20 years
Plant and machinery	10 years
Furniture and fixtures	13 years
Vehicles	5 years

Depreciation methods, useful lives and residual values are reviewed at each reporting date.

The carrying amounts and the movements in the balances are as follows:

Schedule of property, plant and equipment

Tshs million

Cost or valuation	Buildings	Plant and machinery	Furniture and fixtures	Vehicles	Total
Balance at 1 January 2011	1,500	1,700	150	300	3,650
Additions		500			500
Disposals				(50)	(50)
Balance at 31 December 2011 (a)	1,500	2,200	150	250	4,100
Depreciation					-
Balance at 1 January 2011	150	510	23	60	743
Depreciation for the year	75	220	11	50	356
Removals				(10)	(10)
Balance at 31 December 2011 (b)	225	730	34	100	1,089
Net carrying value (a) -(b)	1,275	1,470	116	150	3,011

2. Intangible assets:

- Intangible assets are initially recorded at the consideration paid for acquisition of such assets and are carried at cost less accumulated amortization and impairment.
- Intangible assets consist of software, patents and licenses The Company amortizes intangible assets on a straight-line basis over their respective estimated useful lives. Estimated useful lives for software, patents, licenses and other similar rights generally range from three to five years

Schedule of Intangible Assets

Tshs million

Cost	Software	Patents	Licenses	Total
Balance at 1 January 2011	300	150	100	550
Additions	100			100
Disposals				-
Balance at 31 December 2011 (a)	400	150	100	650
Amortisation				-
Balance at 1 January 2011	180	75	40	295
Amortisation for the year	120	38	20	178
Removals				-
Balance at 31 December 2011 (b)	300	113	60	473
Net carrying value (a) -(b)	100	37	40	177

3. Provisions and contingencies

A provision is recognized in the Statement of Financial Position when the Company has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. If the effect is material, provisions are recognized at a present value by discounting the expected future cash flows.

4. Events after the reporting period

The local government in Malaysia has announced that the company's vacant premises will be taken over and demolished by the government in order to build a public road. The carrying value of the premises at the reporting date is Tshs6.3 million. The company is in the process of negotiating compensation with the government and expects it to be fairly close to the carrying value.

5. Inventory

Inventory is valued at the lower of acquisition or production cost and net realizable value. The cost is generally determined on the basis of a first-in, first-out method. Production costs comprise direct material and labour and applicable manufacturing overheads, including depreciation charges. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses

At the reporting date, inventories costing Tshs1 million had a net realizable value of Tshs0.8 million. These inventories are written down to the net realizable value and the difference of Tshs0.2 million is charged to the cost of sales for the year 20X1.

The major areas for which disclosures are to be made are as follows:

- Accounting convention
- Use of estimates
- Revenue recognition
- Expenses e.g. research & development expenses
- Intangible assets including goodwill
- Impairment of assets
- Depreciation and amortisation
- Retirement benefits

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- Income taxes
- Foreign currency transactions
- Investments
- Inventories
- Accounts receivables
- Earnings per shares



Example

An entity subject to income taxes would be expected to disclose its accounting policies for income taxes, including those applicable to deferred tax liabilities and assets in accordance with IAS 12.

Accounting Policies Extract:

Deferred Tax Items:

In accordance with IAS 12, deferred tax is provided on all temporary differences between the tax basis of the individual companies and the consolidated financial statements. Tax loss carried forward, which is likely to be utilised in the future is recognised as an asset in the amount of deferred tax asset.

The total amount of deferred tax asset, which cannot be recognised as an asset as at 31 December 20X4, is Tshs225 million.



Important

We have discussed the preparation of financial statement extracts in accordance with the accounting policy chosen in various Study Guides under Section B.

For example:

In Study Guide B1 Tangible Non-current Assets, we discussed the preparation of financial statements based on the accounting policy chosen to measure tangible non-current assets (i.e. when the asset is measured under cost model or revaluation model, or when an asset is a held for sale asset or an investment property).

In Study Guide B4 Leases, we discussed the preparation of financial statements in the books of the lessor and lessee based on the accounting policy chosen to account for leases (operating lease or a finance lease).

In Study Guide B6 Financial Instruments, we discussed the various classifications of financial assets and financial liabilities and their impact on the financial statements.



Test Yourself 5

The following trial balance has been extracted from the books of Baywatch Ltd as at 30 September 20X8

	Tshs million	Tshs million
Administrative expenses	500	-
Share capital (3,500,000 ordinary shares of Tshs1,000 each)	-	3,500
Cash at bank and in hand	75	-
Tax (overpayment for the year to 30/09/20X6)	-	25
Distribution costs	750	-
Dividends received (on 31/03/ 20X8)	-	311
Freehold property:		
- at cost	3,375	-
- accumulated depreciation (at 01/10/20X7)	-	325
Interim dividend (paid on 30/06/20X8)	45	-
Investments	2,500	-
Plant and machinery:		
- at cost	6,500	-
- accumulated depreciation (at 01/10/20X7)	-	4,500
Retained earnings at 01/10/20X7		3,428
Purchases	20,000	-
Research expenditure	94	-
Inventory (at 01/10/20X7)	2,875	-
Trade payables	-	3,625
Trade receivables	3,375	-
Sales revenue	-	24,375
Total	40,089	40,089

Additional information

- (i) The inventory at 30 September 20X8 was valued at Tshs4,500 million
- (ii) Depreciation for the year to 30 September 20X8 is to be charged on the historic cost of the non-current assets as follows:
 - Plant and machinery: 15 per cent
 - Freehold property: 5 per cent
- (iii) On 30 September 20X8, the directors proposed a final dividend of Tshs750 per share
- (iv) The company was incorporated in 20X1
- (v) Tax based on the profits for the year at a rate of 35 per cent is estimated to be Tshs1,062.5 million

Required:

Prepare the following financial statement of Baywatch for the year ended 30 September 20X8 in accordance with IAS 1 "Presentation of Financial Statements".

- Statement of profit or loss and other comprehensive income
- Statement of changes in equity
- Statement of financial position

Note: notes to the financial statements are not required. Round all figures to the nearest thousand Tshs

6. Draft and compile financial statements, or extracts of financial statements, of an entity in accordance with its chosen policies and IPSAS.

[Learning Outcomes f]

IPSAS1 Presentation of Financial Statements deals with the format and content of financial statements prepared under IPSAS. This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 1 (Revised 2003), "Presentation of Financial Statements," published by the International Accounting Standards Board (IASB).

IPSAS1 applies to all general purpose financial statements prepared and presented under the accrual basis of accounting in accordance with IPSASs.

4.1 Components of financial statements



Definition

A complete set of financial statements comprises:

- (a) A statement of financial position;
- (b) A statement of financial performance;
- (c) A statement of changes in net assets/equity;
- (d) A cash flow statement;
- (e) When the entity makes publicly available its approved budget, a comparison of budget and actual amounts either as a separate additional financial statement or as a budget column in the financial statements; and
- (f) Notes, comprising a summary of significant accounting policies and other explanatory notes.

IPSAS 1, Para

Public Sector Entity—Statement of Financial Position as at 31 December 20X2 ((in thousands of currency units)

	20X2	20X1
ASSETS		
Current assets		
Cash and cash equivalents	X	X
Receivables	X	X
Inventories	X	X
Prepayments	X	X
Other current assets	X	X
	X	X
Non-current assets		
Receivables	X	X
Investments in associates	X	X
Other financial assets	X	X
Infrastructure, plant and equipment	X	X
Land and buildings	X	X
Intangible assets	X	X
Other non-financial assets	X	X
	X	X
Total assets	X	X

Continued on the next page

Regulatory Requirement Relating to the Preparation of Financial Statements: 341

LIABILITIES		
Current liabilities		
Payables	X	X
Short-term borrowings	X	X
Current portion of long-term borrowings	X	X
Short-term provisions	X	X
Employee benefits	X	X
Superannuation	X	X
	X	X
Non-current liabilities		
Payables	X	X
Long-term borrowings	X	X
Long-term provisions	X	X
Employee benefits	X	X
Superannuation	X	X
	X	X
Total liabilities		
Net assets		
NET ASSETS/EQUITY		
Capital contributed by	X	X
Other government entities	X	X
Reserves	X	X
Accumulated surpluses/(deficits)	X	X
Minority interest	X	X
Total net assets/equity	X	X

**Public Sector Entity—Statement of Financial Performance for the year ended 31 December 20X2
(Illustrating the Classification of Expenses by Function)**

	20X2	20X1
Revenue	X	X
Taxes	X	X
Fees, fines, penalties, and licenses	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other revenue	X	X
Total revenue	X	X
Expenses		
General public services	(X)	(X)
Defense	(X)	(X)
Public order and safety	(X)	(X)
Education	(X)	(X)
Health	(X)	(X)
Social protection	(X)	(X)
Housing and community amenities	(X)	(X)
Recreational, cultural, and religion	(X)	(X)
Economic affairs	(X)	(X)
Environmental protection	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Total expenses	(X)	(X)
Share of surplus of associates	(X)	(X)
Surplus/(deficit) for the period	X	X
Attributable to:		
Owners of the controlling entity	X	X
Minority interests	X	X
	X	X

342: Preparing Financial Statements

Public Sector Entity—Statement of Financial Performance for the year ended 31 December 20X2

(Illustrating the Classification of Expenses by Nature)

	20X1	20X2
Revenue		
Taxes	X	X
Fees, fines, penalties, and licenses	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other revenue	X	X
Total Revenue	X	X
Expenses		
Wages, salaries, and employee benefits	(X)	(X)
Grants and other transfer payments	(X)	(X)
Supplies and consumables used	(X)	(X)
Depreciation and amortization expense	(X)	(X)
Impairment of property, plant, and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Total Expenses	(X)	(X)
Share of surplus of associates	X	X
Surplus/(deficit) for the period	X	X
Attributable to:		
Owners of the controlling entity	X	X
Minority interest	X	X
	X	X

Public Sector Entity—Statement of Changes in Net Assets/Equity for the Year Ended December 31, 20X1

	Contributed capital	Other Reserves	Translation reserve	Accumulated surpluses/ (Deficit)	Total	Minority	Total net assets / equity
	Tshs	Tshs	Tshs	Tshs	Tshs	Tshs	Tshs
Balance at December 31, 20X1 brought forward	X	X	(X)	X	X	X	X
Changes in net assets/equity for 20X2							
Loss on property revaluation		(X)			(X)	(X)	(X)
Gain on revaluation of investments		X			X	X	X
Exchange differences on translating foreign operations			(X)		(X)	(X)	(X)
Net revenue recognized directly in net assets/equity		(X)	(X)		(X)	(X)	(X)
Deficit for the period				(X)	(X)	(X)	(X)
Total recognized revenue and expense for the period		(X)	(X)	(X)	(X)	(X)	(X)
Balance at December 31, 20X2	X	X	(X)	X	(X)	X	X

Note - IPSAS 1 requires a comparative statement of changes in equity to be prepared each year which accompanies the financial statements.

Regulatory Requirement Relating to the Preparation of Financial Statements: 343

IPSAS have generally been based on IFRSs which are adopted to address the needs of the public sector. Some of the key differences between the two sets of accounting standards include:

	IPSASs	IASs / IFRSs
Presentation of financial statements	It always refers to sales as "Revenue". IPSAS does not incorporate the concept of comprehensive income.	It uses the terminology "Sales".
Extraordinary items	IPSAS 1 does not explicitly preclude the presentation of items of revenue and expense as extraordinary items either on the face of the statement of financial performance or in the notes.	IAS 1 prohibits any items of income and expense to be presented as extraordinary items either on the face of the statement of profit or loss or notes.
Financial instruments	IPSAS 28,29 and 30 are modelled on IAS 32 and 39 – Financial assets and liabilities are classified based on IAS 39 principles.	IAS 39 has been revised by the IASB and a new standard - IFRS 9 - has replaced most of the IAS 39 requirements.
Income taxes	IPSAS presumes that entities that operate within the public sector are generally exempt from income taxes and therefore does not cater to the accounting of income taxes.	IAS 12 deals with accounting for current tax and deferred tax.
Consolidation	IPSAS are still based on IAS 27 Consolidated and Separate Financial Statements, IAS 28 Investments in Associates and IAS 31 Interest in Joint Ventures. The definition of control is limited and needs to be revised.	IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements and IFRS 12 Disclosures of Interests in Other Entities deals with consolidated financial statements. The definition of control is elaborate in these standards.
Construction contracts	IPSAS 11 covers only noncommercial contracts. A deficit does not have to be recognized on a contract when contract costs exceed total contract revenues, if the intention at the inception of the contract was not to fully recover contract costs of the parties to that contract.	It covers all commercial and noncommercial contracts. A loss on a construction contract has to be recognised immediately in the statement of profit or loss.
Provisions, Contingent Liabilities And Contingent Assets	Obligations arising from social benefits provided by an entity are excluded from the scope.	A provision has to be made if there is a probable outflow of resources.
Borrowing costs	IPSAS 5 requires borrowing costs to be recognized as an expense in the period in which they are incurred.	IAS 26 requires capitalisation of borrowing costs for qualifying assets.

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Public sector specific guidance	IPSAS 21—Impairment of Non-Cash-Generating Assets • IPSAS 22—Disclosure of Information about the General Government Sector • IPSAS 23—Revenue from Non-Exchange Transactions (Taxes and Transfers) • IPSAS 24—Presentation of Budget Information in Financial Statements	No such guidance is available under IASs / IFRSs.
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Answers to Test Yourself

Answer to TY 1

They are likely to manipulate the profit figure in such a manner as to show higher profits and earn higher remuneration.

Answer to TY 2

The following items should be included in the profit or loss part of statement of profit or loss and OCI:

- Revenue
- Cost of Sales
- Distribution costs
- Administrative expenses
- Finance costs
- Share of profit of associates
- Income tax expense

Note that share of associates' other comprehensive income attributed to owners will be included in the comprehensive income part

The following items should be presented in the other comprehensive income part as follows:

OCI items that may be subsequently reclassified to profit or loss

- Exchange differences on translating foreign operations

OCI items that cannot be reclassified to profit and loss

- Gains on valuation of Investment in equity instruments financial assets
- Gains on property revaluation
- Remeasurement of defined benefit obligations

Answer to TY 3

Nature of expense method

	Tshs'000
Revenue	250,000
Other income	81,000
Change in inventory and work in progress	(30,000)
Raw materials	(92,000)
Wages	(98,000)
Depreciation	(21,500)
Other expenses Profit	(37,500)
	52,000

Function of expenses method

	Tshs'000
Revenue	250,000
Cost of sales (Tshs35,000 + Tshs92,000 + Tshs23,000 - Tshs5,000)	(145,000)
Gross profit	105,000
Other income	81,000
Distribution costs	(25,000)
Administration costs (Tshs50,000 + Tshs21,500)	(71,500)
Other expenses Profit	(37,500)
	52,000

Answer to TY 4

Statement of profit or loss and other comprehensive income

	Tshs'000
Profit for the period (from SOPL)	1,600
Other comprehensive income	
Gains on revaluation of property	600
Tax effect of the revaluation	(120)
Total comprehensive income for the period (1,600 + 480)	2,080

Ramco – Statement of changes in equity for the year ended 31 December 20X7

	Retained profit Tshs'000	Revaluation surplus Tshs'000	Share Capital Tshs'000	Share premium Tshs'000	Total Tshs'000
Balance at 01/01/20X7	2,100	400	1,000	50	3,550
Changes in equity for 20X7					
Rights issue (500 x 1.00 + 500 x 0.25)			500	125	625
Comprehensive income for the period	1,600	480			2,080
Ordinary dividends paid	(400)				(400)
Transfer to realised profits	30	(30)			-
Balance at 31/12/20X7	3,330	850	1,500	175	5,855

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Answer to TY 5

Baywatch Ltd – Statement of profit or loss and other comprehensive income for the period to 30 September 20X8

	Tshs million	Tshs
Sales revenue		24,375
Less: Cost of sales (W1)		(18,375)
Gross profit		6,000
Distribution costs	750	
Administrative expenses (W2)	1,738	(2,488)
		3,512
Other operating income (W3)		311
Profit before taxation		3,823
Income tax expense (W4)		(1,038)
Profit for the financial year		2,785
Profit attributable to:		
Owners of the parent		2,785
Non-controlling interests		-
Total comprehensive income attributable to: Owners of the parent		2,785

Baywatch Ltd – Statement of changes in equity for the year ended 30 September 20X8

	Share capital	Retained earnings	Total
	Tshs million	Tshs million	Tshs million
Balance (01/10/20X7)	3,500	3,428	6,928
For the year (30/09/20X8)		2,785	2,785
Dividend (W5)		(2,670)	(2,670)
	3,500	3,543	7,043

Baywatch Ltd – Statement of financial position as on 30 September 20X8

	Tshs million	Tshs million
Non-current assets		
Land and buildings(W7)	2,881	
Plant and machinery (W8)	1,025	
Investments	2,500	6,406
Current assets		
Inventory	4,500	
Trade receivables	3,375	
Cash at bank	75	7,950
Total assets		14,356
Capital and reserves		
Share capital		
Retained earnings	3,500	7,043
3,543		
Current liabilities		
Trade payables		
Tax	3,625	
1,063		
Proposed dividend	2,625	7,313
Total liabilities		14,356

Workings

W1 Cost of sales

	Tshs million
Opening inventory	2,875
Add: Purchases	20,000
	22,875
Less: Closing inventory	(4,500)
	18,375

W2 Administrative expenses

	Tshs million	Tshs million
Per trial balance		500
Add: Research		94
		594
Add: Depreciation		
Property (5% x 3375)	169	
Plant (15% x 6,500)	975	1144
		1738

W3 Dividends received

Dividends received - Tshs311,000

W4 Tax

	Tshs million
Tax	1,063
Less: Overpayment last year	(25)
	1,038

W5 Dividend paid

	Tshs million
Interim	45
Final	2,625
	2,670

W7 Freehold property

	Tshs million
Cost	3,375
Less: Accumulated depreciation	(325)
Less: Depreciation for the year (W2)	(169)
	2,881

W8 Plant and machinery

	Tshs million
Cost	6,500
Less: Accumulated depreciation	(4,500)
Less: Depreciation for the year (W2)	(975)
	1,025

348: Preparing Financial Statements

Quick Quiz

1. Identify which of the following have to be presented in the statement of profit or loss and other comprehensive income
 - (i) Litigation settlements
 - (ii) Revenue
 - (iii) Gain / loss on disposal of property
 - (iv) Tax expense
2. What are the two methods of classifying expenses while presenting the statement of profit or loss and other comprehensive income?
3. What are the requirements of IAS 1 regarding material items of income and expense?
4. What are the possible reasons for changes in equity and where are they presented in the financial statements?
5. What are the three heads under which a statement of cash flows is broadly divided?

Answers to Quick Quiz

1. (ii). and (iv). are to be presented in statement of profit or loss and other comprehensive income. Others can be presented either in statement of profit or loss and OCI or in the notes.
2. Nature of expense method and function of expense or cost of sales method.
3. When items of income and expense are material, their nature and amount shall be disclosed separately.
4. The possible reasons are:
 - **Income and expenses recognised** during the period.
 - **Other transactions** between the entity and its shareholders (for example, equity contributions and withdrawals, buyback of shares, dividends distributed, and the transaction costs directly related to such transactions).
5. The three heads under which a statement of cash flow is broadly divided are:
 - Cash flow from operating activities
 - Cash flow from investing activities
 - Cash flow from financing activities

Self Examination Question

Question 1

The following trial balance relates to Orchid Ltd at 31 March 20X9:

	Tshs'000	Tshs'000
Sales revenue		384,840
Cost of sales	258,840	
Operating expenses	40,320	
Closing inventories: 31 March 20X9 (Note (i))	18,900	
Finance costs (Note (ii))	9,000	
Land and building: at valuation (note (iii))	113,400	
Plant and equipment: at cost (Note (iii))	64,800	
Accumulated depreciation 1 April 20X8 – plant and equipment		30,240
Investment property: valuation 1 April 20X8 (Note (iii))	28,800	
Investment in equity instruments financial asset	20,000	
Rental income from investment property		2,160
Trade receivables	38,700	
Bank		21,620
Trade payables		21,240
Ordinary shares of Tshs1,000 each		36,000
10% Redeemable preference shares of Tshs1,000 each		18,000
Deferred tax at 31 March 20X8 (Note (v))		9,360
Revaluation surplus (Note (iii))		37,800
Retained earnings: 1 April 20X8		31,500
	592,760	592,760

Note:

- (i) At 31 March 20X9, an inventory list based on a physical count had a total cost of Tshs18.9 million. Some damaged goods that had cost Tshs1.44m were included in these. The realisable value of these goods is expected to be Tshs1.71m, provided that remedial work costing Tshs0.81m is done before they can be sold.
- (ii) Finance costs consist of interest on overdraft, the full year's preference dividend and an ordinary dividend of Tshs160 per share that was paid in September 20X8.
- (iii) Non-current assets:

Land and buildings: A professional valuer submitted a report on 1 April 20X8, revaluing the land at Tshs27 million and building at Tshs86.4 million. The directors decided to incorporate these values in the accounts. On that date, the land and building had a carrying value of Tshs75.6 million and the building had a remaining life of 15 years. You should charge depreciation on a straight line basis. Orchid Ltd does not make a transfer to realised profits in respect of excess depreciation.

Plant: All plant is depreciated at 12.5% on the reducing balance basis. Depreciation is to be charged to cost of sales.

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Investment property: On 31 March 20X9, the investment property was revalued at Tshs24.3 million. Orchid Ltd uses the fair value model in IAS 40 Investment Property to value its investment property.

- (iv) The provision for income tax for the year ended 31 March 20X9 is estimated at Tshs14.4 million. The tax base of the company's net assets is Tshs21.6 million less than their carrying amounts. Deferred tax is to be adjusted to reflect this. Carrying amounts do not include revaluation adjustments above. The rate of income tax is 30%.
- (v) The Investment in equity instruments financial asset was valued at Tshs16 million at the end of the reporting period, 31 March 20X9.

Required:

- (a) Prepare the statement of profit or loss and other comprehensive income for Orchid Ltd for the year ended 31 March 20X9.
- (b) Prepare the statement of financial position for Orchid Ltd as at 31 March 20X9.

Question 2

The following is the trial balance of Mandarin Ltd as at 31 December 20X7.

Trial balance	Tshs'000	Tshs'000
Ordinary shares each Tshs1,000 (fully paid)		1,400
Retained profit 01/01/20X7		968
General reserves 01/01/20X7		684
10 % debentures (issued in 20X4)		800
Freehold land & buildings 01/01/20X7 (cost)	1,720	
Plant and machinery 01/01/20X7 (cost)	3,320	
Provision for depreciation:		
Freehold buildings 01/01/20X7		80
Plant and machinery 01/01/20X7		888
Inventory 01/01/20X7	760	-
Sales		10,780
Purchases	8,608	
Wages and salaries	1,016	
Ordinary dividend (interim)	32	
Debenture interest	40	
Receivables	716	
Light and heat	124	
Sundry expenses	452	
Suspense account		540
Cash	132	
Payables		780
	16,920	16,920

Notes:

- The amount of sundry expenses includes Tshs36,000 paid in respect of insurance for the year ending 1 September 20X8.
- An invoice of Tshs12,000 for electricity for the three months ending 31 December 20X7, which was paid in February 20X8 was omitted to be recorded in light and heat expenses.

Regulatory Requirement Relating to the Preparation of Financial Statements: 351

3. The suspense account balance consists of the following:

	Tshs'000
Proceeds from the issue of 200 ordinary shares	480
Proceeds from the sale of plant	1,200
	1,680
Less: Investment in the shares of companies	(1,140)
	540

4. The freehold property was acquired a few years ago. The building element of the cost was estimated at Tshs400,000 and the estimated useful life of the assets was fifty years at the time of purchase. As at 31 December 20X7, the property is revalued at Tshs3,200,000.
5. The plant which was sold was initially purchased at a cost of Tshs1,400,000 and had a net book value of Tshs1,096,000 as at 1 January 20X7.
6. The applicable tax rate is 30%.
7. Tshs144,000 depreciation is to be charged on plant and machinery for 20X7.
8. The directors decided to provide for the following:
- Audit fees of Tshs16,000
 - Debenture interest due
 - A transfer to the general reserve of Tshs64,000
9. Inventory as at 31 December 20X7 was valued at Tshs880,000 (cost)

Required:

Prepare the financial statements of Mandarin Ltd in a form suitable for internal purposes.

Answer to Self-Examination Question
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Answer to SEQ 1

(a) Orchid Ltd – Statement of profit or loss and other comprehensive income for the year ended 31 March 20X9 (All figures in Tshs'000 unless specified)

	Tshs'000
Revenue	384,840
Cost of sales (W4)	(269,460)
Gross profit	115,380
Operating expenses	(40,320)
Investment income	2,160
Loss on investment property (W1)	(4,500)
Finance cost (W6)	(3,240)
Profit before tax	69,480
Income tax expense (W5)	(11,520)
Profit for the period	57,960
Other comprehensive income - not reclassified subsequently	
Gain on revaluation of land and building (Tshs113,400 – Tshs75,600)	37,800
Loss on Investment in equity instruments financial assets (20,000 – 16,000)	(4,000)
Income tax relating to components of other comprehensive income (Tshs37,800 - Tshs4,000) x 30%	(10,140)
Other comprehensive income for the year	23,660
Total comprehensive income for the year	81,620

(b) Orchid Ltd - SOFP as at 31 March 20X9

	Tshs'000	Tshs'000
Assets		
Non-current assets		
Property, plant and equipment (W3)		137,880
Investment property (W1)		24,300
Financial assets		16,000
		178,180
Current assets		
Inventories (W2)	18,360	
Trade receivables	38,700	57,060
Total assets		235,240

Equity and liabilities		
Ordinary shares of 25c each		36,000
Retained income (W7)		107,360
Non-current liabilities		
Deferred tax (W5) 6,480 + 10,140	16,620	
Redeemable preference shares of Tshs1,000 each	18,000	34,620
Current liabilities		
Trade payables		
Bank overdraft	21,240	
Current tax payable (W5)	21,620	
	14,400	57,260
Total equity and liabilities		235,240

Workings

W1 Investment property

	Tshs'000
Carrying value, per question	28,800
Valuation 31 March 20X6	(24,300)
Loss on valuation, to be transferred to profit for the period (IAS 40)	4,500

W2 Adjustment for damaged closing inventories

	Tshs'000
Cost of damaged inventories	1,440
Recoverable amount	1,710
Additional remedial costs	(810)
Fair Value Less Costs to Sell	900
Value of inventories per question	18,900
Write down = Tshs1,440 – Tshs900 per above (as NRV is lower)	(540)
Adjusted CV for the SOFP	18,360

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W3 Non-current assets

		Tshs'000
A	Land	27,000
	Buildings: per IAS 16, depreciation is based on revalued amount:	
	Revalued amount (a)	86,400
	Remaining life at the revaluation date in years (b)	15
	Depreciation on straight line basis = (a)/(b)	(5,760)
B	Net carrying amount of building	80,640
	Plant and equipment	
	Cost per question	64,800
	Accumulated depreciation, per question	(30,240)
	Carrying value 31 March 20X9, before depreciation	34,560
	Depreciation for the year on the above at 12.5%	(4,320)
C	Carrying value after depreciation at 31 March 20X9	30,240
	Total depreciation charge for the year = 5,760 + 4,320	10,080
	Summary	
	Land and building (A + B)	107,640
	Plant and equipment (C)	30,240
	Total (property, plant and equipment)	137,880

W4 Cost of sales

	Tshs'000
Per question	258,840
Adjustment for inventory (W2)	540
Depreciation (W3)	10,080
	269,460

W5 Taxation

	Tshs'000
Deferred tax	
Tax base of the company's assets is less than carrying value by	21,600
Tax effect of the above (deferred tax liability required) @ 30%	6,480
Existing deferred tax liability	9,360
Excess deferred tax liability, to be transferred to profit for the period	2,880
Current tax expense, according to question (ii)	14,400
Net tax expense according to question ((ii) – (i))	11,520

W6 Finance cost

	Tshs'000
Per question	9,000
Less: Equity dividend (36,000 shares x Tshs160)	(5,760)
	3,240

Note: dividend on redeemable preference shares are correctly included in the finance costs; therefore no adjustment is required.

W7 Retained income

	Tshs'000
Balance at 31 March 20X8 per question	31,500
Total comprehensive income for the year	81,620
Ordinary dividend	(5,760)
Balance at 31 March 20X9	107,360

Answer to SEQ 2**Mandarin Ltd - Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7**

	Tshs'000	Tshs'000
Revenue	-	10,780
Less: Cost of goods sold	-	-
Opening inventory	760	-
Purchases	8,608	-
	9,368	-
Less: Closing inventory	(880)	(8,488)
Gross profit	-	2,292
Other income	-	-
Profit on disposal of plant (W7)	-	104
Wages, salaries and commission	(1,016)	-
Sundry expenses (452 – 24 Prepaid insurance)	(428)	-
Light and heat (124 + 12)	(136)	-
Depreciation (W4)	-	-
Freehold buildings	(8)	-
Plant	(144)	-
Audit fees	(16)	-
Debenture interest	(80)	(1,828)
Profit before tax	-	568
Income tax expense (30% of 568)	-	(170)
Profit for the year	-	398
Other comprehensive income – Not reclassified to profit or loss	-	-
Gains on property revaluation (W6)	1,568	-
Income tax relating to components of other comprehensive income (30% of 1,568)	(470)	(1,098)
Total comprehensive income for the year	-	1,496

Mandarin Ltd - Statement of changes in equity for the year ended 31 December 20X7

	Share capital	Share premium account	Retained earnings	Revaluation surplus	General reserve	Total
	Tshs'000					
Balance at 01/01/20X7	1,400		968		684	3,052
Issue of share capital (W10)	200	280				480
Dividends paid			(32)			(32)
Total comprehensive income for the year			398	1,098		1,496
Transferred to general reserve			(64)		64	-
Balance as at 31/12/20X7	1,600	280	1,270	1,098	748	4,996

356: Preparing Financial Statements

Mandarin Ltd - Statement of financial position as at 31 December 20X7

	Tshs'000	Tshs'000
Non-current assets Tangible assets		
Freehold property	3,200	
Plant and machinery (W4)	1,192	
Investments	1,140	5,532
Current assets		
Inventory	880	
Receivables	716	
Pre-paid expenses (Insurance: 36 x 9/12)	24	
Cash	132	1,752
		7,284
Capital and reserves		
Share capital – Tshs1,000 par value of each ordinary shares		1,600
Reserves		
Share premium	280	
Revaluation surplus	1,098	
General reserve	748	
Retained earnings	1,270	3,396
Non-current liabilities		
10% debentures (secured)		800
Current liabilities		
Income tax provision (170 + 470)	640	
Payables	780	
Accrued expenses	68	1,488
		7,284

Workings

W1 Accrued interest on 10% debentures

	Tshs'000
Interest expense on 10% debentures (10% of 800,000)	80
Amount already paid as shown in trial balance Accrued interest payable	(40)
	40

W2 Accrued expenses shown in SOFP

	Tshs'000
Debenture interest (800 x 10% -40) (W1)	40
Light & heat	12
Audit fees	16
	68

W3 Plant and machinery

	Tshs'000
According to trial balance	3,320
Cost of the plant sold	(1,400)
Accumulated depreciation (W9)	(728)
	1,192

W4 Depreciation on the building portion of freehold property

Depreciation = Cost / Useful life of the asset

$$\frac{4,00,000}{8,000} = 50$$

W5 Reduced down value of the freehold property

	Tshs'000
Freehold land & building on 01/01/20X7	1,720
Less: Accumulated depreciation	(80)
Less: Depreciation for the year (W4)	(8)
	1,632

W6 Revaluation surplus

	Tshs'000
The property is revalued at	3,200
Less: Carrying value (1,720 – 80 - 8) (W5) Revaluation surplus	(1,632)
	1,568

W7 Profit on disposal of plants

	Tshs'000
Proceeds from the disposal of plants	1,200
Less: Reduced down value	(1,096)
Profit on disposal of plants	104

W8 Cost of remaining plant

	Tshs'000
Cost of the remaining plant is (3,320, - 1,400)	1,920

W9 Accumulated depreciation on plant

	Tshs'000
According to trial balance	888
Charge for the year 20X7	144
Less: Depreciation on disposals (-1,400 – 1,096)	(304)
	728

W10 Share premium

	Tshs'000
Proceeds from ordinary shares	480
Less: Nominal value of shares issued (200 x Tshs1,000)	(200)
Excess consideration over the nominal value	280

STUDY GUIDE C2: REPORTING FINANCIAL PERFORMANCE

Get Through Intro

There is no doubt that financial statements provide very useful information. However, if the data in the statements are supported by the disclosure of important financial ratios, the usefulness of the statements greatly increases. One such important ratio is Earnings per Share (EPS).

The statement of profit or loss discloses the absolute amount of profit, whereas the EPS presents a relative profit figure. EPS is simply calculated by dividing earnings by the number of shares. EPS highlights the efficiency in the use of resources. If resources (cash received by issuing shares) have increased by 50%, the earnings should also, ideally, increase by around 50%. This will maintain the EPS. However if the earnings increase by only 25%, the EPS will be reduced, highlighting the fact that the additional resources were not used efficiently.

Some of the important factors that determine the share prices on stock markets are the EPS for the company and the Price/Earnings ratio (P/E ratio) prevailing for the industry in which the company operates.

Certain convertible instruments can be modified into ordinary shares. Mostly these conversions will not give cash to the company. Since resources are not increased, earnings will not increase. However, the number of shares will increase. This reduces the earnings per share. This is called a diluted EPS.

In order to progress, you will need to understand what EPS and diluted EPS represent. You will also have to calculate these figures as all listed companies need to disclose it. This Study Guide will ensure you can do that in the future!

Learning Outcomes

- a) Explain why EPS is a better indicator than the profit trend.
- b) Calculate basic EPS in situations:
 - i. where there has been a bonus issue of shares during the year
 - ii. where there have been stock splits during the year
 - iii. where there has been a rights issue of shares during the year.
- c) Calculate the diluted EPS in the following situations:
 - i. where convertible debt is in issue
 - ii. where share options and warrants exist.
- d) Distinguish between and account for adjusting and non-adjusting events after the reporting date.
- e) Account for changes in accounting policy, error and changes in accounting estimates.

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1. Explain why EPS is a better indicator than the profit trend.
 2. Calculate basic EPS in situations:
 - i where there has been a bonus issue of shares during the year
 - ii where there have been stock splits during the year
 - iii where there has been a rights issue of shares during the year
- [Learning Outcomes a and b]

1.1 Meaning of earnings per share (EPS)

EPS is the amount which an entity has earned per share for the given period.

Calculation of EPS in its simplest form

EPS is calculated as the ratio of earnings to the number of shares in issue. The numerator is the amount of earnings and the denominator is the number of shares.



Example

Total earnings are Tshs200,000,000 and total number of shares is 100,000.

EPS is Tshs2,000 (i.e. Tshs200,000,000 / 100,000 shares).

1.2 Why the trend of EPS may be a more accurate indicator of performance than a company's profit trend

The performance of a company can be judged from its profitability. Its investors expect it to be able to maintain or increase its profitability. The question that arises is: how do we measure this?

One possible measure is absolute profit. If profit increases, it may appear that the company has performed well. Consider the following example.



Example

Brick Co earned a net profit of Tshs8,000 million in the year 20X5 and Tshs10,000 million in 20X6. The weighted average number of ordinary shares during 20X5 was 800,000 and during 20X6, 1,200,000.

The company appeared to perform better in 20X6 than 20X5 because its total profit increased.

There has been an increase of Tshs2,000 million in the profits (Tshs10,000 million - Tshs8,000 million), on the base profit of Tshs8,000 million. In percentage terms, this works out to: $\text{Tshs2,000} / \text{Tshs8,000} \times 100 = 25\%$ (increase).

However, let us check this using EPS:

Basic EPS for 20X5 is $\text{Tshs8,000 million} / 800,000 \text{ shares} = \text{Tshs10,000}$

Basic EPS for 20X6 is $\text{Tshs10,000 million} / 1,200,000 \text{ shares} = \text{Tshs8,330}$

There has been a decrease of Tshs1,670 (Tshs10,000 - Tshs8,330) in the earnings per share, in the base figure of Tshs10,000. The percentage is: $\text{Tshs1,670} / \text{Tshs10,000} \times 100 = 16.7\%$ (decrease)

If we take EPS as the basis, we find that the company has not performed well in 20X6. Which is the better basis?

There is no doubt that the company increased its total profits. However, the increase in profits was lower than the increase in resources available. Therefore the **additional resources were not utilised efficiently**, at least in the short run.

Therefore, the EPS is a better indicator of performance than a company's profit trend.

Calculations of Basic Earnings per Share

**Definition**

Basic earnings per share shall be calculated by dividing **profit or loss attributable to ordinary equity holders of the parent entity** (the numerator) by **the weighted average number of ordinary shares outstanding** (the denominator) during the period.

IAS 33, Para 10

If we put this into equation form, we get

$$\text{EPS} = \frac{\text{Profit or loss attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding}}$$

1. Calculating earnings

'Earnings' means profit or loss (or profit and loss from continuing operations, if presented) **attributable to ordinary equity holders of the parent entity**.

To arrive at the profit or loss attributable to the ordinary shareholders, it is necessary to deduct any dividends or other financing costs in relation to preference shares

The amounts of dividends related to preferred shares deducted from profit or loss is:

- (a) the after-tax amount of preferred dividend on non-cumulative preferred shares declared in respect of the period; and
- (b) the after-tax amount of the preferred dividends for cumulative preferred shares required for the period, whether or not the dividends have been declared.

2. Number of shares (the denominator)**Definition**

For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period.

IAS 33, Para 19

Why is a weighted average required?

This is because the numerator (earnings) and the denominator (number of shares) may not necessarily be comparable. Earnings relate to a **PERIOD** (the period covered by the statement of profit or loss). However, the number of shares relate to a particular **DATE** (the date of the SOFP).

The number of shares may change during the year for a number of reasons e.g. issue of new shares, buyback of shares and conversion of debt into shares.

If the number of shares has changed during the year, it means that at some point, more money was available (from the issue of shares) and hence profits should increase more to make it comparable to the numerator, a weighted average of the number of shares is calculated. Therefore, the earnings during the **PERIOD** are compared with the weighted average number of shares during the **PERIOD**.

**Example**

Lilac Paints Plc earned Tshs100 million during the year 20X6. The number of ordinary shares on the reporting date is 100,000, including 60,000 shares it issued on 1 June 20X6, and excluding 10,000 shares it repurchased on 1 October 20X6.

It is wrong to conclude that the EPS is Tshs1,000 (Tshs100,000,000 / 100,000 shares), because the number of shares was not 100,000 throughout the year, whereas the earnings relate to the full year.

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How is weighted average calculated?

Calculation of weighted average involves two factors: the **number** of shares and the **period** for which they were outstanding. A **time weighting factor** is used, being the number of days for which the shares are outstanding as a proportion of the total days in the period. It can be calculated based on the balance of shares or the number of shares in each transaction.



Example

Continuing the above example of Lilac, calculate the weighted average first, then EPS.

		Shares issued	Treasury shares repurchased	Shares outstanding
1Jan 20X6	Balance	50,000	-	50,000
1June 20X6	Issued	60,000	-	110,000
1Oct 20X6	Repurchased	-	10,000	100,000
31Dec 20X6	Balance	110,000	10,000	100,000

Weighted average based on the balance:

In this case, **the period for which the balance remained unchanged is used in the calculation of weighted average**. For example, the balance of 50,000 shares was constant from 1 January to 31 May 20X6, i.e. 5 months. Therefore, a weight of 5 will be attached to the balance of 50,000:

50,000 x 5/12 =	20,833
110,000 x 4/12 =	36,667
100,000 x 3/12 =	25,000
Weighted average =	82,500

Now, it is easier to calculate the EPS:

$$\text{EPS} = \frac{\text{Profit or loss attributable to ordinary equity holders of the parent entity}}{\text{Weighted average number of ordinary shares outstanding}}$$

$$\text{EPS} = \frac{\text{Tshs } 100,000,000}{82,500 \text{ shares}}$$

$$= \text{Tshs } 1,212$$

In such cases, as a result of changes in the number of shares, **there is a proportionate change in the resources available to the company** i.e. cash or other economic benefits are received or paid. It is to be noted that the changes in the number of shares are **treated prospectively** (from the date of the change to the end of the period) and a **weighted average is calculated**.

1.3 Bonus shares

The changes discussed in the previous section (i.e. when there is a issue of shares for cash) involved corresponding changes in resources. However, there is another type of change in the number of shares for which there is no corresponding change in resources. In other words, the number of shares will increase or decrease without receipt or payment in the form of cash or other economic benefits. This is known as a bonus issue as shares are being issued for free.

Where this happens, the number of ordinary shares outstanding before the event (e.g. a bonus issue) is **adjusted as if the event had occurred at the beginning of the earliest period reported**. This change in the number of shares does not need a weighted average calculation.



Example

Panama Tiles had an issued capital of 2 million shares of Tshs1,000 each on 31 December 20X6. It issues, on 1 April 20X7, bonus shares in the ratio of 1:2 (1 share for every 2 existing). 1m shares ($\frac{1}{2} \times 2m$) are issued, increasing the number of shares issued to 3 million.

For both the years, 20X6 and 20X7, the number of shares will be treated as 3 million. There is no need to calculate any weighted average.



Test Yourself 1

The following details are provided:

1. Profit attributable to ordinary equity holders of the parent entity 20X5: Tshs500 million
2. Profit attributable to ordinary equity holders of the parent entity 20X6: Tshs800 million
3. Ordinary shares outstanding until 31 August 20X6: 400,000 shares
4. A bonus issue was made on 1 September 20X6 at 1 ordinary share for 4 ordinary shares outstanding on 31 August 20X6

Required:

Calculate the basic earnings per share.

1.4 Stock splits

A Stock split is when the nominal value of each existing issued share of a class is split into smaller denominations. The total number of shares increases, without increasing the amount of issued capital.

In other words stock split merely increases the number of shares without affecting the firm's assets. This results in a larger number of less valuable shares. This fundamental change in the nature of the shares is reflected in a calculation of EPS by simply increasing the number of shares.



Example

Pure Drinks Inc has 4 million Tshs1,000 shares outstanding on 1 January 20X7. On 30 June 20X7, the nominal value of Tshs1,000 each of the existing shares is split into two shares of Tshs500 each. The total number of shares will increase to 8 million shares (4 million shares \times 2).

This is similar to a bonus issue where the number of shares has again been doubled, but the amount of total issued capital remains the same. The issued capital will remain same. However it will be disclosed as 8 million shares of Tshs500 each = Tshs4,000 million.

For all the periods reported, i.e. 20X6 and 20X7, the number of shares to calculate EPS will be taken as 8 million shares.

1.5 Rights issue

What is a rights issue?

A rights issue is an **issue of new shares for cash** offered to the existing shareholders as a right. Usually, company law stipulates that the new shares issued should first be offered to existing shareholders as a right. This ensures that the shareholding pattern and the control over a company are preserved. However, if the shareholder does not want the shares, he can transfer the rights to others.



Example

Paul is a 20% shareholder of Paulson Ltd. The company issues 100,000 new shares. It must offer 20,000 shares to Paul as a right. It is then up to Paul to decide whether he wants to buy them.

If a rights issue is for full value (i. e. for the fair value of the shares), there will be a proportionate change in the resources available to the entity. The rules for the calculation of weighted average stated in above are applicable for a rights issue as well. However, if the exercise price is lower than the fair value of the shares, there is an element of bonus in the rights issue. The number of shares is **adjusted as if the event had occurred at the beginning of the earliest period reported.**

The number of ordinary shares to be used in calculating the **earnings per share for all periods before the rights issue** is the number of ordinary shares outstanding before the issue, **multiplied by the following factors:**

$$= \frac{\text{Fair value (market value) per share immediately before the exercise of rights}}{\text{Theoretical ex - rights fair value per share}}$$

Theoretical ex-rights price (TERP)

Usually, certain period is stipulated for the rights issue. The shareholders are required to apply for the rights shares within that period. During this period, the price of shares is affected by the rights attached to them. Such a price is known as a 'cum-rights' price ('including rights' price). The purchaser who purchases the shares during this period also receives the rights. Once the right issue expires, the purchaser of shares no longer has a right to apply for rights shares. Then the shares and their price become 'ex-rights' i.e. without the rights. Theoretical ex-rights price is the price that a share will theoretically have after the rights period expires. TERP is based on the company's market capitalisation and the number of shares outstanding.

The theoretical ex-rights fair value per share is calculated in turn as follows:

$$= \frac{\text{Fair value of all outstanding shares before exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding before exercise} + \text{Number of shares issued in the exercise}}$$

This presents a very interesting situation. The principles discussed above, where weighted average is to be calculated and where the number of shares is to be restated, are to be applied simultaneously. This is how it is done:



Example

A company has an issued capital of 200,000 shares of Tshs1,000 each. It makes a rights issue of 1share for every 2 shares held on 1 October 20X7 at Tshs1,500 per share. The accounting period is a calendar year.

The fair value of shares the day before the rights issue was Tshs2,500 each.

The theoretical ex-rights price is calculated as:

$$\frac{\text{Fair value of all outstanding shares before exercise of rights} + \text{Total amount received from exercise of rights}}{\text{Number of shares outstanding before exercise} + \text{Number of shares issued in the exercise}}$$

$$\frac{(200,000 \times \text{Tshs } 2,500) + (100,000 \times \text{Tshs } 1,500)}{(200,000 + 100,000)} = \text{Tshs } 2,170$$

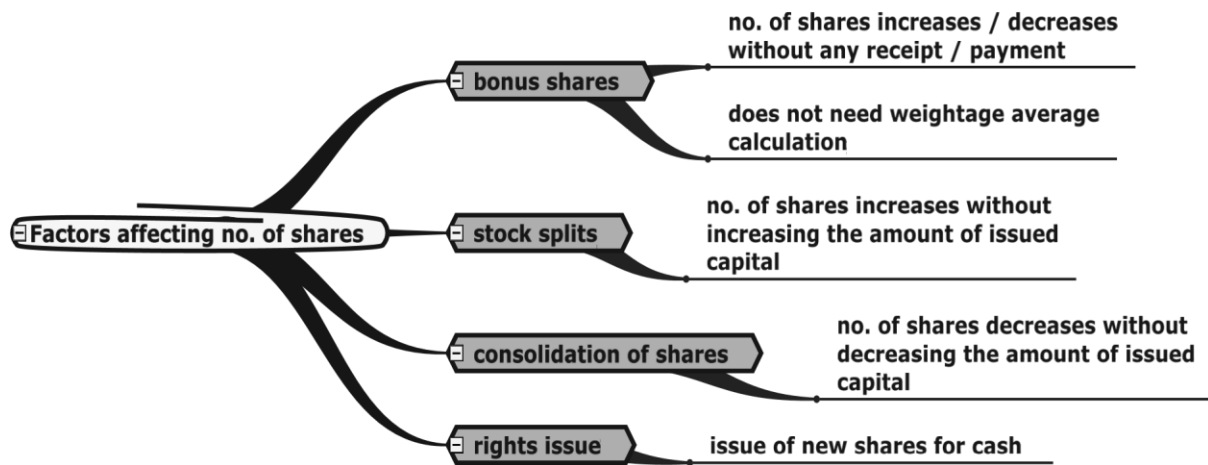
Therefore theoretical ex-rights price is Tshs2,170.

Therefore the adjustment factor is calculated as Tshs2,500/Tshs2,170 = 1.15

Assuming the profit for the year ended 31 December 20X7 is Tshs500 million, basic EPS after rights issues is

$$\frac{\text{Tshs } 500,000,000}{(200,000 \times 1.15 \times 9/12) + (300,000 \times 3/12)} = \text{Tshs } 2,020$$

SUMMARY



 **Test Yourself 2**

The following information is provided:

Profit attributable to ordinary equity holders of parent company:

Years	20X5	20X6	20X7
	3,000,000	3,500,000	4,200,000

No. of shares outstanding before rights issue - 1,000 The company had a 1 for 4 rights issue.

Exercise price: Tshs6,000

Date of rights issue: 31 January 20X6

Last date to exercise rights: 1 April 20X6

Market price of 1 ordinary share immediately before exercise on 1 April 20X6: Tshs12,000

Required:

Calculate EPS on 31 December (the reporting date) for each of the three years.

3. Calculate the diluted EPS in the following situations:

- i. where convertible debt is in issue
- ii. where share options and warrants exist

[Learning Outcome c]

2.1 Meaning of dilution

 **Definition**

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.

IAS 33, Para 5

Diluted EPS means an EPS that is reduced or diluted due to increase in the number of shares (the denominator) without a proportionate increase in the earnings (the numerator).

2.2 Potential ordinary shares

In the discussions on basic EPS so far, we divided earnings by the number of shares. While determining the number of shares, we considered only the shares which entitle the holders to a share in the earnings **at present**.

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There are some financial instruments or other contracts that may entitle their holders to ordinary shares in the company.



Definition

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares.

IAS 33, Para 5

Therefore potential ordinary shares are shares likely to come into existence as a result of a financial instrument or a contract.

2.3 Dilutive potential ordinary shares

The word dilution indicates a reduction in strength or intensity. Put simply, if earnings per share are going to be reduced (or loss per share increased) as a result of potential shares being converted into ordinary shares, the potential shares are said to be dilutive.



Example

The profit attributable to ordinary equity holders of the parent entity is Tshs100,000,000. The number of ordinary shares is 50,000. Potential ordinary shares are to be converted into 10,000 ordinary shares. For the sake of simplicity, let us assume that the profit figure does not change.

Basic EPS in this case is

$$\frac{\text{Tshs } 100,000,000}{50,000 \text{ shares}} = \text{Tshs } 2,000$$

If the potential shares are converted into ordinary shares,

$$\text{EPS} = \frac{\text{Tshs } 100,000,000}{60,000 \text{ shares}} = \text{Tshs } 1,670.$$

EPS will be reduced or 'diluted' by the potential conversion. This EPS is called a diluted EPS and the potential shares are called the dilutive potential ordinary shares.

2.4 Why is diluted EPS calculated?

The information presented in the financial statements is used by the users to take decisions about the future. The presentation of basic EPS is not enough; information on diluted EPS is relevant for the existing as well as the potential investors.

- Existing shareholders will know what the EPS could be in the future, on shares held by them. Based on market expectations, they can check whether the expected returns sufficient for their needs. Accordingly, they can decide whether to hold the shares or to sell them.
- Potential shareholders can decide whether to buy the shares or not, using a similar analysis.



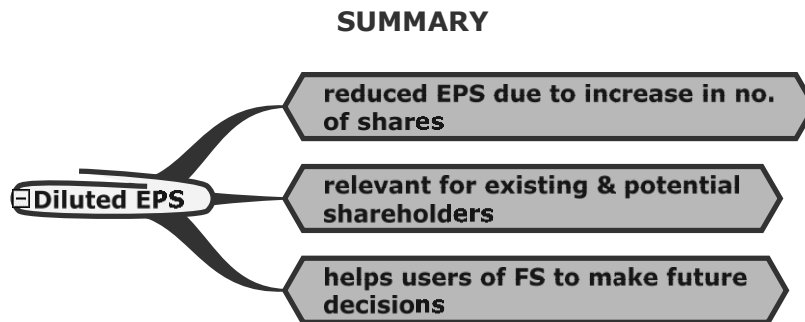
Example

An entity has earnings of Tshs100,000,000 available for ordinary shareholders and the number of shares in issue is 50,000.

$$\text{EPS} = \frac{\text{Tshs } 100,000,000}{60,000 \text{ shares}} = \text{Tshs } 1,670$$

Suppose that, according to certain contractual terms, the number of shares is going to increase to 100,000 next year. After that, the EPS will be Tshs100,000,000 / 100,000 shares = Tshs1,000. This is the diluted EPS, and this

information is more relevant to investors than the basic EPS. Investors base their decisions on their expectations for the future of an entity.



2.5 Adjustments required to the numerator and denominator

Both the numerator (earnings) and denominator (number of shares) that are used to calculate the basic EPS **need to be adjusted when calculating the diluted EPS.**

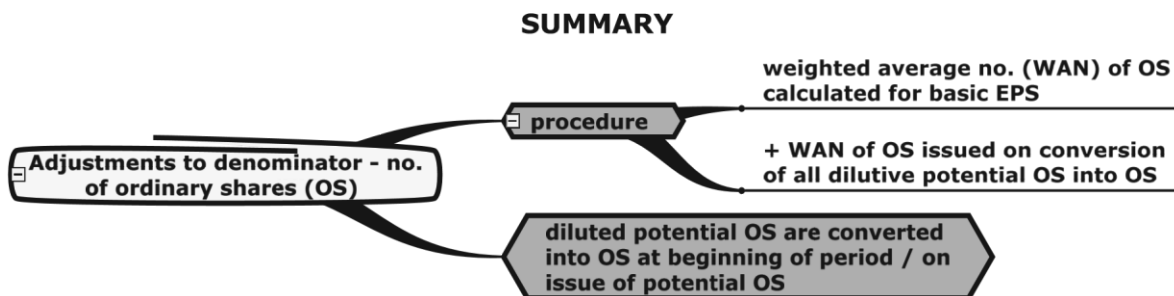
Adjustments to the denominator (number of shares)

The number of ordinary shares will be the weighted average number of **ordinary shares** calculated for the basic EPS, **plus** the weighted average number of ordinary shares that **would be issued** on the conversion of all the dilutive potential ordinary shares into ordinary shares.

Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of issue of the potential ordinary shares.

Example

The existing number of ordinary shares of Zanco Ltd is 80,000. Bonds worth Tshs100,000,000 are to be converted in future into 20,000 ordinary shares. For the purpose of calculation of the number of shares, these potential shares are added and the total number is 80,000 shares + 20,000 shares = 100,000 shares.



Adjustments to the numerator (earnings)

As you can see above, in order to calculate diluted EPS, we basically ‘fast-forward’ in time and assume that the items e.g. bonds or preference shares are converted into shares. However, if we convert the items into shares, we also have to then remove any interest or dividends which would be payable on these. IAS 33 therefore specifically states that:

1. Any dividends, related to dilutive potential ordinary shares. Until the conversion, such items are deducted from net profits to calculate the profits available to the ordinary shareholders. After the conversion into ordinary shares, this dividend is not deductible.

Example

100,000,000 9% preference shares are converted into 200,000 ordinary shares. Upon conversion, since the preference shares will no longer exist, the dividend of Tshs9,000,000 is not payable on preference shares. This amount is added to the profits available for ordinary shareholders.

- Any interest on the bonds, debentures or loan that is to be converted into ordinary shares; after they are converted into shares, the interest is no longer payable.

 **Example**

Continuing the above example of Zanco

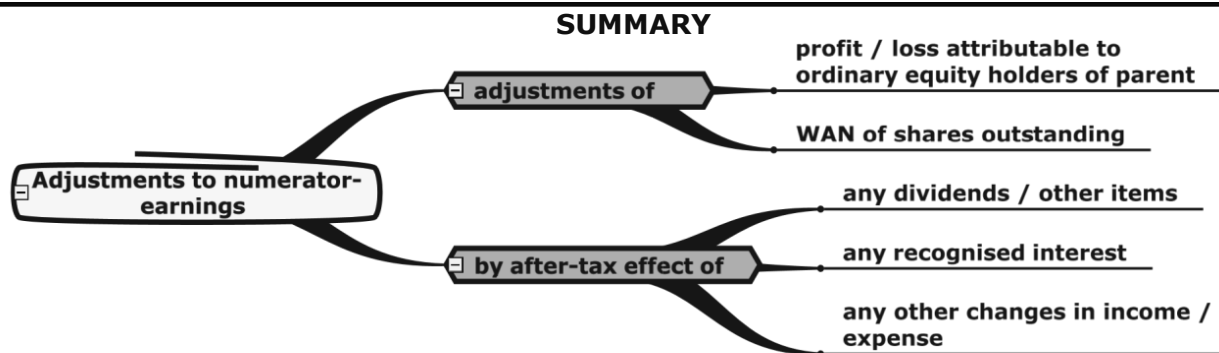
Bonds worth Tshs100,000,000 bearing 8% interest are to be converted into 20,000 ordinary shares. The tax rate is 30%. Earnings available to ordinary shareholders are Tshs75,000,000.

After the conversion, there will be no interest charge payable on the bonds. Therefore the savings net of tax are $Tshs8,000,000 - (30\% \times Tshs8,000,000) = Tshs8,000,000 - Tshs2,400,000 = Tshs5,600,000$.

The revised earnings available for ordinary shareholders are $Tshs75,000,000 + Tshs5,600,000 = Tshs80,600,000$.

The diluted EPS in this situation is

$$EPS = \frac{Tshs\ 100,000,000}{50,000\ \text{shares}} = Tshs\ 2,000$$



2.6 Illustrative questions on calculations of diluted EPS

1. Convertible bonds

Convertible bonds are bonds that are converted into ordinary shares on the given date and the given terms. From the company's statement of financial position, the bonds are reduced and the share capital (and share premium, if the conversion is at a premium) is increased.

 **Example**

Solamine Co issued 500,000 convertible bonds of Tshs1,000 each. Each bond is convertible on 1 July 20X8 into 8 ordinary shares of 1 each. On conversion, Tshs400,000,000 is transferred from the convertible bonds account to the ordinary share capital account ($8/10 \times 500,000,000$) and Tshs100,000,000 to the share premium account ($2/10 \times Tshs500,000,000$).

On the reporting date, 31 December 20X6, there are 4,000,000 ($500,000 \times 8$) potential shares.

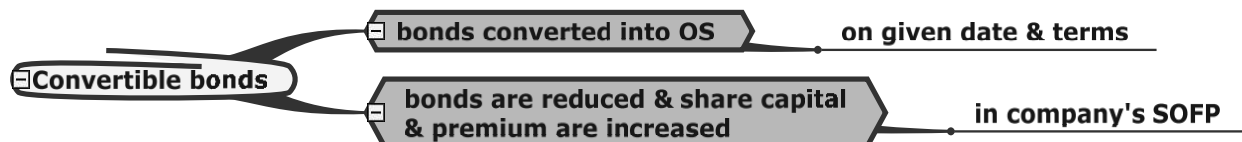
 **Example**

	Tshs
Profit attributable to ordinary equity holders of the parent entity	1,200 million
Ordinary shares outstanding	800,000
Basic EPS	Tshs1,500
No of Convertible bonds (fully convertible into three ordinary shares each)	100,000
Interest expense for current year	80 million
Current and deferred tax relating to that interest expense	20 milliom

Answer

	Tshs
Adjusted profit attributable to ordinary equity holders of parent (Tshs1,200 million + Tshs80 million – Tshs20 million) [Interest of Tshs80 million will be saved on conversion, however, the tax shield (deduction) of Tshs20 million on this interest will be lost]	1,260 million
No. of ordinary shares resulting from the conversion of bonds (100,000 x 3 shares)	300,000 shares
No. of ordinary shares used to calculate diluted EPS: (800,000 shares + 300,000 shares)	1,100,000 shares
Diluted earnings per share = Tshs1,260 million/1,100,000 shares	Tshs1,145
Extent of dilution in EPS = Tshs1,500 – Tshs1,145	Tshs355

(Basic earnings per share are reduced by this amount due to the conversion of potential shares)



 **Test Yourself 3**

Profit attributable to ordinary equity holders of the parent entity	Tshs 1,800,000
Ordinary shares outstanding	1,200 shares
Basic earnings per share	Tshs1,500
No. of convertible bonds (Fully convertible into five ordinary shares each)	100
Interest expense for current year	Tshs120,000
Current and deferred tax relating to that interest expense	Tshs30,00

Required:

Calculate diluted earnings per share.

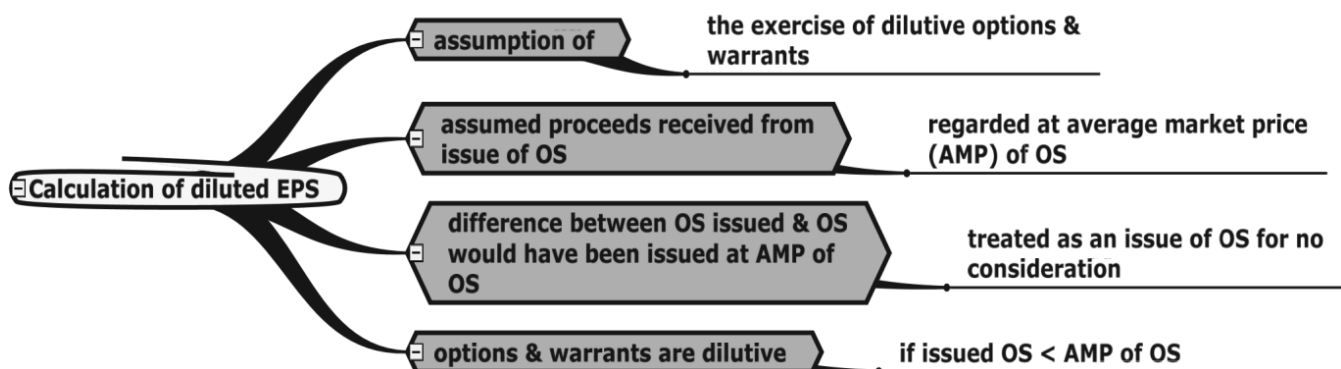
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2. Share options and warrants

Options, warrants and their equivalents are financial instruments that give the holder the right to purchase ordinary shares. Calculation of diluted EPS is performed as follows:

1. An entity assumes that dilutive options or warrants shall be exercised.
2. Assumed proceeds from these instruments will be regarded as having been received from the issue of ordinary shares at the average market price of the ordinary shares during the period.
3. The **difference** between the number of ordinary shares **issued** and the number of ordinary shares that **would have been issued** at the average market price of ordinary shares during the period will be treated as an issue of ordinary shares for **no consideration** (free shares).
4. Options and warrants are dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares during the period.
5. Potential ordinary shares are assumed to consist of the following:
 - (a) A contract to issue a certain number of shares at average market price. These shares are neither dilutive nor anti-dilutive.
 - (b) A contract to issue the remaining ordinary shares for no consideration. These shares are dilutive and are added to the number of shares outstanding in the calculation of diluted EPS.

SUMMARY



Example

Profit attributable to ordinary equity holders of the parent entity for year	Tshs300,000,000
Weighted average number of ordinary shares outstanding during 20X6	800,000
Average market price of one ordinary share during year 20X6	Tshs3,000
Weighted average number of share options during year 20X6	200,000
Exercise price for share options during year 20X6	Tshs2,400

Required:

Calculate basic and diluted earnings per share.

Answer

Note: Tshs has been assumed as currency unit

	Calculation of earnings per share (EPS)	Total earnings	No. of shares	EPS
		Tshs		Tshs
A	Profit for the year attributable to ordinary equity holders of parent	300,000,000		
B	Weighted average shares outstanding during year 20X6		800,000	
C	Basic earnings per share			375
D	Weighted average number of shares under option		200,000	
E	Weighted average number of shares that would have been issued at average market price: $(200,000 \times \text{TShs}2,400) / \text{Tshs}3,000$		160,000	
F	Difference (d – e)		40,000	(Refer note)
G	Adjusted number of shares (b + f)		840,000	
H	Diluted earnings per share = $(a)/(g) = \text{Tshs}300,000,000/840,000$ shares			357

Note

Total agreed value of options = $200,000 \times \text{Tshs}2,400$	Tshs480,000,000
If shares were issued at average market price, no. of shares would have been $\text{Tshs}480,000,000 / \text{Tshs}3,000$. These shares are neither dilutive nor anti-dilutive.	160,000 shares

Therefore 40,000 (200,000 - 160,000) shares are deemed to have been issued without consideration, causing dilution of the EPS.

3. Distinguish between and account for adjusting and non-adjusting events after the reporting date.

[Learning Outcome d]

The date on which an entity determines and reports its financial position is known as the end of the reporting period. This date is very crucial for every entity. The events occurring up to the end of the reporting period affect the financial results of the company, thus inclusion of these events is very important in order to ascertain the financial position.

Sometimes, events occurring after the end of the reporting period provide additional information of the events occurred before the end of the reporting period such that it may affect the financial results of the entity.

IAS 10, Events after the reporting period, provides guidance on accounting and disclosure of events after reporting period.



Definition

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of reporting period and the date when the financial statements are authorised for issue.

Following are a few examples of events occurring after the reporting period:

1. Theft of plant and equipment
2. Amalgamation of companies
3. Resignation of the CEO of the company

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4. Closure of one of the manufacturing facilities
5. Significant purchase of shares of other companies

The conditions for **events after the end of reporting period** to apply are:

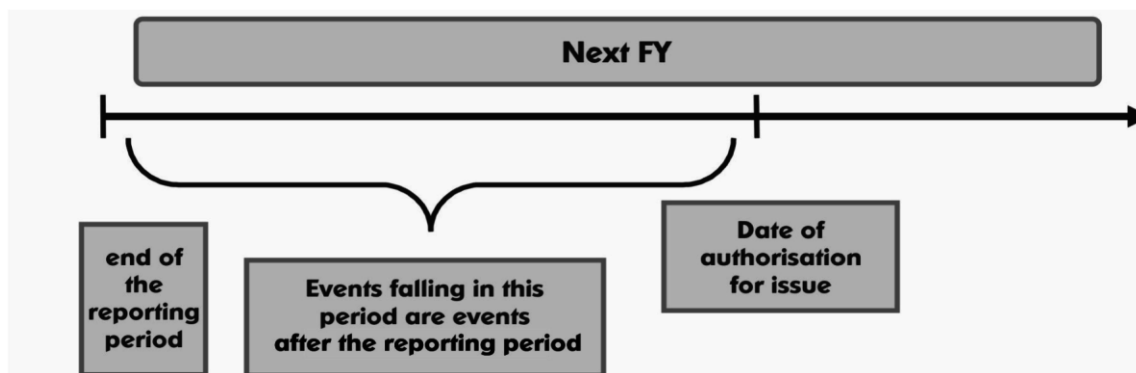
1. The event may be either **favourable** or **unfavourable** (i.e. **good or bad for the company**)
2. The event **arises after the end of reporting period**
3. The event occurs between the **end of reporting period** and the **date of authorisation of financial statements for issue**

Events arising after the end of reporting period

Financial statements are prepared up to the end of the financial year e.g. for the year to 31 December 20X8. However, the **process of preparation of the statements takes some time** e.g. the financial statements for the year to 31 December 20X8 could be finalised on 28 February 20X9.

In the meantime, some events may take place that have a bearing on the financial statements. The question that arises is whether the financial statements need to be **changed** as a result of these events occurring after the end of reporting period but before the statements are authorised for issue.

Diagram 1: Events after end of the reporting period



3.1 Date of 'authorisation for issue'

The date of 'authorisation for issue' of statement of financial position changes according to circumstances. It depends upon the management structure, statutory requirements and procedures followed in preparing and finalising the financial statements.

The following are treated as the dates of authorisation for issue:

- For a registered company, the date on which the **board authorises the financial statements**.
- Where the management of an entity is required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval, the authorisation date is the date on which the **management authorises them for issue to the supervisory board**.



Test Yourself 4

Stylish Plc has the following details available:

- Management authorises the financial statements for issue to its supervisory board on 17 May 20X9. The supervisory board (of non-executives) approves the financial statements on 28 August 20X9.

Required:

What is the date of authorisation for issue?

**Tip**

The date of public announcement of profits or other selected financial information does not decide the date of authorisation for issue.

3.2 Events after the reporting period

IAS 10 distinguishes two types of events after the reporting period:

1. Adjusting events
2. Non-adjusting events

1. Adjusting events

'Adjusting events' are events after the reporting period that **necessitates** adjustments to the figures in the financial statements. They provide evidence of conditions that **existed at the end of reporting period**.

An entity simply **adjusts the amounts originally recognised in its financial statements** in order to reflect the effect of 'adjusting events after the reporting period'.

IAS 10 lists the following instances of adjusting events:

- (a) The **settlement of a court case** after the reporting period confirms that the entity had a present obligation at the end of reporting period.
- (b) The bankruptcy of a customer that occurs after the reporting period usually confirms that a loss existed at the end of the reporting period on a trade receivable.
- (c) the sale of inventories after the reporting period may give evidence about their net realisable value at the end of the reporting period.
- (d) The determination after the reporting period of the cost of assets purchased, or the proceeds from assets sold, before the end of reporting period.
- (e) Evidence of permanent diminution in the value of long term investments prior to the year.
- (f) The discovery of fraud or errors that show that the financial statements are incorrect.

Going concern assumption

Sometimes events after the reporting period indicate that the going concern assumption is no longer valid. The going concern assumption means that the entity is likely to continue in a similar capacity for the foreseeable future. The basis of measurement of assets is based on this assumption.

If management of any company decides to close the unit, and the effect is so pervasive that going concern assumption is not appropriate IAS 10 **requires** a fundamental change in the basis of accounting **rather than** just an adjustment to the values recognised within the original basis of accounting

When the company is considered to be a going concern the financial statements are prepared on a going concern basis. If the company is not considered a going concern the financial statements are prepared on a break-up basis.

**Example**

Equipment with a book value of Tshs75 million (cost less depreciation) is retained at the value under the cost model while the entity is a going concern.

When it ceases to be a going concern, the entity will have to value the asset at the lower of its carrying amount and the realisable value, which is likely to be well under Tshs75 million.



Test Yourself 5

Langweld Ltd had provided for a bad debt of Tshs50 million towards the total amount of Tshs90 million receivable from Mushco at the end of reporting period, i.e. 31 December 20X9. The financial statements were authorised on 31 July 20X7. In the meanwhile, Mushco was declared insolvent on 30 June 20Y0 and nothing could be recovered from it.

Required:

Is this an adjusting event? State the reasons.



Test Yourself 6

Sham Ltd is being sued for anti-competitive behaviour. This is denied by Sham Ltd, and only a contingent liability was shown in the financial statements on 31 December 20X8.

On 14 January 20X9, the court awards Tshs70 million as damages against Sham Ltd. The date for the approval of the financial statements by the management for the issue to the Supervisory Board is March 9, 20X9.

Required:

Determine whether the event has occurred before or after the reporting period and give the accounting entries and the disclosures.



Test Yourself 7

Sun Engineering was preparing its financial statements for 20X8. The company's lathe machine is under repair.

Its carrying value in the books is Tshs175 million. While the financial statements are under preparation, on 27 January 20X9, the company is informed that the machine is irreparable and the scrap value is Tshs25 million.

Required:

Discuss how this would be dealt with in the books.

2. Non-adjusting events

Non-adjusting events are:

- (a) Events that **occur after the reporting period**.
- (b) These events normally **do not affect the valuation of assets / liabilities** in the financial statements as at the end of reporting period.
- (c) Non-adjusting events should not be adjusted in the financial statements. Instead they should be disclosed where the outcome of such events would influence the economic decisions made by users of the financial statements.
- (d) Where the disclosure of such an event is required, the entity should provide details of the nature of the event and an estimate of its financial effect, or state that such an estimate cannot be made.

IAS 10 lists the following instances of non-adjusting events:

- (i) According to IAS 10, if an entity proposes or declares dividends to shareholders after the reporting period, the entity shall not record those dividends as a liability in the financial statements. However, if dividends are proposed and declared after the reporting period, but before the financial statements are approved for issue, the dividends are to be disclosed in the notes to the financial statements.

- (ii) A major business combination or disposal of a subsidiary.
- (iii) Major purchases and disposals of assets.
- (iv) Destruction of a production facility by fire after the reporting period.
- (v) Announcement of a plan to discontinue an operation.
- (vi) Announcement or commencement of implementation of a major restructuring and
- (vii) Major litigation arising from events occurring after the reporting period.



Test Yourself 8

Sona Lights has prepared its financial statements for the period to 31 December 20X9.

On 28 January 20Y0 (before the authorisation of the financial statements), the directors declare dividends totalling Tshs2 million.

Required:

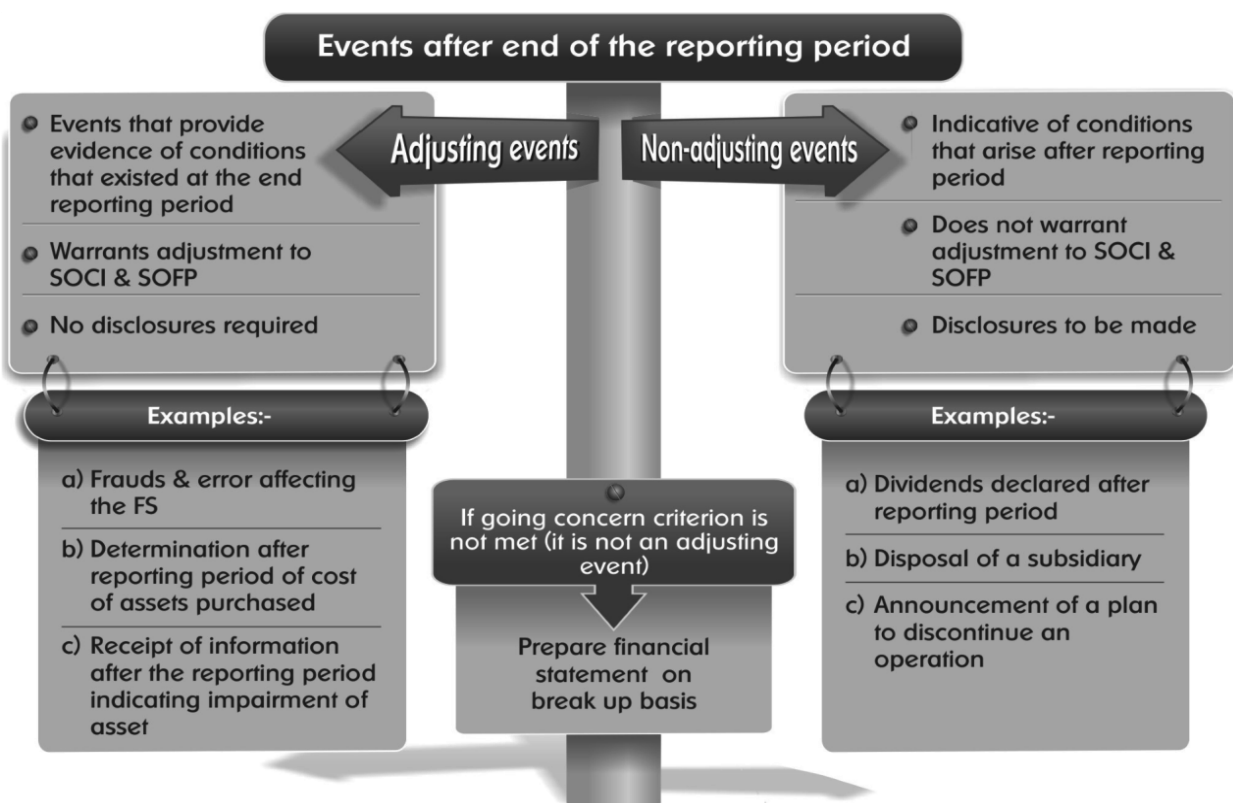
Explain whether this is an adjusting event or a non-adjusting event and mention the effect of this event in the financial statements.



Tip

Non-adjusting events after the reporting period do not affect the statement of financial position and the statement of comprehensive income at the end of reporting period. However, they may influence the financial status of the entity on a future date. Therefore, such significant events must be disclosed by way of a note in the financial statements of the entity.

Diagram 2: Adjusting events and non-adjusting events



4. Account for changes in accounting policy, errors and changes in accounting estimates.
[Learning Outcome e]

4.1 Accounting policies



Definition

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

IAS 8 Para 5

While preparing financial statements there are many areas which can be accounted for differently. For example, inventory can be valued using different methods such as FIFO, average cost (AVCO) etc. An entity has to select the one most appropriate method and apply it consistently. IAS 2 does not permit the use of LIFO as a cost formula to measure inventory.

1. Selection and application of accounting policies

While selecting accounting policies an entity should use the following criteria:

- (a) For transactions, other events or conditions (which will have a material effect on the financial statements) on which guidance from either the IFRS Standard or Interpretation is available, the accounting policy to be applied would be based on the available guidance from the IFRS. However, these policies need not be applied when the effect of applying them is not material.
- (b) In the absence of an IFRS that specifically applies to a transaction, other event or condition, management should use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable.

In making the judgement, management can refer to, and consider the applicability of, the following sources in descending order:

- (a) the requirements in IFRSs dealing with similar and related issues; and
- (b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework.

Management may also consider the most recent pronouncement of other standard setting bodies that use a similar conceptual framework like that of the IASB. Also other accounting literature and industry practices can be referred as long as it does not interfere with IASB's Conceptual Framework.

2. Consistent application of accounting policies

According to IAS 8, an entity shall **select and apply its accounting policies consistently** for **similar transactions**, other events and conditions, **unless** a standard or an interpretation specifically requires **or permits categorisation** of items for which **different policies** may be appropriate. If a standard or an interpretation requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

The application of the same accounting policies within each period and from one period to the next allows the users of financial statements to compare the financial statements of the entity year after year and study the trends in financial position.

3. Changes in accounting policies

A change in accounting policy means **changing a method used** for preparing and presenting a part of a financial statement from the one which was adopted previously.

Changes to accounting policies are permitted only under the following circumstances:

- The change is required by a standard or interpretation.
- The change will result in greater accuracy of the financial statements, and therefore increases the understanding of the financial statements.

 **Test Yourself 9**

During 20X9, Menz Co has reported depreciation in its expenses. However, the directors feel that they should split depreciation into two parts i.e. depreciation on factory equipment and depreciation on office furniture. Depreciation on factory equipment will be reported in the cost of sales and depreciation on office furniture will be reported in expenses. The proposed financial statements are as follows:

Statement of comprehensive income

	20X6	20X5
	Tshs	Tshs
Sales		
Cost of sales		
Purchases		
Add: Depreciation on equipment	X	
Gross profit		
Expenses		
Depreciation		X
Depreciation on office furniture	X	
Profit		

Required:

Decide whether this is a permissible change.

A change in accounting policy to meet the requirement of an accounting standard can occur in the following situations:

- (a) When a **new accounting standard** or interpretation is **introduced** for certain transactions or events.
- (b) When the **available accounting standard is revised** for certain transactions or events.
- (c) when the change **results in more reliable financial statements** which result in more relevant information (also referred to as voluntary change).

4. Entities are allowed to change their accounting policies voluntarily, provided:

- they are in a position to justify how the change in the accounting policy would make the financial statements more reliable.
- the changed accounting policy does not lead to non-compliance with any relevant accounting standard.

Some examples of voluntary changes made to accounting policies are as follows:

- Change in accounting policy for inventory valuation from FIFO to weighted average cost
- Change in depreciation policy from straight line method to reducing balance method
- Changing from writing off to capitalising interest relating to construction of non-current assets

5. The following items are not treated as a change in accounting policy

- (a) The application of an accounting policy for transactions, other events, or conditions that differ in substance from those occurred previously.

 **Example**

ICC Ltd manufactured bags until 20X8. It had 5 motor vehicles at that time which were used for the delivery of bags. ICC Ltd classified all these motor vehicles as non-current assets in 20X8.

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However, in 20X9 shareholders have approved a proposal for a change in the nature of the business from manufacturer of bags to sale of used motor vehicles. ICC Ltd classified all the existing 5 vehicles as current assets (not non-current assets) during 20X9 as they will be sold as part of normal business. This change in classification will not be treated as a change in accounting policy.

(b) The application of a new accounting policy for transactions, other events, or conditions, which did not occur in the past or which were not material.

 **Example**

If Healthcare Foundation obtains a government grant for the first time in 20X9, this grant will be dealt with in the financial books under International Accounting Standard 20 Accounting for Government Grants and Disclosure of Government Assistance. This is a transaction which was not in existence in earlier years. Therefore it cannot be treated as a change in accounting policy.

 **Test Yourself 10**

Moonbeam Co follows the accounting policy of depreciating its plant and machinery using the straight line method. The company feels that the WDV method of depreciation is more realistic. Therefore, it wishes to change its accounting policy to valuation under WDV method.

Required:

Discuss, giving proper reasons, whether it can do so.

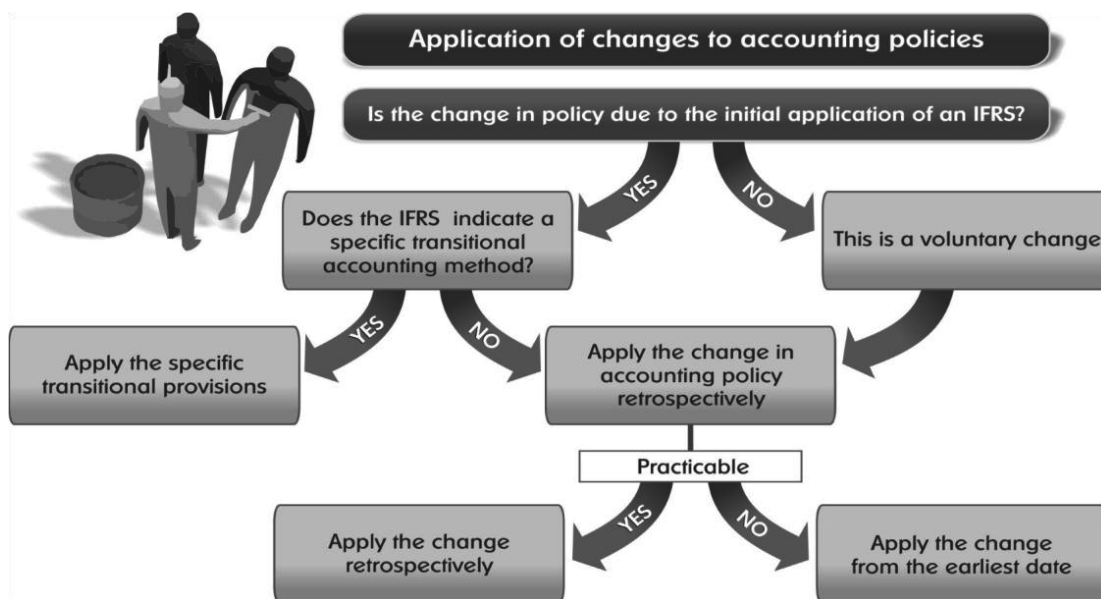
Accounting for changes in accounting policies

In accordance with IAS 8, a **change in accounting policy is applied retrospectively**. This requires the entity to adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

Generally it is quite straightforward to apply the change in accounting policy retrospectively.

However, there are occasions when entities find it impracticable to determine the adjustments to be made on account of the change in the accounting policies.

Diagram 3: Application of changes to accounting policies



4.2 Errors

Depending on the time of occurrence, errors are of two types:

- Errors **committed** and **discovered** in the **current** year
- Errors **committed earlier** but **discovered** in the **current** year; also known as **prior period errors**



Definition

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.
- could **reasonably** be **expected** to have been **obtained** and **taken into account** in the preparation and presentation of those financial statements.

IAS 8, Para 5

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



Example

Sunshine Enterprises prepares its financial statements by recording a purchase of a CNC machine during 20X9, worth Tshs50 million under purchases instead of purchase of non-current assets and the error comes to light in the following accounting year.

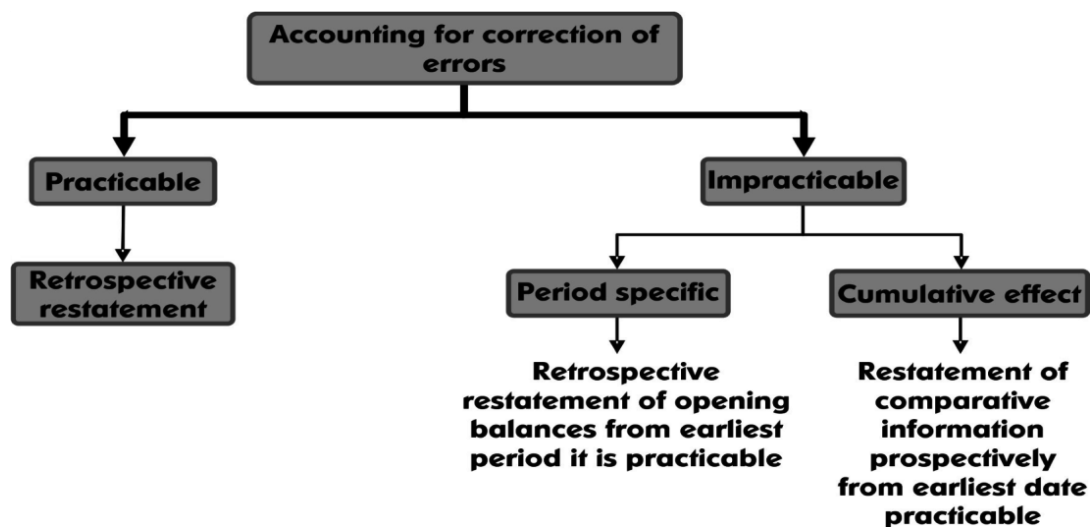
Considering the nature of the transaction and the value of the transaction, it is a **material** transaction. Also the company had **information** when the financial statements for 20X9 were **authorised** and could **reasonably be expected to have considered the transaction** and taken it into account while preparing the financial statements during 20X9. Therefore this is a prior period error.

Accounting for Errors

- If material errors committed earlier are discovered **in the current year**, entities are required to rectify such errors or make changes to their accounting policies.
- An entity shall correct material **prior period errors** retrospectively in the first set of financial statements authorised for issue after their discovery by:
 - (a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or
 - (b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

The following diagram summarises the accounting treatment for the prior period errors

Diagram 4: Accounting for correction of errors



Example

The financial statements of Sunshine Enterprises for 20X8, show inventory at Tshs265,153. However, the inventory statement as at 31 December 20X8, has erroneously excluded the valuation of inventory amounting to Tshs85,222 which was lying with its sub-contractor. Hence it has undervalued its inventory. This came to light in 20X9, after the financial statements were authorised. Here it is possible to make the correction retrospectively.

Therefore, the correction of the error in the financial statements would have to be made retrospectively from 20X8.

4.3 Estimates

There are many items in the financial statements which cannot be measured with precision. In such cases an entity has to make a judgement to estimate the value of these elements.

The following are some examples of items that require estimation:

- a) Bad debts
- b) Inventory obsolescence (inventory that is slow moving or difficult to sell)
- c) The fair value of financial assets or financial liabilities
- d) The useful lives of, or expected pattern of consumption of, the future economic benefits in depreciable assets

The entities make these judgements on the basis of the latest available reliable information. Disclosures about accounting estimates are to be made in respect of:

- Their nature
- Their carrying amount as at the end of reporting period

Accounting for estimates

By its very nature the revision of an estimate to take account of more up to date information does not relate to prior periods. Instead such a revision is based on the latest information available and therefore should be recognised prospectively.

Therefore IAS 8 requires that the effect of a change in an accounting estimate, shall be recognised prospectively by including it in profit or loss in:

- (a) the period of the change, if the change affects that period only; or
- (b) the period of the change and future periods, if the change affects both.

To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it shall be recognised by adjusting the carrying amount of the related asset, liability or equity item in the period of the change.



Test Yourself 11

Jupiter Ltd is preparing its financial statements for 20X9. The management wishes to change the valuation of its inventory from the FIFO method to the Weighted Average method.

Required:

Discuss whether the change would warrant a prior period adjustment.



Test Yourself 12

An entity procures a second-hand machine and determines the depreciation charge based on the expected life of the machine. However, at a future period, the entity realises that the estimated life of the machine does not match the original estimate. As a result, there is a change in the rate of depreciation from 10% to 12%.

Required:

Can this change in the depreciation rate qualify for retrospective restatement?



Test Yourself 13

The original cost of equipment is Tshs115 million and an estimated useful life of ten years with a nil residual value. It is depreciated on a straight line basis annually that comes to Tshs11.5 million p.a. The carrying amount of the equipment after three years will be Tshs80.5 million.

It was decided in the fourth year that the remaining useful life of the equipment is only three years and not seven years.

Required:

State the accounting treatment of the asset in the books.



Test Yourself 14

The Daily Press Ltd was incorporated on 1 January 20X9. The draft statement of financial position for the year ended 20Y0 and 20X9 is given below:

	20Y0	20X9
	Tshs'000	Tshs'000
Property, plant and equipment	434,000	358,000
Research and development	17,000	17,000
Other assets	1,349,000	1,350,000
Total assets	1,800,000	1,725,000
Share capital	150,000	150,000
Retained earnings		
Year ended 20X9	75,000	75,000
Year ended 20Y0	75,000	
Liabilities	1,500,000	1,500,000
Total equity and liabilities	1,800,000	1,725,000

The following information is relevant:

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During 20X9, the company had capitalised Research and Development costs. However during 20Y0, the company realised that the expense did not meet with the requirements of research and development.

Required:

Redraft the statement of financial positions after making the relevant changes.

Answers to Test Yourself

Answer to TY 1

A bonus issue entails capitalising the profits of the entity and issuing shares to the existing shareholders, without receiving any resources in return. In short, it is only a book entry.

The number of shares is adjusted as if the bonus issue had occurred at the beginning of the earliest period reported, i.e. 20X5.

Bonus issue = $1/4 \times 400,000 = 100,000$ shares, so total revised number of shares = $400,000 + 100,000 = 500,000$.

EPS (20X6) = $Tshs800,000,000 / 500,000$ shares = Tshs1,600 EPS

(20X5) = $Tshs500,000,000 / 500,000$ shares = Tshs1,000

The time weighing factor is not used (the bonus shares are treated as having existed for the entire period).

In such cases, as a result of changes in the number of shares, there is no proportionate change in the resources available to the company. Changes in the number of shares are **treated retrospectively** and a **weighted average is not calculated**.

Answer to TY 2

Calculation of theoretical ex-rights value per share:

$$\frac{\text{Fair value of all outstanding shares before exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding before exercise} + \text{Number of shares issued in the exercise}}$$

(Tshs12,000 x 1,000 shares) + (Tshs6,000 x 250 shares)	Tshs13,500,000
1,000 shares + 250 shares	1,250
Theoretical ex-rights value per share	Tshs10,800
Calculation of adjustment factor:	
Fair value per share before exercise of right	Tshs12,000
Theoretical ex-rights value per share	Tshs10,800
Adjustment factor (Tshs12,000 / Tshs10,800)	1.11

Calculation of basic earnings per share

	20X5	20X6	20X7
Basic EPS as originally reported	$3,000,000/1,000$ = Tshs3,000		
Basic EPS restated for rights issue	$3,000,000/(1,000 \times 1.11)$ = Tshs2,700		
Basic EPS including effects of rights issue = 3,500,000		$3,500,000/1,215$	
($1,000 \times 1.11 \times 3/12$) + ($1,250 \times 9/12$) Weighted average is calculated after multiplying the number by weight		= Tshs2,880	
Basic EPS			$4,200,000/1,250$ = Tshs3,360

Answer to TY 3

Adjusted profit attributable to ordinary equity holders of parent: Tshs1,800,000 + Tshs120,000 – Tshs30,000 (Interest of Tshs120,000 will be saved on conversion; however, the tax shield (deduction) of Tshs30,000 on this interest will be lost)	Tshs1,890,000
No. of ordinary shares resulting from conversion of bonds (100 bonds x 5 shares)	500 shares
No. of ordinary shares used to calculate diluted EPS: (1,200 + 500)	1,700 shares
Diluted earnings per share = Tshs1,890,000 / 1,700	Tshs1,111
Extent of dilution in EPS = Tshs1,500 - Tshs1,111	Tshs389

(Basic earnings per share are reduced by this amount due to conversion of potential shares)

Answer to TY 4

In this case, the date of authorisation for issue will be 17 May 20X9 when management authorises the financial statements for issue to the supervisory board.

Answer to TY 5

This is an adjusting event because on 30 June 20Y0:

- it indicates that the previously recognised loss at the end of reporting period needs to be adjusted
- the financial statements have not yet been authorised for issue (financial statements are authorised for issue on 31 July 20Y0).

Answer to TY 6

This is an event occurring after the end of reporting period but before approval of the financial statements for issue. This event affects the valuation of company’s liabilities. **Hence this is an adjusting event.** Sham Ltd must create a provision for Tshs70 million in the financial statements for 20X8, to replace the contingent liability.

Accounting entry

Dr	Legal cost account	Tshs70 million	
	Cr Provision account		Tshs70 million

Being creation of a provision on account of court order dated 14 January 20X9

Disclosure

The company had a contingent liability of Tshs70 million on 31 December 20X8, in respect of the court case. The court order was passed on 14 January 20X9, according to which a liability of Tshs70 million became payable. Since this happening related back to the reporting date, i.e. 31 December 20X8, the company provided for the liability, of Tshs70 million rather than treating it as a contingent liability in its financial statements.

Answer to TY 7

The financial statements are not approved. Also it is an event after the reporting period and it affects the valuation of the asset at the end of reporting period. Hence it is an adjusting event. Therefore Sun engineering would have to reduce the carrying cost of the machine to Tshs25 million.

Accounting entry

The following accounting entry would have to be recorded in the financial books of the company:

	Tshs	
Dr Impairment loss on lathe machine Account	150 million	
Cr Lathe machine		150 million

Being impairment loss on lathe machine recognised

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Answer to TY 8

In accordance with IAS 10, proposed dividends are not to be recorded in the books by way of a liability. Therefore it is a non-adjusting event.

The financial statements do not warrant any adjustment entries.

However the notes to financial statements should disclose the amount of proposed dividends in the note on retained earnings.

Answer to TY 9

Step-1: Is the change prescribed by a standard?	No
Step-2: Is it required by law?	No
Step-3: Will it result in greater accuracy?	Yes

Decision- Accept the change

Answer to TY 10

The WDV method of depreciation is permitted by IAS 16. Also the company feels that this method of depreciation is more realistic and makes the financial statements more reliable. Therefore the change in accounting policy is acceptable.

This means that company is permitted to change the accounting policy and make the appropriate disclosures in the financial statements.

Answer to TY 11

The above change in inventory valuation method falls under the purview of a change in the accounting policy. Hence it is a prior period adjustment

Answer to TY 12

The change to the rate of depreciation cannot be carried out retrospectively since the circumstances and information available at the time of original estimation are different from the information and circumstances on the date of the change in the accounting standard.

Answer to TY 13

The depreciation should be charged in that year (and in the next two years) by bringing forward the carrying amount divided by the revised remaining useful life i.e. $Tshs80.5 \text{ million} / 3 = Tshs26.83 \text{ million}$. The depreciation charged for the past three years should not be changed.

The effect due to the increase in the annual depreciation from Tshs11.5 million to Tshs26.83 million in the current and the next two years should be disclosed.

Answer to TY 14

This change in accounting policy should be applied retrospectively as follows (the tax implications as a consequence of this challenge have been ignored for the purposes of this illustration):

	20Y0	20X9
	Tshs'000	Tshs'000
Property, plant and equipment	434,000	358,000
Research and development *	-	-
Other assets	1,349,000	1,350,000
Total assets	1,783,000	1,708,000
Share capital	150,000	150,000
Retained earnings		
Year ended 20X94 (W1)	58,000	58,000
Year ended 20Y0	75,000	
Liabilities	1,500,000	1,500,000
Total equity and liabilities	1,783,000	1,708,000

Workings

W1 Adjustment re-capitalised borrowing cost

	20X9
	Tshs'000
Retained earnings as given	75,000
Less: R & D expenses	(17,000)
Balance c/f	58,000

* Research and development (R & D) expenses have been expensed and therefore the R & D expenses shown in the statement of financial position for 20X9 and 20Y0 becomes nil.

Quick Quiz

- How is the figure for basic earnings per share calculated?
- What is meant by diluted earnings per share?
- Preference shares are expected to be converted into ordinary shares on 1 July 20X7. The EPS increases from Tshs3,350 to Tshs3,530. The preference shares are said to be: (select the correct one)

Dilutive potential ordinary shares Anti-dilutive potential ordinary shares
- identifies the period covered by the events as starting immediately after the reporting period, and ending on the date of:

A Issue of the financial statements.
B Approval of the financial statements for issue.
C Publication of the financial statements.
- You learn of the bankruptcy of a customer that occurs after the reporting period. You need to:

A adjust the financial statements.
B leave the financial statements, but note the details. **C** ignore it.
- You learn of a change to the proceeds from assets sold, before the reporting period. You need to:

A adjust the financial statements.
B leave the financial statements, but note the details. **C** ignore it.
- Explain briefly the circumstances where changes in accounting policies are justified.
- Are the notes containing significant accounting policies, a component of financial statements?

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9. Are entities at liberty to choose their accounting policy?
10. If an error is made on previously issued financial statements, is it considered to be an accounting change?
11. Roma Engineering makes a provision for non-moving inventory based on “no issues made during last 12 months”. However in the current year it wants to make a provision based on a technical evaluation? Does this amount to a change in accounting policy?

Answers to Quick Quiz

1. Basic EPS is calculated by dividing profit or loss attributable to ordinary equity holders of the parent (numerator) by the weighted average number of ordinary shares existing (denominator) during the period.
2. When potential ordinary shares are converted into ordinary shares in the future, the earnings attributable to each ordinary share will be reduced ('diluted'). The ratio which calculates this amount is the diluted EPS.
3. Anti-dilutive potential ordinary shares, since the EPS is expected to increase after the conversion.
4. The correct option is **B**.
5. The correct option is **A**.
6. The correct option is **A**.
7. An entity shall change an accounting policy only if the change:
 - (a) is required by an IFRS; or
 - (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.
8. Yes
9. No, since changes to accounting policies are permitted only under the following circumstances:
 - ⓐ The change is required by a standard.
 - ⓑ The change is required by law.
 - ⓒ The change will result in greater accuracy of the financial statements, and therefore increases the understanding of the financial statements.
10. The correction of an error in previously issued financial statements is not deemed to be an accounting change
11. In accordance with the accounting policy, only a provision for non-moving inventory is to be made. The method is only a guideline and a better way of estimating non-moving inventory. Hence it is not a change in accounting policy.

Self-Examination Questions

Question 1

The following are extracts from a company's consolidated statement of profit or loss for the year to 31 March 20X6:

	Tshs 'million
Sales	57,600
Cost of sales	(33,600)
Gross profit	24,000
Other operating expenses Operating profit	(9,920)
	14,080
Income from associated companies	2,400
Interest payable	(1,280)
Impairment of non-current assets	(6,400)
Profit before tax	8,800
Taxation	(4,480)
Profit for the year	4,320
Share of profit attributable to	
- Owner of the parent	4,136
- Non-controlling interest	(184)
Profit for financial year	4,136

1. The issued share capital of the company on 1 January 20X6 consisted of:
 - 19,200,000 ordinary shares of Tshs2,500 each.
 - 9% non-redeemable preference shares of Tshs1,600 million.
2. The tax charge given above includes tax relief of Tshs1,000 million on the impairment of non-current assets.
3. The company also had Tshs3,200 million 8% convertible loan stock dated 20X8. The loan stock was to be redeemed at par in 20X8 or converted to ordinary shares on the basis of 40 new shares for each Tshs100,000 of loan stock at the option of the stockholders.
4. The company's income tax rate was 30%.
5. There were directors' share warrants (issued in 20X4) which entitled the directors to receive 1,200,000 new shares in total in 20X8 at no cost to the directors.
6. The following share issues took place during the year to 31 December 20X6:
 - 1 May 20X6 rights issue of 1new share at Tshs1,500 for every 4 shares held. The market price of the company's shares the day before the rights was TShs2,400.
 - 1 July 20X6 issue of Tshs1,600 million 7% non-redeemable preference shares at par.

Both issues were fully subscribed. The company's basic earnings per share in the year to 31 December 20X5 were disclosed as Tshs160.

Required:

Calculate for the company for the year to 31 December 20X6:

- (i) The basic earnings per share including the comparative
- (ii) The fully diluted earnings per share (ignore comparative)

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Question 2

Rex Co issued Tshs1,500 million of 7% convertible debentures, which can be converted in 2 years into 1 share per Tshs5,000 of the debenture amount.

It also issued Tshs4,000 million, 12% convertible debentures, which can be converted in 12 months for 1 share per Tshs10,000 of the debenture amount.

Rex Co has issued capital of 2,500,000 shares of Tshs5,000 each.

Earning for the period is Tshs1,225 million after tax. Tax charges are at 42%.

Required:

Calculate, for Rex Co, the basic earnings per share and the diluted earnings per share.

Question 3

The profits made by Chemco for the years ending 31 Mar 20X5, 20X6 and 20X7 are Tshs2,000 million, Tshs3,000 million and Tshs3,500 million respectively. The number of shares on 1 April 20X6 was 600,000.

Chemco made a rights issue for every 3 shares, of 1 new share @ Tshs3,000 in 20X6. The last date for exercise of right was 31 December 20X6. The market prices of one share of Chemco as at 31 December 20X6 were Tshs6,000.

Required:

Calculate the EPS for 20X5, 20X6 and 20X7.

Question 4

Exchange rates plummeted on 2 October 20X7. As a result, the market value of an investment held by Venus Ltd decreased by Tshs3 million and continued at the same level until the date of approval of the company's financial statements on 12 December 20X7. The value of the investments as at 30 September 20X7 was Tshs5 million.

Required:

How will this event be dealt with in the financial statements of Venus Ltd at 30 September 20X7? Give the necessary disclosures to be made in the financial statements.

Question 5

During 20X6, Dolly Co discovered that some products that had been sold during 20X5 were incorrectly included in inventory on 31 December 20X5 at Tshs9.75 million.

Dolly's accounting records for 20X6 show sales of Tshs156 million, cost of goods sold of Tshs129.75 million, (including Tshs9.75 million for the error in opening inventory), and income taxes of Tshs7.875 million.

In 20X5 Dolly reported

	Tshs'000
Sales	110,250
Cost of goods sold	(80,250)
Profit before income taxes	30,000
Income taxes	(9,000)
Profit	21,000

- In 20X5 opening retained earnings were Tshs30 million and closing retained earnings were Tshs51 million.
- Dolly's income tax rate was 30 per cent for 20X6 and 20X5. It had no other income or expenses.
- Dolly had Tshs7.5 million of share capital throughout, and no other components of equity except for retained earnings. Its shares are not publicly traded and it does not disclose earnings per share.

Required:

Discuss and illustrate the accounting and financial reporting implications of this situation for Dolly Co.

Question 6

Wonderwall Ltd earned Tshs38,349 million profit (after tax) during the year ended 30 June 20X8. The weighted average number of shares outstanding during the year was 255.66 million.

The following are the details pertaining to potential ordinary shares as at 30 June 20X8:

- Wonderwall issued convertible debentures which can be converted into 9 million ordinary shares on 30 June, 20X0. In the event the debentures are not converted, they shall be redeemed on 30 June, 20X0. The interest on debentures for the year 20X8 amounted to Tshs2,250 million.
- Preference shares issued in 20X5 are convertible into 12 million ordinary shares at the option of the preference shareholders. The conversion option is exercisable on 30 June, 20X1. The dividend paid on preference shares during the year 20X8 amounted to Tshs735 million.
- Wonderwall issued options carrying the right to acquire 4.5 million ordinary shares of the company on or after 30 June, 20X8 at a strike price of Tshs9,900 per share. During the year 20X8, the average market price of the shares was Tshs11,000 per share.

The company is subject to income tax at the rate of 30%.

Required:

Calculate the basic and diluted earnings per share for Wonderwall for the year to 30 June 20X8. Note: Ignore comparatives

Answers to Self Examination Questions**Answer to SEQ 1**

- (i) **Basic EPS:** There is no need to adjust the tax effect of the impairment separately. All items included in arriving at profit for the financial year are also included in the calculation of EPS.

Since we need the figure of earnings attributable to the ordinary shares, the payment of preference dividends is to be deducted:

Preference dividends	Tshs million
On the existing shares: 9% on Tshs1,600 million for full year	144
On the new issue: 7% on Tshs1,600 million for six months	56
	200

Numerator = Earnings attributable to ordinary shares (Tshs4,136 million – Tshs200 million) = Tshs3,936 million

Denominator = Weighted average number of shares in issue

Theoretical ex-rights price =

$$\frac{\text{Fair value of all outstanding shares before exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding before exercise} + \text{Number of shares issued in the exercise}}$$

$$\frac{(19,200,000 \times \text{Tshs } 2,400) + (4,800,000 \times \text{Tshs } 1,500)}{(19,200,000 + 4,800,000)} = \text{Tshs } 2,220$$

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Weighted average calculation

19,200,000 x Tshs2,400/Tshs2,220 x 4/12	6,918,919 shares
24,000,000 x 8/12	16,000,000 shares
Weighted average number	22,918,919 shares
EPS = Earnings attributable to ordinary shares/Weighted average number of shares	<u>Tshs3,936 million</u> 22,918,919 shares = Tshs172
Restated earnings for 20X5 = Tshs160 x Tshs2,220/Tshs2,400 (20X5 is the earliest period presented, the increase in the number is assumed to have taken place at the beginning of 20X5 and hence the EPS that was reported earlier, i.e. Tshs160 is restated.)	Tshs148

(ii) Fully diluted earnings per share: For calculating the diluted EPS, the numerators and denominators as above are taken as starting points and adjusted further.

(a) The conversion of loan stock has the following effects:	
1. Increase in the number of shares by Tshs3,200 million / (Tshs100,000 x 40 shares)	1,280,000 shares
2. Increase in the profits attributable to ordinary shareholders Savings in interest = Tshs3,200 million x 8%	Tshs256 million (Tshs76.8 million)
Increase in income tax = Tshs256 million x 30%	
Net increase in profits	Tshs179.2 million

(b) Conversion of directors' share warrants	
1. Increase in the number of shares (given)	1,200,000
2. Increase in the profits attributable to ordinary shareholders	Nil

Calculation of fully diluted EPS	
Adjusted numerator = Tshs3,936 million + Tshs179.2 million	Tshs4115.2 million
Adjusted denominator = 22,918,919 + 1,280,000 + 1,200,000	25,398,919
Fully diluted EPS = Tshs4,115.2 million/25,398,919 shares	Tshs162

Answer to SEQ 2

$$\text{Basic EPS} = \frac{\text{Total earnings}}{\text{No. of ordinary shares}}$$

$$\begin{aligned} \text{Basic EPS} &= \frac{\text{Tshs1,225 million}}{2,500,000} \\ &= \text{Tshs490} \end{aligned}$$

Diluted EPS

Calculation of earnings per incremental shares to check the potential shares are dilutive or anti-dilutive

$$1 - \text{tax rate} = 1 - 0.42 = 0.58$$

$$\begin{aligned} \text{(i) 7\% convertible debentures} &= \frac{\text{Tshs105 million} \times 0.58}{300,000 \text{ shares}} \\ &= \text{Tshs203} \end{aligned}$$

$$\begin{aligned} \text{(ii) 12\% convertible debentures} &= \frac{0.58 \times \text{Tshs480 million}}{400,000 \text{ shares}} \\ &= \text{Tshs696} \end{aligned}$$

if

Earning per incremental share on the conversion of 12% debenture is Tshs696, which is greater than the basic EPS of Tshs490. Therefore, it is anti-dilutive and is excluded from the diluted EPS calculation.

Earning per incremental share on the conversion of 7% convertible debentures is dilutive. Therefore, it is considered for the calculation of diluted EPS.

$$\text{Diluted EPS} = \frac{\text{Tshs } 1,225 \text{ million} + \text{Tshs } 60.9 \text{ million} *}{2,500,000 + 300,000}$$

= Tshs460

*0.58 x Tshs105 million

Answer to SEQ 3

Calculation of theoretical ex-rights value per share:

$$\frac{\text{Fair value of all outstanding shares before exercise of rights} + \text{Total amount received from exercise}}{\text{Number of shares outstanding before exercise} + \text{Number of shares issued in the exercise}}$$

$$\frac{(\text{Tshs } 6,000 \times 600,000) + (3,000 \times 200,000)}{600,000 + 200,000} = \text{Tshs } 5,250$$

Calculation of EPS

Market value per share immediately before the exercise of rights / Theoretical ex-rights fair value per share

	20X5	20X6	20X7
Original EPS $\frac{\text{Tshs } 2,000 \text{ million}}{600,000}$	Tshs3,333		
EPS restated for rights issue $\frac{\text{Tshs } 2,000 \text{ million}}{600,000} \times \frac{5,250}{6,000}$	Tshs2,917		
EPS including effects of right issue $\frac{\text{Tshs } 3,000 \text{ million}}{(600,000 \times 9/12 \times 6,000/5,250) + (800,000 \times 3/12)}$		Tshs4,200	
EPS $\frac{\text{Tshs } 3,500 \text{ million}}{800,000}$			Tshs4,375

Answer to SEQ 4

This is an event after the end of the reporting date. The event does not affect the value of the company's assets / liabilities on the date of the statement of financial position. However, this is a significant event, which will influence the financial position of the company in the future. Hence a disclosure regarding the post-statement of financial position decline in the value of investments is to be made in the financial statements.

Disclosure

The value of stocks held in Venus Ltd is Tshs5 million as at the end of the reporting date. However, due to a crash in the foreign currency markets and the stock exchanges during October 20X7, the value declined to Tshs3 million and continued at the same level until the date of approval of financial statements of the company on 12 December 20X7.

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Answer to SEQ 5

Retrospective restatement of errors of Dolly Co

Extract from the statement of profit or loss

	20X6	20X5
	Tshs'000	Tshs'000
Sales	156,000	110,250
Cost of goods sold	(120,000)	(90,000)
Profit before income taxes	36,000	20,250
Income taxes Profit	(10,800)	(6,075)
	25,200	14,175

Dolly Co

Statement of changes in equity

	Share capital	Retained earning	Total
	Tshs'000	Tshs'000	Tshs'000
Balance on 31 December 20X4	7,500	30,000	37,500
Profit for the year ended 31 December 20X5 as restated		14,175	14,175
Balance on 31 December 20X5	7,500	44,175	51,675
Profit for the year ended 31 December 20X6		25,200	25,200
Balance on 31 December 20X6	7,500	69,375	76,875

Extracts from the notes

Some products that had been sold in 20X5 were incorrectly included in inventory on 31 December 20X5 at Tshs9.75 million. The financial statements of 20X5 have been restated to correct this error. The effect of the restatement on those financial statements is summarised below. There is no effect in 20X6.

	20X5
	Tshs'000
(Increase) in cost of goods sold	9,750
Decrease in income tax expense	(2,925)
Decrease in profit	6,825
(Decrease) in inventory	(9,750)
Decrease in income tax payable	2,925
Decrease in equity	6,825

Answer to SEQ 6

Earnings Per Share of Wonderwall Limited

	20X8
(i) Basic earnings per share	
Profit (Tshs38,349 million)	Tshs38,349 million
Weighted average number of ordinary shares outstanding during the year (given)	255.66 million
Earnings per share (basic)	Tshs150
(ii) Diluted earnings per share	
Profit after taxation (Tshs38,349 million + 7,350,000)	390,840,000
Weighted average number of ordinary shares, options and convertible preference shares outstanding during the year (W2)	268,110,000
Earnings per share (diluted)	1.458

Working notes**W1 Ranking in order of dilution**

	Increase in earnings	Increase in no. of ordinary shares	Earnings per incremental shares	Rank
Convertible Debentures	1,575 million (Tshs2,250 m x (1-0.30))	9,000,000	175	3
Convertible Preference Shares	735 million	12,000,000	61.25	2
Options	-	*450,000	-	1

$$\frac{* 4.5\text{m shares} \times (\text{Tshs } 11,000 - \text{Tshs } 9,900)}{\text{Average market price (Tshs. } 11,000)} = 450,000$$

(Represents equivalent increase in number of shares)

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W2 Testing for dilutive effect

	Profit from operations attributable to ordinary shareholders	Ordinary Shares	EPS	Effect
	Tshs million		Tshs	
Options (Rank 1)	38,349 -	255,660,000 450,000	150	-
Convertible preference shares (Rank 2)	38,349 735	256,110,000 12,000,000	149.73	Dilutive
Convertible debentures (Rank 3)	39,084 1,575	268,110,000 9,000,000	145.8	Dilutive
	40,659	277,110,000	146.7	Anti-dilutive

Since diluted earnings per share increases on taking the convertible preference shares into consideration i.e. EPS increases from Tshs145.8 to Tshs146.7, the convertible debentures are considered to be anti-dilutive and therefore need to be ignored in the calculation of diluted earnings per share.

STUDY GUIDE D1: PREPARATION OF GROUP CONSOLIDATED EXTERNAL REPORTS

■ Get Through Intro

You may work for multinational corporations at some point in your career, and so you will need to have a thorough understanding of the concept, principles and techniques of consolidation.

You may wonder why there is need for preparing consolidated accounts. The purpose is to show the financial statements of a group of companies together as if the group was one single entity.

Consolidation of accounts does not mean merely adding together like items in the financial statements of the group companies. For example, if the sales of the parent company are Tshs30 million and that of the subsidiary are Tshs20 million then one would assume that consolidated sales are Tshs50 million (Tshs30 million + Tshs20 million). This would be true if there are no intra-group transactions but if the sales of the parent company include sales of Tshs5 million to the subsidiary then is it correct to say that consolidated sales are Tshs50 million? Can the group sell Tshs5 million to itself? The answer is no and this Study Guide will teach you how to make these adjustments and others.

In this Study Guide you will be introduced to the concept of a group; understand the meaning of parent and subsidiary. A study of this Study Guide will equip you to make adjustments mentioned above and leave you in a position where you will be able to prepare consolidated financial statements of a simple group with confidence and ease.

■ Learning Outcomes

- a) Identify the need for preparing consolidated financial statements.
- b) Discuss the circumstances in which entities are required to prepare and present statutory consolidated financial statements.
- c) Define group and explain the importance of control in identifying a group.
- d) State the purpose of preparing consolidated financial statements.
- e) Identify and state the laws, regulations accounting standards and other requirements that govern the production of consolidated financial statements by entities.
- f) Identify circumstances when a subsidiary can be excluded from consolidation.
- g) Prepare a consolidated statement of financial position for a simple group.
- h) Discuss the meaning of purchase consideration and understand various methods of purchase consideration.
- i) Account for goodwill and non-controlling interest.
- j) Prepare a consolidated statement of profit or loss and other comprehensive income and statement of changes in equity for a simple group.
- k) Evaluate and calculate the figures to be included in consolidated financial statements in respect of an acquisition, continuing ownership or disposal of a subsidiary but not including part disposals and disposal of an associate

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1. Identify the need for preparing consolidated financial statements.
2. Discuss the circumstances in which entities are required to prepare and present statutory consolidated financial statements.

[Learning outcomes a and b]

1.1 Need for preparing consolidated financial statements

The global financial crisis that started in 2007 highlighted the lack of transparency about the risks to which investors were exposed from their involvement with 'off balance sheet vehicles' (such as securitization vehicles), including those that they had set up or sponsored. As a result, the G20 leaders, the Financial Stability Board and others asked the Board to review the accounting and disclosure requirements for such 'off balance sheet vehicles'.

In today's global economy, most companies operate as a group, in which one main company controls the operations of many others. Each entity in a group prepares its own financial statements in which the investments in / by other group entities are reported.



Example

Virgin Records, a company in the Tanzania, is owned by EMI Records to the extent of 75%.

The Statement of financial position of Virgin Records will not reflect this fact separately. The statement of financial position will show simply the aggregate share capital: this will include the share held by EMI Records as well as those of other shareholders in Virgin Records.

However, the breakdown of share capital (showing the share held by EMI) will be given in a note to the statement of financial position of Virgin Records, in the following manner:

	Tshs
Share capital	1,000,000
Break-up	
EMI Records	750,000
ABC Co	200,000
Others	50,000
Total ordinary shares	1,000,000
The SOFP of EMI Records will reflect: Investment in Virgin Records	750,000

If the shareholders of the investing company wish to know how their investment is performing i.e., is the other entity making profits or losses, the individual financial statements are of no use. They cannot ascertain the financial viability of the investment made by their company from the individual financial statements they receive from it. They will remain doubtful about whether their money is in safe hands or not.



Example

Continuing with the previous example of Virgin records

From the individual financial statements of EMI Records, the shareholders of EMI Records have no means of knowing:

- How Virgin Records has deployed its capital among the various assets it owns?
- What its liabilities are?
- Whether it is earning profits or losses?

In short, they cannot ascertain whether the investment in Virgin Records is financially sound or not.

In a group, one main company controls the operations of many other entities. In such situations, it becomes imperative for the shareholders, directors, employees, suppliers, customers, government departments and other stakeholders to know the financial standing of the group as a whole.

Hence, consolidated financial statements are prepared.

1.2 Circumstances in which entities are required to prepare and present statutory consolidated financial statements

IFRS 10 states that consolidated financial statements have to be prepared where a group of entities are controlled by a parent.

In addition to this, **the Companies Act 2002 (enacted by the Parliament of the United Republic of Tanzania)**, lays down specific responsibility on the Directors of a group company to prepare group accounts in addition to the individual financial statements.

The group accounts shall be consolidated accounts comprising of:

- (a) a consolidated balance sheet dealing with the state of affairs of the parent company and all its subsidiaries to be dealt with in group accounts;
- (b) a consolidated profit and loss account dealing with the profit or loss of the parent company and those subsidiaries; and
- (c) a consolidated cash flow statement

Circumstances when a subsidiary can be excluded and cannot be excluded are discussed in detail in the next learning outcome.

1.3 Group as a single economic unit

IAS 27 revised defines consolidated financial statements as “The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.”

Consolidated financial statements are prepared by combining the financial statements of all the group entities, in order to **determine the financial status of the group as if it were one single economic entity.**

In substance, the parent and subsidiary can be viewed as a single entity, known as the group. Further the group has no legal existence, except for accounting purpose



Test Yourself 1

Discuss the validity of the following statement:

‘Fruits Inc is the parent of Apple Inc. Fruits Inc has prepared consolidated financial statements incorporating the accounts of Apple Inc. Hence, Fruits Inc and Apple Inc are now no longer two **distinct companies.**’

3. Define group and explain the importance of control in identifying a group.
4. State the purpose of preparing consolidated financial statements.
5. Identify and state the laws, regulations accounting standards and other requirements that govern the production of consolidated financial statements by entities.
6. Identify circumstances when a subsidiary can be excluded from consolidation.

[Learning outcome c, d, e and f]

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2.1 Concept of a group



Definition

Group is a parent and all its subsidiaries.

Parent is an entity that controls one or more entities.

Subsidiary is an entity that is controlled by another entity

IFRS 10, Appendix A

Separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 Financial Instruments

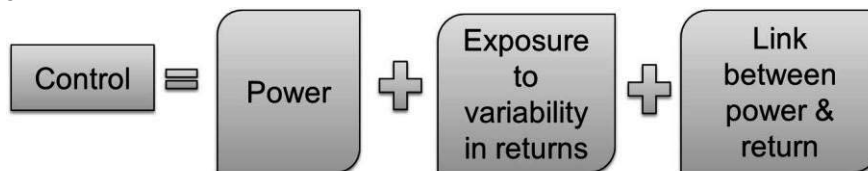
IAS 27, Para 4

2.2 Concept of control and its importance

Under IFRS 10, an investor controls an investee if and only if the investor has ALL the following:

1. power over the investee;
2. exposure, or rights, to variable returns from its involvement with the investee; and 3. ability to use its power over the investee to affect the amount of the investor's returns.

Diagram 1: Control



These are discussed in turn below:

1. Power

One of the important elements of control is **power**. IFRS 10 provides by far the most detailed guidance in evaluating whether an entity has power over the investee. The guidance in IFRS 10 requires an investor to evaluate all of the following to determine if it has power over the investee:

- Right to direct the relevant activities of the investee
- The way decisions about the relevant activities are made
- The rights that the investor and other parties have in relation to the investee
- Factors to be considered in consolidating a deemed separate entity (SILO)

Power arises from rights.

To have power over an investee, an investor must have existing rights that give the investor the current ability to direct the relevant activities.

Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:

- (a) rights in the form of voting rights (or potential voting rights) of an investee;
- (b) rights to appoint, reassign or remove members of an investee's key management personnel who have the ability to direct the relevant activities;
- (c) rights to appoint or remove another entity that directs the relevant activities;
- (d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and

- (e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.

Voting right

In accordance with IFRS 10, power can be obtained directly from ownership of the majority of voting rights. However one needs to carefully assess the various possibilities before confirming control.

- (a) Power with a majority of the voting rights:** control arises when an investor owns over 50% of the voting rights of an investee. This is the most common form for obtaining control over an investee. However, the voting rights should be substantive and not protective. For example, if an investor holds the majority of the voting rights, but legal or regulatory requirements prevent the holder from exercising its rights, then such rights would not give control over the investee.

A company controls another entity directly when it acquires majority of the voting rights of the other entity.

Wholly-owned subsidiary	An entity acquires 100% voting rights of another entity
Partially-owned subsidiary	An entity acquires more than 50% to 100% voting rights of another entity

If the subsidiary is not fully owned (i.e. if the parent company holds less than 100% shares in the subsidiary), the remaining shareholders together are called the non-controlling interest.



Definition

Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent.

IFRS 3, Appendix A

- (b) Majority of the voting rights but no power:** in some cases, voting rights may be designed in a manner such that they are not the dominant factor in deciding control over an investee. This may happen if the investor cannot direct the relevant activities of the investee or the rights may not be substantive. In such cases, the investor does not control the investee.



Example

Hope Co holds 100% of the shares of Wish Co, 70% of the shares of Dream Co and 40% of the shares of Fear Co.

Then by virtue of the majority of the voting rights:

- Wish Co is a fully owned subsidiary of Hope Co.
- Dream Co is a partially owned subsidiary of Hope Co. Fear Co is not a subsidiary of Hope Co.

Moreover, Hope Co needs to check whether the voting rights are substantive and whether they give it power to direct the relevant activities of the investee in order to consolidate Wish Co, Dream Co and Fear Co.



Test Yourself 2

Blue Co owns nominal share capital of Tshs2 million in Red Co out of its total share capital of Tshs6 million. Blue Co also owns shares worth Tshs3 million in Green Co and Tshs5.5 million in White Co. The share capital of Green Co is Tshs3 million and that of White Co is Tshs10 million.

Determine the relationship between Blue Co, Red Co, Green Co and White Co.

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(c) **Power without a majority of the voting rights:** this could be due to:

- (i) a contractual arrangement between the investor and other vote holders;
- (ii) rights arising from other contractual arrangements;
- (iii) the investor's voting rights, referred to as de facto control (for example, when the investor holds significantly greater voting rights than any other vote holder or organised group of vote holders) (iv) potential voting rights (considered only if they are substantive); or
- (v) a combination of (a)–(d).



Example

Wonder Ltd holds 40 per cent of the voting rights of an investee and twelve other investors each hold 5 per cent of the voting rights of the investee. A shareholder agreement grants Wonder the right to appoint, remove and set the remuneration of management responsible for directing the relevant activities.

To change the agreement, a two-thirds majority vote of the shareholders is required.

Does Wonder have power over the investee?

Answer

In this case, Wonder cannot conclude on the basis of its holding and the relative size of the other shareholdings in comparison to its shareholding to determine whether it has sufficient power to control the investee.

However, after considering its contractual right to appoint, remove and set the remuneration of management, it may conclude that it **has power over the investee**.

The fact that Wonder might not have exercised this right or the likelihood of it exercising its right to select, appoint or remove management shall not be considered when assessing whether Wonder has power.



Example

Appointments of CEO and the majority of the board members in Demanto Ltd are controlled by Genfast Ltd as a result of a contract. The voting rights of shareholders relate to administrative tasks only. In this case, the conduct of relevant activities is directed by means of contractual arrangements.

2. Variable returns

The second element of control pertains to returns. To control an investee, an investor must be exposed, or have rights to variable returns from its involvement with the investee.

This happens when the investor's returns from its involvement have the potential to vary as a result of the investee's performance.

Although only one investor can control an investee, more than one party can share the returns of an investee. For example, holders of non-controlling interests can share the profits or distributions of an investee, but cannot control the investee.



Example

Baywatch Ltd holds a bond with fixed interest payments. Is this investment subject to variable returns?

Answer

The fixed interest payments are variable returns for the purpose of IFRS 10 because they are subject to default risk and they expose the investor to the credit risk of the issuer of the bond.

The amount of variability (i.e. how variable those returns are) depends on the credit risk of the bond.

3. Link between power and returns

This is the third and final element of 'control'. The link between power over an investee and the returns is essential to having control. The investor does not control the investee in the following circumstances:

- an investor has power over an investee, but cannot benefit from that power
- an investor receives a return from an investee, but cannot use its power to direct the activities that significantly affect the returns of that investee

Therefore, it becomes necessary that the investor should have the ability to use its power over the investee to affect its returns.



Important

Continuous assessment of control

IFRS 10 requires a continuous assessment of control of an investee. This continuous reassessment would consider both changes in an investor's power over the investee and changes in the investor's exposure or rights to variable returns. This assessment will be made based on changes in facts and circumstances, but would be revisited at least at each reporting period.

2.3 Purpose of preparing consolidated financial statements

The purpose of preparing Consolidated financial statements are as follows:

1. Consolidated financial statements help to ascertain the financial status of the group as a whole.
2. Consolidated financial statements show the full earnings on a parent entity's investment. The parent's individual accounts show only the dividend received, if any, from the subsidiaries.
3. Consolidated financial statements safeguard the interests of the ordinary shareholders of the parent entity. If the subsidiary is making losses, then the parent's share of this loss will be deducted from the profits of the parent entity while preparing the consolidated financial statements. This knowledge helps shareholders to take decisions about retaining or disposing of their investment in the parent entity.
4. Consolidated financial statements help management of the parent entity form a picture of the group as a whole. Sometimes when one is involved in the day-to-day functioning of entities, one can lose sight of the big picture. Consolidated financial statements provide an overview of the financial status of the group as a whole.
5. Consolidated financial statements help prevent companies from indulging in malpractices and manipulations to avoid taxes, to smooth profits etc. e.g. If consolidation were not compulsory, then heavy inventories in one entity could be transferred as sales to another entity in the group to smooth the profits.



Test Yourself 3

Explain how consolidated financial statements help prevent companies from indulging in malpractices and manipulations.



Tip

Merely preparing consolidated financial statements does not prove that the entities are a single operating unit. A group has no legal existence, except for accounting purposes.

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2.4 Regulations and accounting standards that govern the production of consolidated financial statements

In accordance with the Tanzanian Companies Act 2002, at the end of each accounting period, the directors of a parent company having subsidiaries, shall prepare group accounts along with the individual accounts, which shall be laid before the company in general meeting when the parent company's individual accounts are so laid.

The group accounts shall be consolidated accounts comprising of:

- (a) a consolidated balance sheet dealing with the state of affairs of the parent company and all its subsidiaries to be dealt with in group accounts;
- (b) a consolidated profit and loss account dealing with the profit or loss of the parent company and those subsidiaries; and
- (c) a consolidated cash flow statement

The accounts shall give a true and fair view of the state of affairs as at the end of the accounting period, and the profit or loss and the cash flow for the accounting period, of the undertakings included in the group, so far as concerns members of the company.

The accounting for consolidated financial statements is primarily governed by the following IFRS / IAS:

- IFRS 10 Consolidated Financial Statement
- IFRS 3 Business Combinations
- IAS 28 Investments in Associates and Joint Venture

2.5 Exemption from preparing consolidated financial statements

A parent need not prepare consolidated financial statements, only if all the conditions mentioned below are fulfilled:

- (a) It is a wholly or partially-owned subsidiary of another entity, and its other owners have been informed, and do not object to, the parent not presenting consolidated financial statements.
- (b) The ultimate or any intermediate parent publishes consolidated financial statements that comply with International Financial Reporting Standards.
- (c) The parent's debt or equity instruments are not traded in a public market
- (d) It is not in the process of issuing its securities in public securities market

Further according to The Companies Act 2002 in Tanzania, a parent company is exempt from preparation of group accounts if:

it is itself a subsidiary of another company that does prepare group accounts. the group headed by that company is not an ineligible group.

A group is ineligible if any of its members is –

- (i) A public company or a body corporate which not being a company has power under its constitution to offer its A shares or debentures to the public and may lawfully exercise that power
- (ii) A bank
- (iii) An insurance company
- (iv) A dealer or an investment

Diagram 2: Exemptions from consolidation



Test Yourself 4

If Fast Co is a partially-owned subsidiary of Steady Co, and Medium Co is a partially-owned subsidiary of Fast Co:

Required:

When can Fast Co be exempted from preparing its consolidated financial statements?



Test Yourself 5

King Co owns 60% of the shares of Queen Co who owns 90% of the shares of Jack Co. Queen Co do not wish to include the accounts of Jack Co in its consolidated financial statements, to which its shareholders do not object. It is coming up with a public issue of shares in the next financial year for which it is in the process of filing its financial statements. King Co includes the accounts of Jack Co in its consolidated financial statements.

Required:

Can Queen Co be exempted from preparing its consolidated financial statements?

6. Prepare a consolidated statement of financial position for a simple group.
7. Discuss the meaning of purchase consideration and understand various methods of purchase consideration.
8. Account for goodwill and non-controlling interest.

[Learning Outcome g, h and i]

3.1 The acquisition method

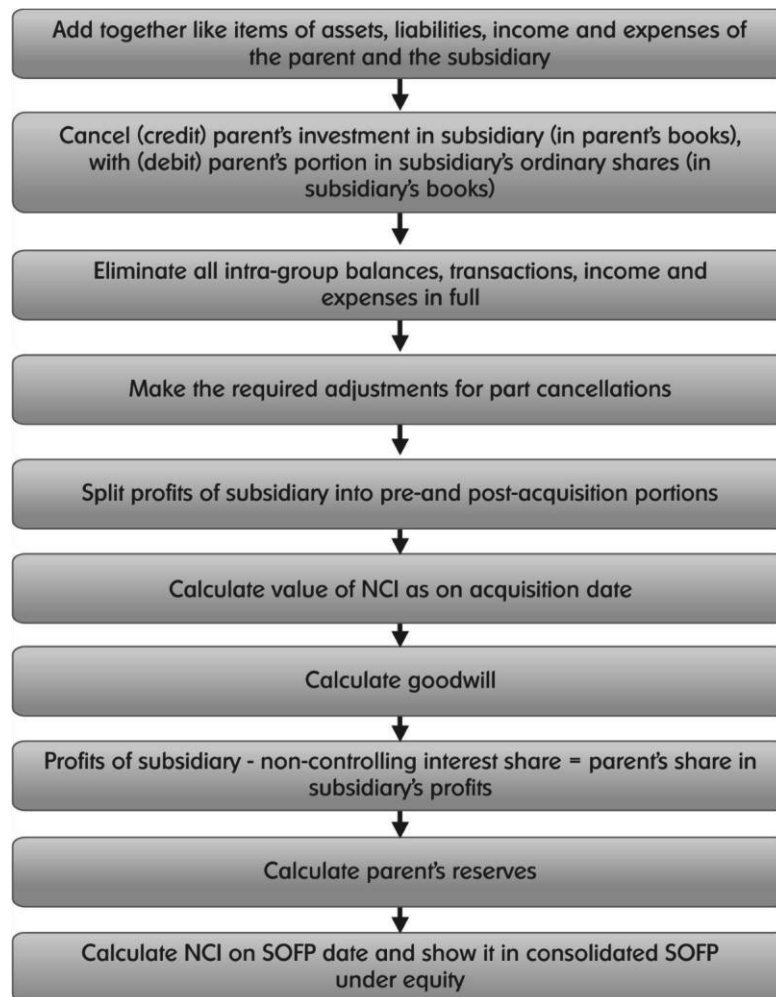
All business combinations should be recognised using the acquisition method which involves the following steps:

1. **Identifying an acquirer** - which obtains control of the other entity. If this cannot be established from shareholdings and other factors listed in IFRS 10 provides additional indicators which include:
 - power over more than one-half of the voting rights of the other entity by virtue of an agreement with other investors; or
 - power to govern the financial and operating policies of the other entity under a statute or an agreement; or
 - power to appoint or remove the majority of the members of the board of directors; or power to cast the majority of votes at meetings of the board.

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2. **Determining the acquisition date** - This is generally the date on which the parent company (acquirer) transfers consideration and acquires the net assets of the acquiree. This is important in determining pre and post-acquisition reserves of the acquiree. For example, the acquisition date will be earlier than the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date.
3. **Recognising and measuring the identifiable assets** acquired, the liabilities assumed and any noncontrolling interest in the acquiree. (non-controlling interest discussed in detail later)
4. Recognising and measuring **goodwill** or a gain from a bargain purchase. (Goodwill discussed in detail later)

Diagram 3: Preparation of Consolidates SOFP



Note

- IFRS 10 requires that the financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements shall be prepared as of the same date.
- IFRS 10 requires that consolidated financial statements shall be prepared using uniform accounting policies for like transaction and other events in similar circumstances.

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to that group member's financial statements in preparing the consolidated financial statements to ensure conformity with the group's accounting policies

The term **non-controlling interest** will be explained little later in this Study Guide.

3.2 Addition of like items and intra-group cancellations

First of all, scrutinise the individual accounts of the parent and all its subsidiaries.

-
- **Cancel all intra-group items** e.g. items that appear as an asset in one entity (e.g. trade receivable) and a liability in the other (e.g. trade payable) which belong to group companies.
- **Add together all un-cancelled assets and liabilities** of the parent and the subsidiary, line by line and reflect in the consolidated statement of financial position.

This represents **all the assets and liabilities of the group as a whole**, whether belonging to the parent or the subsidiary.

Part-cancellation

In real life, not all intra-group transactions as recorded in the books of the subsidiary and parent **match or fully cancel each other**.

The reasons why intra-group transactions do not match each other are:

- There could be goods in transit and cash in transit as at the reporting date.
- Loan stock may be issued by one company to the other, but the other company may not have taken it up entirely.
- A cheque issued by one company to the other may not have been realised in the other's bank account.



Test Yourself 6

Broom Co acquired 100% shares of Vroom Co on 31 December 20X5. The statement of financial positions of the two companies as on 31 December 20X5 are:

	Broom Co		Vroom Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Tangible assets		45,000		30,000
Investments: Shares of Vroom Co	23,000			
Loan stock of Vroom Co	5,000	28,000		
Current assets				
Inventories	10,000		8,000	
Receivables	8,000		9,000	
Cash at bank	4,000	22,000	3,000	20,000
Total assets		95,000		50,000
Equity and liabilities				
Capital and reserves				
Ordinary shares	63,000		23,000	
Retained earnings	18,000	81,000	8,500	31,500
Non-current liabilities				
Loan stock				10,000
Current liabilities				
Payables		14,000		8,500
Total liabilities		95,000		50,000

Additional information: Payables in Broom Co include Tshs6 million payable to Vroom Co. Receivables in Vroom Co comprise receivables from Broom Co only.

Required:

Prepare a consolidated statement of financial position for the group.

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3.3 Consideration (cost of acquisition)

The consideration transferred in a business combination is to be measured at fair value. Consideration can be paid in any form such as cash, other assets, ordinary or preference equity instruments, options, warrants etc. It should be calculated as the sum of the fair values (as at acquisition date) of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer.

1. Contingent consideration



Definition

Contingent consideration is the consideration that an acquirer commits to the acquiree in cash or additional equity interests or other assets after the acquisition date on the fulfilment of a certain specified event or condition in the future.

This kind of arrangement is made generally when there is a difference in the opinion between the acquirer and the acquiree regarding the fair value of the acquired business.

This arrangement is recognised as at the acquisition date at its fair value, resulting in an equity or liability.

Initially contingent consideration is measured at the acquisition-date fair value of the obligation. The fair value depends on the estimation of the circumstances and the probability of the event occurring or fulfilment of the commitment on the date of acquisition.

Contingent consideration can be classified into equity or liability on the basis of the definitions of an equity instrument and a financial liability according to IAS 32 Financial Instruments: Presentation.

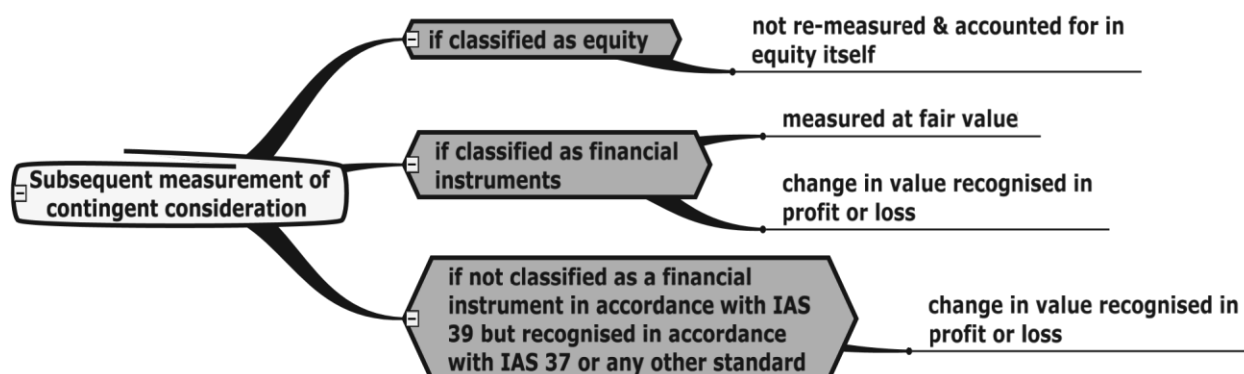
Subsequent measurement of contingent consideration does not affect goodwill.

Subsequent changes in the valuation of contingent consideration after the acquisition date are accounted for as follows:

- If the contingent consideration is classified as equity then it is not remeasured, and is accounted in equity itself.
- If the contingent consideration is classified as a financial instrument in accordance with IFRS 9 Financial Instrument, it is measured at fair value and the change in the value is recognised either in the profit or loss or equity in accordance with the requirements of IFRS 9.
- If the contingent consideration is not classified as a financial instrument in accordance with IFRS 9 and is recognised in accordance with IAS 37 Provisions, Contingent Assets and Contingent Liabilities or any other applicable standard, then the change in the value is recognised in the profit or loss.

Goodwill therefore is not affected by the actual outcome of the contingent consideration.

SUMMARY



2. Deferred consideration

Any consideration which is not payable immediately but is payable in the future and which is not contingent is called a deferred consideration.

Such consideration should be valued at present value of the amount payable. For this, amount payable in future should be multiplied by the present value factor (present value factor is calculated using the cost of capital to the parent).



Example

On 1 January 20X7, Welldone Co acquired 80% shares in Don Co, out of 100,000 shares. It agreed to pay Tshs5,000 per share in cash immediately and Tshs120 million after 31 December 20X8. Cost of capital of Welldone is 10%.

Therefore total consideration will be:

Present value factor is used for calculation

	Tshs million
Immediate 100,000 shares x 80% x Tshs5,000	400
Deferred Tshs120 million x $\frac{1}{(1.10)^2}$	99
Total consideration	499

Unwinding of the discount on the deferred consideration is required on the reporting date. The amount should be charged to finance cost. Unwinding does not affect the consideration amount.



Example

Continuing the previous example of Welldone Co

In the above case, on 31 December 20X8, the following entry should be made in order to record approx. Tshs10 million (Tshs99 million x 10%)

Dr Finance cost	Tshs10 million	
Cr Provision for deferred consideration		Tshs10 million
Being unwinding of the discount on deferred consideration		

As a result of this, the amount payable will be Tshs109 million (Tshs99 million + Tshs10 million) at the end of 31 December 20X8. On 31 December 20X9 by further unwinding of approx. Tshs11 million (Tshs109 million x 10%); the amount will be Tshs120 million (Tshs109 million+ Tshs11 million).

3. Consideration paid in cash

When a consideration is paid in cash, it is accounted as follows:

Dr Investment	X	
Cr cash		X
Being consideration paid		

4. Consideration in shares

The accounting for consideration when the payment is not by cash is explained by the following example:



Example

On 1 April 20X6, Shweta Co acquired 24,000 shares in Yash Co by way of exchange of two shares in Shweta Co for every three shares in Yash Co. The face value of Shweta Co's share is Tshs1,000 each and its market price is Tshs2,000 each.

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In this case, the consideration in Yash Co is calculated as follows:

No of shares issued x FV per share = $(24,000 \times 2/3) \times \text{Tshs}2,000 = 32,000,000$

Dr Investment	Tshs32,000,000	
Cr Share capital (Tshs32,000,000 x 1/2)		Tshs16,000,000
Cr Share premium (Tshs32,000,000 x 1/2)		Tshs16,000,000
Being consideration in Yash Co recorded		

(Fair value of the share is Tshs1,000, the market price is Tshs2,000, and premium is Tshs1,000 (Tshs2,000 - Tshs1,000). So, the ratio of capital: premium is 1:1)



Test Yourself 7

On 1 January 20X6, Fruit Co acquired 16,000 shares in Preservative Co. This was by way of exchange of three shares in Fruit Co for every four shares in Preservative Co. The face value of Fruit Co's share is Tshs1,000 each and its market price is Tshs1,500 each.

Required:

How will this consideration be recorded by Fruit Co?



Tip

Ordinary shares in the consolidated SOFB are always equal to the ordinary shares of the parent entity only. This is because the consolidated accounts are prepared for the shareholders of the parent entity, so should reflect their share capital.

3.4 Non-Controlling Interest (NCI)

IFRS 10 requires the consolidated financial statements of the group to include the accounts of all its subsidiaries (whether wholly or partly owned) under the full consolidation method i.e. 100% consolidation.

When a subsidiary is not wholly owned, (i.e. owned 100% by the parent), a part of the net assets belong to the minority shareholders. This is called the non-controlling interest (NCI). IFRS 3 allows an accounting policy choice, available on a transaction by transaction basis, to measure non-controlling interest either at:

- fair value (sometimes called the full goodwill method); or
- the non-controlling interest's proportionate share of net assets of the acquiree (option is available on a transaction by transaction basis).

Furthermore

- (i) Management must **elect**, for each acquisition, the option to measure the non-controlling interest
- (ii) If non-controlling interest is measured at fair value, it can be determined by referring to the market price of shares held by non-controlling shareholders just before the acquisition by the parent.

Measurement of non-controlling interest

Same methods of measurement are continued, except for a few changes. According to the new requirements, for each business combination, the acquirer shall measure at the acquisition date components of any noncontrolling interests in the acquiree **that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation** at either:

- (i) the fair value; or
- (ii) the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets.

All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by IFRS.

Thus, non-controlling interests are those other than the present ownership interests that entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. The choice to measure non-controlling interest using any of the **two methods will not be available** and these components of non-controlling interests shall be measured at their **acquisition-date fair values**. However, if any other IFRS requires another measurement basis it will be measured in accordance with that IFRS. For example, if a share-based payment transaction is classified as equity, an entity will be expected to measure it in accordance with IFRS 2.



Example

Ermo Inc has issued 200 preference shares, which are classified as equity. These preference shares have a nominal value of Tshs1,000 each. The preference shares give their holders the right to a preferential dividend, before any dividend is paid to the holders of ordinary shares. Upon liquidation of Ermo Inc, the holders of the preference shares are entitled to receive their share before the holders of ordinary shares receive theirs. Vermo Inc acquires all ordinary shares of Ermo Inc. The acquisition gives Vermo Inc control over Ermo Inc. The acquisition-date fair value of the preference shares is Tshs12,000 each.

IFRS 3 states that for each business combination, the acquirer shall measure at the acquisition date the components of non-controlling interest in the acquiree. The non-controlling interests that relate to Ermo Inc's preference shares do not qualify for the measurement choice in paragraph 19 of IFRS 3 because they do not entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. Therefore, the acquirer measures the preference shares at their acquisition-date fair value of Tshs12,000 each.

Had the shares been issued as consideration in a share based transaction then instead of the fair value, valuation would have been made according to IFRS 2, as there is a particular IFRS governing such transactions.

Option 1 – Measuring non-controlling interest at fair value

The fair value of the equity shares not held by the acquirer is determined on the basis of the market prices prevailing on the date of acquisition.

However, to determine the fair value of the non-controlling interest will require expertise and additional time. If this is possible then only this option can be selected.

Option 2 – Measuring non-controlling interest by calculating the share of the fair value of net assets acquired in accordance with revised IFRS 3

Only the share of the value of the assets and liabilities of the acquiree is considered to be the amount of noncontrolling interest in accordance with the requirements of revised IFRS 3.

Calculation of the value of non-controlling interest using the share of net assets on acquisition date =
Proportionate **NCI** holding x acquisition date FV of net assets

Where, FV of net assets = FV of all identified assets – FV of all identified liabilities

OR

Share capital + all reserves on acquisition date + FV adjustment on acquisition

Since there is an option to value non-controlling interest at fair value, it is expected that the examiner will specify the method to use in the question by stating.

'It is the group policy to value non-controlling interest at'

If you are asked to use fair value, there are three options to calculate it:

- (a) Value is given in the question
- (b) On the basis of the subsidiary's share price just before acquisition
- (c) the amount of goodwill attributable to non-controlling interest is given.

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In case (c), calculate non-controlling interest's value as share of net assets and add non-controlling interest's share in goodwill to it.

Non-controlling interest is calculated on acquisition date as well as on reporting date. non-controlling interest at acquisition date is considered in calculating goodwill and non-controlling interest on reporting date is shown in the consolidated statement of financial position **within equity but separately from the parent entity's share in the equity**.



Tip

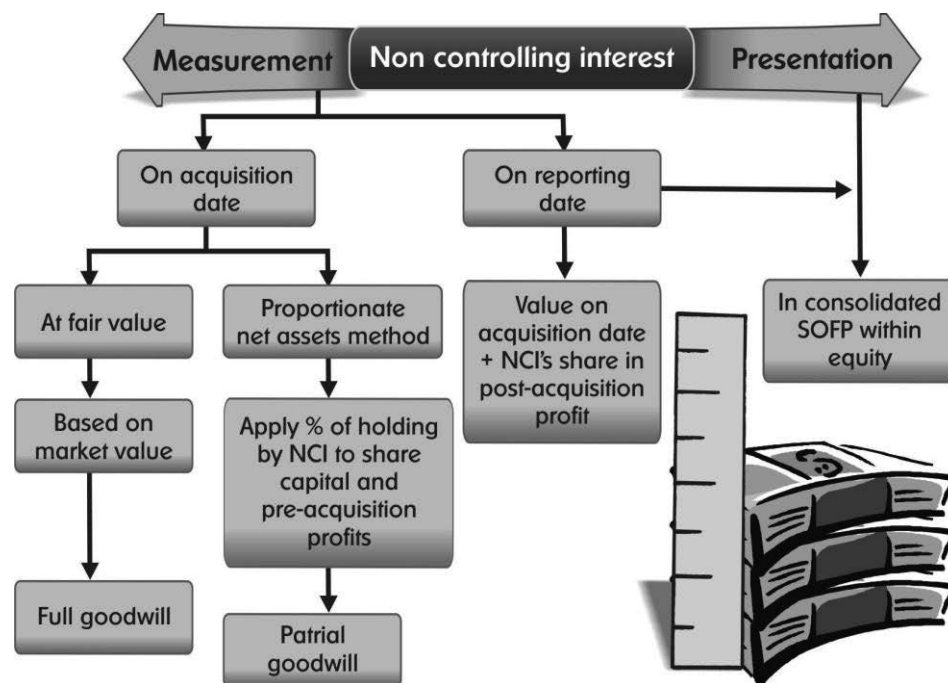
IFRS 3 gives us two options in measurement of non-controlling interest

Option 1: measuring non-controlling interest at fair value we do not add pre-acquisition reserves to the non-controlling interest because that is already taken care of by the fair value of non-controlling interest.

Option 2: measuring non-controlling interest by calculating the share of the value of net assets acquired in accordance with revised IFRS 3 - we add the pre-acquisition reserves to the non-controlling interest.

Non-controlling interest to be shown in the statement of financial position is calculated as the value of non-controlling interest considered for calculation of goodwill + post-acquisition profit.

Diagram 4: Measurement and presentation of non-controlling interest



3.5 Goodwill

1. Definition



Definition

Goodwill is an asset representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised.

2. Measurement and recognition of goodwill in consolidated financial statements:

Goodwill is calculated as the excess of the total of the purchase consideration plus value of non-controlling interest over the acquisition date net assets. Therefore, **goodwill is a residual value**.



Example

Mac

Peter's is a very successful restaurant. However, Peter (the owner) is now old and wants to sell his restaurant.

He knows that the value that the new owner of his business will get is more than JUST the price of the chairs, tables, premises, inventory etc.

The new owner will get a successful business and will not have to worry about getting any customers.

Peter will definitely **demand and obtain a price for the name that he has built up**.

If the value of the net identifiable assets of **Mac Peter's** is Tshs40 million but Peter demands and obtains Tshs50 million for his business, then this additional price or premium of Tshs10 million (Tshs50 million – Tshs40 million) which Peter gets is **positive goodwill**.

As stated above, since there are two ways of calculating non-controlling interest, goodwill can be calculated using two methods:

- **Full goodwill method:** based on fair value of non-controlling interest
- **Partial goodwill method:** based on share of non-controlling interest in the value of net assets of the company acquired. In this case goodwill shows only the acquirer's share (this is because in connection with the non-controlling interest, the same amount is repeated in both, value of non-controlling interest and net assets of subsidiary, and therefore does not affect goodwill)



Example

On 1

April 20X6 Wish Co buys 80% shares for Tshs20 million of Dish Co. Details of Dish Co at 31 March 20X6 are:

Ordinary shares Tshs20 million
Retained earnings Tshs2 million

The fair value of the non-controlling interest is Tshs5 million.
Account for the acquisition for Wish Co. applying both the methods of non-controlling interest.

Option 1: Non-controlling interest at fair value

Dr	Fair value of identifiable net assets acquired	Tshs22 million	
Dr	Goodwill	Tshs3 million	
	Cr	Cash /capital (Consideration)	Tshs20 million
	Cr	Non-controlling interest	Tshs5 million

	Tshs'000
Consideration transferred	20,000
Add: Fair value of NCI	5,000
	25,000
Less: Controlling interest's share in fair value of the identifiable net assets acquired	22,000
	3,000

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The goodwill relating to the controlling interest is Tshs2.4 million (Tshs20 million – (Tshs22 million x 80%)) the remaining goodwill of Tshs0.6 million (Tshs3 million - Tshs2.4 million) is pertaining to the non-controlling interest. Non-controlling interest's share of goodwill can also be calculated as Tshs5 million – (Tshs22 million x 20%).

Option 2: Non-controlling interest at proportion of net assets

Dr	Fair value of identifiable net assets acquired	Tshs22 million	
Dr	Goodwill	Tshs2.4 million	
	Cr	Consideration	Tshs20 million
	Cr	Non-controlling interest	Tshs4.4 million

	Tshs'000
Consideration transferred	20,000
Add: Proportionate value of NCI (Tshs22,000 x 20%)	4,400
	24,400
Less: Fair value of the identifiable net assets acquired	(22,000)
	2,400

The goodwill of Tshs2.4 million is attributable only to the parent. Value of non-controlling interest added to the consideration is also added to the net assets. This ultimately nullifies the result. Effectively, goodwill is the difference between the consideration of Tshs20 million and the share of the fair value of the identifiable net assets acquired (Tshs22 million x 80%) Tshs17.6 million.

Goodwill is an intangible asset which is recognised and reflected in the consolidated statement of financial position.



Example

Asking Co pays Tshs8 million to buy 80% shares in Basking Co. The net identifiable asset is Tshs6.5 million and the fair value of 20% of the non-controlling interest is Tshs2.2 million.

Then the amount of goodwill will be:

	Tshs'000
Investment in shares of Basking Co	8,000
Fair value of non-controlling interest	2,200
	10,200
Less: Net assets acquired	(6,500)
Positive balance – to be treated as intangible asset	3,700

Positive goodwill amounting to Tshs3.7 million will be reflected as an intangible asset in the consolidated statement of financial position.

3. Recognising and measuring a gain on bargain purchase

When there is negative goodwill, it is called as gain on bargain purchase. Therefore goodwill or bargain purchase is calculated as the difference between:

- Fair value of the consideration on the acquisition date + Amount of non-controlling interest in the acquiree + Fair value of the acquirer's previously held equity interest in the acquiree on the acquisition date
- Fair values of the identifiable assets acquired and liabilities assumed on the acquisition date

$$\text{Goodwill} = A - B$$

$$\text{Bargain purchase} = B - A$$

The IFRS also lays down that the identification and the measurement of the assets and liabilities acquired / assumed shall be reassessed before the gain on bargain purchase is recognised. Any additional assets or liabilities that are

identified in this review should be recognised. The acquirer should also review all the procedures used to measure the fair values for all the following to see if they in accordance with the requirements of IFRS for recognition at the acquisition date:

- the identifiable assets acquired and liabilities assumed
- the non-controlling interest in the acquiree, if any
- for a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree the consideration transferred

This ensures that the measurements are done appropriately and shows the total consideration of all available information as of the acquisition date.

After ensuring the above, the acquirer should recognise the resulting gain in profit or loss on the acquisition date. The gain shall be attributed to the acquirer.



Example

Mac Paul's is a restaurant which was very successful. In the last month, however, there was a bad case of food poisoning which was featured across the local television network and in the local press. This bad publicity has ruined the business and Paul (the owner), who is old wants to sell his restaurant.

His competitor Jerry, who is aware of the potential of Paul's business, decides to buy it. Being a shrewd businessman, he offers a price of Tshs45 million, which is less than the net value of Paul's business (Tshs54 million).

If Jerry's offer is accepted by Paul, then the difference in price offered and accepted by Paul and the value of Paul's business Tshs9 million (Tshs54 million – Tshs45 million) is a **gain on bargain purchase**.



Example

Mariplex acquires 75% of shares of Barnlet for Tshs140 million. The identifiable assets are measured at Tshs250 million and the liabilities assumed are measured at Tshs50 million. The valuer appointed by Mariplex determines the fair value of the 25% non-controlling interest in Barnlet as Tshs42 million.

The identifiable net assets of Barnlet amount to Tshs200 million (Tshs250 million - Tshs50 million). This exceeds the fair value of the consideration transferred plus the fair value of the non-controlling interest in Barnlet i.e. (Tshs140 + Tshs42) = Tshs182 million.

Therefore Mariplex will now review the procedures used to identify and measure the assets acquired and liabilities assumed, fair value of both the non-controlling interest in Barnlet and the consideration paid. After the review Mariplex determines that the procedures and the measures used were appropriate. The gain on the purchase of the 75% interest is measured as follows by Mariplex:

Option 1: Non-controlling interest at fair value

	Tshs'000	Tshs'000
Fair value of the consideration transferred	140,000	
Add: Fair value of non-controlling interest in Barnlet	42,000	182,000
Less: Amount of the identifiable net assets acquired (Tshs250,000 - Tshs50,000)		(200,000)
Gain on bargain purchase		(18,000)

Mariplex would record its acquisition of Barnlet in its consolidated financial statements as follows:

	Tshs'000	Tshs'000
Dr Identifiable assets acquired	Tshs250,000	
Cr Cash		Tshs140,000
Cr Liabilities assumed		Tshs50,000
Cr Gain on the bargain purchase		Tshs18,000
Cr Equity – Non-controlling interest in Barnlet		Tshs42,000

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Option 2: Non-controlling interest at proportion of net assets

Workings

Non-controlling interest (25%)

Amount of non-controlling interest in Barnlet= 25% of Tshs200 million = Tshs50 million

	Tshs'000	Tshs'000
Consideration paid	140,000	
Add: Amount of non-controlling interest in Barnlet	50,000	190,000
Less: Amount of the identifiable net assets acquired (Tshs250,000 - Tshs50,000)		200,000
Gain on bargain purchase		(10,000)

Gain on bargain purchase is treated as an item of income, and reflected in the consolidated statement of profit or loss



Test Yourself 8

When would a company be willing to be bought by an acquirer for an amount lower than the value of its total net assets?

3.6 Factors affecting goodwill

1. Measurement period

To record an acquisition, an acquirer has to gather a lot of information in order to identify and measure the following as of the acquisition date in accordance with the requirements of this IFRS:

- the identifiable assets acquired, liabilities assumed and non-controlling interest in the acquiree;
- the consideration transferred for the acquiree (or the other amount used in measuring goodwill);
- in a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer; and
- the resulting goodwill or gain on a bargain purchase.

IFRS 3 requires that the identifiable assets acquired and liabilities assumed in acquisition should be recorded at the fair value.

This exercise involves a lot of time and therefore sometimes it may not be possible to gather the required information by the end of the reporting period in which the combination occurs. In such a case, the acquirer shall report in its financial statements provisional amounts for the items for which the accounting is incomplete. These amounts should be then adjusted when the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date.



Definition

The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognised for a business combination.

IFRS 3 Para 46

However, the measurement period shall not exceed one year from the acquisition date.

The measurement period provides the acquirer with a reasonable time to obtain the information necessary to account for acquisition. **During the measurement period, the acquirer shall retrospectively adjust the provisional**

amounts recognised at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.

The measurement period adjustments can only be related to new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognised as of that date.



Example

Continuing the example of Mariplex

If Mariplex acquires Barnlet on 30 September 20X7, Mariplex appoints a valuer to determine the fair value of an item of property, plant and equipment acquired from Barnlet. Mariplex has to issue its consolidated financial statements for the year ended 31 December 20X7 by 31 March 20X8. However the valuer could not complete his work by 31 March 20X8 and so Mariplex recognised the asset at a provisional fair value of Tshs30 million. The item of property, plant and equipment had a remaining useful life of five years at the acquisition date. Mariplex received the valuation of the item on 31 August 20X8 as Tshs40 million on the date of acquisition.

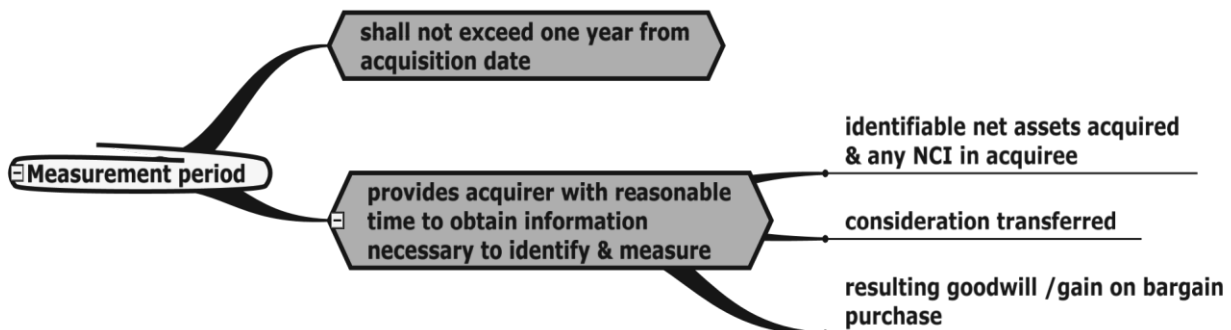
Mariplex would in its financial statements for the year ended 31 December 20X8, retrospectively adjust the 20X7 (prior year) information as follows:

The carrying amount of property, plant and equipment as of 31 December 20X7 is increased by Tshs9.5 million. Adjustment is measured as fair value adjustment at the acquisition date of Tshs10 million less the additional depreciation that would have been recognised if the asset's fair value at the acquisition date had been recognised from that date (Tshs0.5 million for 3 months' depreciation).

1. The gain on bargain purchase as of 31 December 20X7 is increased by Tshs10 million.
- 2.
3. Depreciation expense for 20X7 is increased by Tshs0.5 million.
- 4.
5. Mariplex will disclose in its financial statements of 20X7 that the initial accounting for the business combination has not been completed because the valuation of property, plant and equipment has not been received. In the financial statements of 20X8 it would give the amounts and explanations of the adjustments to the provisional values recognised during the current reporting period.

Therefore Mariplex discloses that the 20X7 comparative information is adjusted retrospectively to increase the fair value of the item of property plant and equipment at the acquisition date by Tshs9.5 million, offset by an increase in bargain purchase of Tshs10 million and an increase in depreciation expense of Tshs0.5 million.

SUMMARY



Test Yourself 9

Pineapple Co pays Tshs8 million for acquiring 80% shares of Biscuit Co. The fair value of 20% of noncontrolling interest is Tshs1.5 million and identifiable net asset are Tshs7.5 million.

It also pays Tshs10 million for acquiring 75% shares of Cake Co. The fair value of 25% of non-controlling interest is Tshs2.5 million and identifiable net asset are Tshs13 million.

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It also acquires Dessert Co by paying Tshs5.5 million for acquiring 60% shares. The non-controlling interest on the basis of its proportionate interest in identifiable net assets of Dessert Co is Tshs4.75 million. The net identifiable assets are Tshs2.5 million.

Required:

Calculate the goodwill in each case and say how it will be accounted for in the consolidated financial statements.

2. Subsequent accounting for goodwill

(a) After initial recognition, the acquirer shall measure **goodwill acquired in a business combination at cost less any accumulated impairment losses**.

(b) Goodwill acquired in a business combination **shall not be amortised**.

Instead, the acquirer shall test it for impairment annually or more frequently



Test Yourself 10

Black Co acquired White Co on 31 December 20X5. The statement of financial position of Black Co and White Co on that date were:

	Black Co		White Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Tangible assets		60,000		35,000
Investments: Shares of White Co (100% shares in white)	30,000			
Loan stock of White Co	5,000	35,000		
Current assets				
Inventories	10,000		8,000	
Receivables	8,000		9,000	
Cash at bank	4,000	22,000	-	17,000
Total assets		117,000		52,000
Equity and liabilities				
Equity				
Ordinary shares	73,000		16,000	
Retained earnings	30,000	103,000	12,500	28,500
Non-current liabilities				
Loan stock	-			10,000
Current liabilities				
Bank overdraft	-		3,000	
Payables	14,000	14,000	10,500	13,500
Total liabilities		117,000		52,000

Additional information: Payables in Black Co include Tshs4 million payable to White Co. The receivables in White Co include Tshs7.5 million receivable from Black Co.

Required:

Prepare a consolidated statement of financial position for the group.

3. Acquisition related costs

Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. Under IFRS 3 the acquirer is required to recognise acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. **The costs to issue debt or equity securities are recognised in accordance with IAS 32 (for equity) and IAS 39 (for debt).**



Example

Trico incurred costs for the services of lawyers, investment bankers, accountants and valuation experts in the process of acquiring Becatol. It also incurred costs for issuing shares (consideration is paid in the form of shares). These costs, except for cost of issue of shares, would be recognised as expenses as they are not part of the fair value exchange between the buyer and the seller of the acquired business. They are recognised as an expense in the statement of profit or loss in which payments are made in exchange for services rendered. The costs related to share issue should be charged to equity.

4. Contingent liability

A contingent liability (as at the acquisition date) assumed in a business combination should be recognised if:

it is a present obligation that arises from past events and its fair value can be measured reliably

Therefore, even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, a contingent liability will be recognised at the acquisition date fair value.

Subsequent measurement of contingent liabilities

After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:

- (a) the amount that would be recognised in accordance with IAS 37; and
- (b) the amount initially recognised, less, if appropriate, cumulative amortisation recognised in accordance with IAS 18 Revenue. This requirement does not apply to contracts accounted for in accordance with IFRS 9.

5. Pre- and post-acquisition profits

When preparing the consolidated financial statements, the profits and reserves of a subsidiary entity have to be split into two categories:

- (a) Pre-acquisition profits
- (b) Post-acquisition profits



Definition

Pre-acquisition profits are profits made by the subsidiary **before the date of acquisition** by the parent.

Post-acquisition profits are profits made by the subsidiary after the date of acquisition by the parent.

(a) Pre-acquisition profits

Pre-acquisition profits = all the brought forward reserves of the subsidiary + Profit for the year in which the subsidiary is acquired, **up to the date of acquisition**

All pre-acquisition profits (whether shown as share premium, revaluation surplus or anything else) are to be deducted from the consideration (investment) in the subsidiary when calculating goodwill.



Tip

IFRS 3 (20X8) requires that while calculating goodwill, total net assets of the subsidiary should be deducted without bothering about the parent's or non-controlling interest's share.

However, non-controlling interest still gets credit (indirectly) for all the pre-acquisition amounts by VALUATION mode. Where proportionate net assets method is used, non-controlling interest's value on acquisition date will be exactly equal to its share of pre-acquisition equity. Where fair value method is used for non-controlling interest valuation on acquisition date, indirectly the non-controlling interest gets credit for net book value of assets, fair value adjustments to individual assets as well as its share of goodwill.



Test Yourself 11

Red Co acquires shares in Blue Co by paying Tshs20 million. The share capital and reserves of Blue Co were as follows:

- Ordinary shares Tshs10 million
- Retained earnings Tshs7 million

Required:

Calculate goodwill in the following two cases:

- Case 1: If the figures reflected in reserves are as on the date of acquisition.
- Case 2: If the pre-acquisition portion of retained earnings was Tshs3.5 million.

(b) Post-acquisition profits

Post-acquisition profits include profits reflected in the retained earnings in the subsidiary's accounts after the acquisition date.

Post-acquisition profits are added to the parent entity's retained earnings in the consolidated statement of financial position.

Post-acquisition profits of the subsidiary equal reserves at the year-end less pre-acquisition profits.



Example

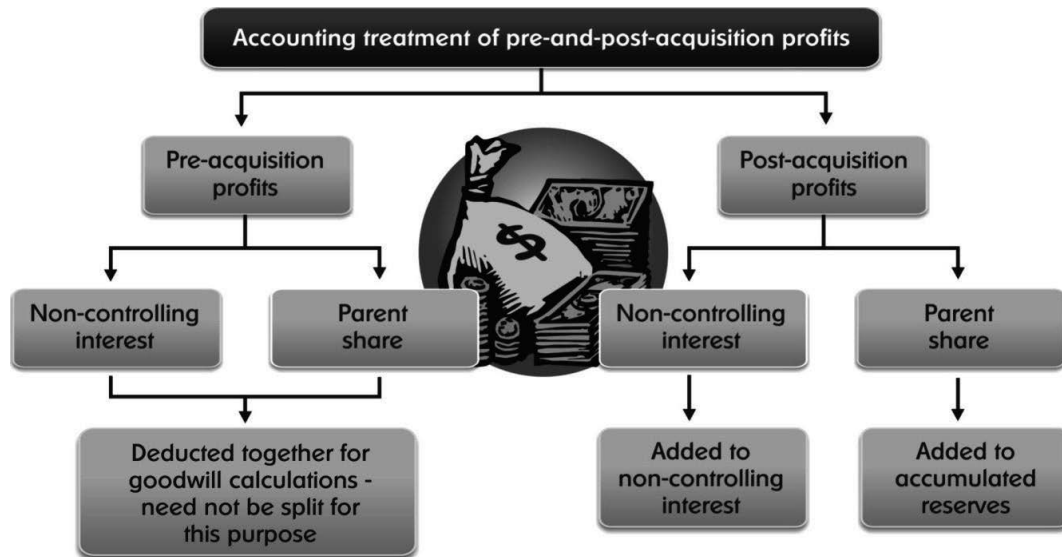
Continuing with the information given in the above Test Yourself, assume that the reserves of Blue Co at the year-end are Tshs7 million:

	Tshs'000
Reserves as of year end	7,000
Less: Pre-acquisition profits Post-acquisition profits	(3,500)
	3,500

Post-acquisition profits amounting to Tshs3.5 million will be added to the retained earnings (reserves) of Red Co in the consolidated statement of financial position.

As the profit (or loss) of the subsidiary is attributable to both, the parent entity and non-controlling interest, in the consolidated statement of profit or loss, profit or loss of the non-controlling interest's share is disclosed separately.

Diagram 5: Accounting treatment of pre & post-acquisition profits of subsidiary



Test Yourself 12

Rose Co acquired shares in Lotus Co on 01 October 20X5.

The statements of financial position of Rose Co and its subsidiary Lotus Co as on 31 December 20X5

	Rose Co		Lotus Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Tangible assets		75,000		53,000
Investments				
Ordinary shares of Lotus Co	50,000		-	
Loan stock of Lotus Co	10,000		-	
		60,000		-
Current assets				
Inventories	15,000		12,500	
Receivables	20,000		20,000	
Cash at bank	8,000		4,000	
		43,000		36,500
Total assets		178,000		89,500
Equity and liabilities				
Capital and reserves				
Ordinary shares	115,000		40,000	
Reserves	44,750		25,000	
		159,750		65,000
Non-current liabilities Loan stock				12,000
Current liabilities				
Payables		18,250		12,500
Total liabilities		178,000		89,500

Additional information

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1. The receivables of Rose Co include Tshs10 million receivable from Lotus Co. The payables in Lotus Co include Tshs6.5 million payable to Rose Co.
2. The balance in reserves as on the date of acquisition was Tshs22 million.
3. Rose Co bought ordinary shares with a par value of Tshs30 million for Tshs50 million.
4. The fair value of the non-controlling interest of 25% is Tshs18 million.

Required:

Prepare a consolidated statement of financial position for the group.

9. Prepare a consolidated statement of profit or loss and other comprehensive income and statement of changes in equity for a simple group.
10. Evaluate and calculate the figures to be included in consolidated financial statements in respect of an acquisition, continuing ownership or disposal of a subsidiary but not including part disposals and disposal of an associate.

[Learning Outcomes j and k]

4.1 Consolidated statement of profit or loss

1. If income consists of post-acquisition profits only (i.e. the subsidiary has been owned for over 1 year) and a 'non-controlling interest' exists
 - (a) First, add together like items appearing in the individual statement of profit or loss of the parent entity and subsidiary entity, up to the line 'profit after tax for the year'.
 - (b) Then the non-controlling interest share in subsidiaries' profit after tax is shown separately as non-controlling interest in the statement of profit or loss.
 - (c) Parent share is shown below non-controlling interest's share and is calculated as (a) less (b) above.



Example

Bell Co acquired 80% share in Well Co on 1 January 20X5.

The statement of profit or loss of Bell Co and Well Co for the year to 31 December 20X5

	Bell	Well
	Tshs'000	Tshs'000
Turnover	80,000	50,000
Cost of sales	(32,000)	(20,000)
Gross profit	48,000	30,000
Administrative expenses	(18,000)	(12,000)
Profit before taxation	30,000	18,000
Taxation	(10,000)	(6,000)
Profit after taxation	20,000	12,000

Prepare a consolidated statement of profit or loss for the group

Consolidated statement of profit or loss for the year to 31 December 20X5

	Tshs'000
Turnover (Tshs80,000 + Tshs50,000)	130,000
Cost of sales (Tshs32,000 + Tshs20,000)	(52,000)
Gross profit	78,000
Administrative expenses (Tshs18,000 + Tshs12,000)	(30,000)
Profit before taxation	48,000
Taxation (Tshs10,000 + Tshs6,000)	(16,000)
Profit for the year	32,000
Other comprehensive income	
Gain on property revaluation	10,000
Total comprehensive income for the year	42,000
Profit attributable to:	
Owner of the parent	29,600
Non-controlling interest (Tshs12,000 x 20%)	2,400
	32,000

2. If the subsidiary is acquired during the year

The profits for the year of the subsidiary are split to ascertain the pre- and post-acquisition profits.

For this, the statement of profit or loss of the subsidiary for the year is split into two parts:

The first part shows the profits up to the date of acquisition (pre-acquisition profits). The second part shows the income after the date of acquisition (post-acquisition profits).

	Parent share	Non-controlling interest share
Pre-acquisition profits	Total net assets, including pre-acquisition profits, are deducted from the total of the consideration, the value of NCI and the acquisition date fair value of previously held equity interests for calculating goodwill. Therefore, none of the pre-acquisition income is included in the statement of profit or loss for the year	
Post-acquisition profits	Added to parent's income for the year and reflected in consolidated statement of profit or loss and other comprehensive income	Added to non-controlling interest and included in consolidated SOFP

**Tip**

Pre-acquisition profits are NOT included in the consolidated statement comprehensive income.

The consolidated statement of profit or loss is prepared as follows:

- (a) Time apportion each line showing only post-acquisition portion.
- (b) Add together like items appearing in the individual statement of profit or loss of the parent and postacquisition portion of the subsidiary up to 'profit after taxation.'
- (c) In the consolidated profit after tax, show the share of the non-controlling interest in the post-acquisition profits of the subsidiary separately
- (d) Also, show parent's share below the non-controlling interest's share

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4.2 Consolidated statement of profit or loss and other comprehensive income

Using the data calculated in the consolidated statement of profit or loss, the consolidated statement of profit or loss and other comprehensive income is prepared. The most common item appearing in the other comprehensive income part is "Revaluation Gains".

Further non-controlling interest also has a share in the other comprehensive income. For disclosure purposes, the total comprehensive income attributable to parent and the non-controlling interest will be shown separately.

Let us understand this part by adding an item of OCI in the example discussed above.



Example

Continuing the example of Bell Co

Assume Bell Co made a revaluation gain of Tshs 10 million. With this further information you are required to prepare consolidated statement of profit or loss and other comprehensive income.

Consolidated statement of profit or loss and other comprehensive income for the year to 31 December 20X5

	Tshs'000
Turnover (Tshs80,000 + Tshs50,000)	130,000
Cost of sales (Tshs32,000 + Tshs20,000)	(52,000)
Gross profit	78,000
Administrative expenses (Tshs18,000 + Tshs12,000)	(30,000)
Profit before taxation	48,000
Taxation (Tshs10,000 + Tshs6,000)	(16,000)
Profit for the year	32,000
Other comprehensive income	
Gain on property revaluation	10,000
Total comprehensive income for the year	42,000
Profit attributable to:	
Owner of the parent	29,600
Non-controlling interest (Tshs12,000 x 20%)	2,400
	32,000
Total comprehensive income attributable to:	
Owner of the parent (Tshs29,600 + 80% of Tshs10,000)	37,600
Non-controlling interest (Tshs2,400 + 20% of Tshs10,000)	4,400
	42,000

4.3 Consolidated statement of changes in equity

In the consolidated statement of changes in equity, non-controlling interest's share in equity will be shown separately. In parent's equity, its share in the subsidiaries' post acquisition equity should be added. Parent's share in the dividend paid by subsidiary should not be shown in the consolidated statement of changes in equity, but only non-controlling interest's share should be shown under the non-controlling interest column.



Example

The summarised statements of changes in equity of Alpha and Beta for the year ended 31 March 20X9 are given below:

Summarised statement of changes in equity		
	Alpha	Beta
	Tshs'000	Tshs'000
Balance at 01 April 20X8	120,000	85,000
Add: Net profit for the period	21,000	4,000
Less: Dividend paid	(8,500)	(6,000)
Balance at 31 March 20X9	132,500	83,000

On 1 October 20X6 Alpha purchased an 80% equity shareholding in Beta. The equity of Beta as shown in its own financial statements at that date was Tshs30 million. The fair value of non-controlling interest at the acquisition date was Tshs9 million.

Required:

Prepare the consolidated statement of changes in equity.

Consolidated statement of changes in equity for the year ended on 31 March 20X9

	Parent	NCI	Total
	Tshs'000	Tshs'000	Tshs'000
Balance at 01 April 2008 (W1 & W2)	164,000	20,000	184,000
Add: Net profit for the period (W3 & W4)	24,200	800	25,000
Less: Dividend paid	(8,500)	(1,200)	(9,700)
Balance at 31 March 20X9	179,700	19,600	199,300

W1 Consolidated equity at 01 April 20X8 (Parent's share)

	Tshs'000
Alpha	120,000
Beta (Tshs85,000 - Tshs30,000) x 80%	44,000
	164,000

W2 Consolidated equity at 01 April 20X8 (NCI's share)

	Tshs'000
Fair value of NCI	9,000
Consolidated post acquisition increase (Tshs85,000 - Tshs30,000) x 20%	11,000
	20,000

W3 Parent's share in net profit

	Tshs'000
Alpha	21,000
Beta (Tshs4,000 x 80%)	3,200
	24,200

W4 NCI's share in net profit

Tshs4,000 x 20% = Tshs800

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Test Yourself 13

Hat Co acquired control (in accordance with IFRS 10) in Cat Co by obtaining their 75% shares on June 20X9. The statement of profit or loss of Hat Co and Cat Co for the year ended 31 December 20X9 is:

	Hat Co	Cat Co
	Tshs'000	Tshs'000
Sales	125,000	67,500
Less: Cost of sales	(61,250)	(35,625)
Gross profit	63,750	31,875
Administrative expenses Profit before taxation	(25,000)	(11,875)
	38,750	20,000
Taxation	(6,750)	(5,000)
Profit after taxation	32,000	15,000

On 31 December 20X9, Cat Co's property plant and equipment was revalued from Tshs200 million to Tshs250 million.

Required:

Prepare a consolidated statement of profit or loss and other comprehensive income for the group.

4.4 Disposal of subsidiary

For a full disposal apply the following treatment

Statement of profit or loss

- The disposed subsidiary needs to be consolidated up to the date of disposal and accordingly the share of NCI need to be disclosed.
-
- Show the profit or loss on disposal of subsidiary.

Statement of financial position

There will be no consolidation and also no non-controlling interest as there is no subsidiary at the date the statement of financial position is prepared.



Important

Remember the syllabus requires you to understand full disposal in this paper. Part disposal will be studied at C level.



Example

Harry Ltd Bought 80% shares of Potter Ltd for Tshs648 million on 1 October 20X5. At the date Potter Ltd retained earnings were Tshs360 million. The following are the individual summarised financial statements of Harry Ltd and Junes for the year to 30 September 20X8:

Statement of financial position

	Harry Ltd	Potter Ltd
	Tshs'000	Tshs'000
Non-current assets	720,000	540,000
Investment in Potter Ltd	648,000	
Current asset	740,000	740,000
	2,108,000	1,280,000
Equity and liabilities		
Share capital	1,080,000	360,000
Retained earnings	828,000	720,000
Current liabilities	200,000	200,000
	2,108,000	1,280,000

Statement of profit or loss

	Harry Ltd	Potter Ltd
	Tshs'000	Tshs'000
Profit before tax	306,000	252,000
Tax expense	(90,000)	(72,000)
	216,000	180,000

It is the group's policy to value NCI at the proportionate value of the fair value of the net assets acquired. Harry Ltd sells its entire holdings in Potter Ltd for Tshs1,300 million on 30 September 20X8.

Required:

Prepare the consolidated statement of financial position and the statement of profit or loss at 30 September 20X8.

Answer**Harry Group - Consolidated statement of financial position as at 30 September 20X8**

	Tshs'000
Non-current assets	720,000
Current asset (Tshs740,000 + Tshs1,300,000)	2,040,000
	2,760,000
Equity and liabilities	
Share capital	1,080,000
Retained earnings (W3)	1,480,000
Current liabilities	200,000
	2,760,000

Note: Since the entire holdings in Potter Ltd for was disposed on 30 September 20X8, it is not consolidated in the statement of financial position.

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Harry group - Consolidated statement of profit or loss for the year ended 30 September 20X8

	Tshs'000
Profit before tax (Tshs306,000 + Tshs252,000)	558,000
Profit on disposal (W2)	364,000
Tax expense(Tshs90,000 + Tshs72,000)	(162,000)
Profit for the year	760,000
Profit attributable to	
- Owners of the parent	724,000
- Non-controlling interest	36,000
	760,000

Working

W1 Goodwill

	Tshs'000
Consideration	648,000
Add: Fair value of NCI (20% of Tshs360,000)	144,000
	792,000
Less: Fair value of net assets acquired	(720,000)
	72,000

W2 Profit or loss on disposal

	Tshs'000	Tshs'000
Fair value of consideration received		1,300,000
Less: Share of consolidated carrying value on the date of loss of control Net assets (Tshs1,080,000 x 80%)	864,000	
Goodwill	72,000	(936,000)
		364,000

W3 Retained earnings

	Harry Ltd	Potter Ltd
	Tshs'000	Tshs'000
Per question – date of disposal	828,000	720,000
Add: Gain on disposal	364,000	-
Reserves at acquisition	-	(360,000)
		360,000
Share of post-acquisition profit in Potter Ltd (80% of Tshs360,000)	288,000	
	1,480,000	

Answers to Test Yourself

Answer to TY 1

Merely preparing consolidated financial statements does not establish a single operating unit. A group has no legal existence, except for accounting purposes.

Fruits Inc has prepared consolidated financial statements to incorporate the accounts of Apple Inc in its accounts, in order to determine the financial status of the group. It has not established a new company.

Hence the statement 'Fruits Inc and Apple Inc are now no longer two distinct companies' is incorrect

Answer to TY 2

		Red Co	Green Co	White Co
Total share capital	Tshs'000	6,000	3,000	10,000
Blue Co's holding	Tshs'000	2,000	3,000	5,500
Blue Co share of share capital	%	33.33%	100%	55%

Red Co is **not a subsidiary** of Blue Co
 Green Co is a **fully-owned subsidiary** of Blue Co
 White Co is a **partially-owned subsidiary** of Blue Co

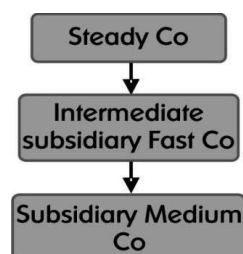
Note - Additional facts and circumstances that may provide evidence that Blue co has, or does not have power need to be considered. This includes the ability of Blue to direct the relevant activities of Red, Green and White. Furthermore, it needs to be checked whether the voting rights acquired by Blue are substantive, in order to conclude control in Red, Green and White.

Answer to TY 3

A parent wishes to consolidate a subsidiary which is incurring heavy losses in its consolidated financial statements due to following reasons

- If the group wished to downplay its performance to mislead competitors.
- If the group wished to get certain concessions, allotments etc. from governments.
- If this could help in getting some tax concessions, subsidies etc. for the industry in which the group functions.

Answer to TY 4

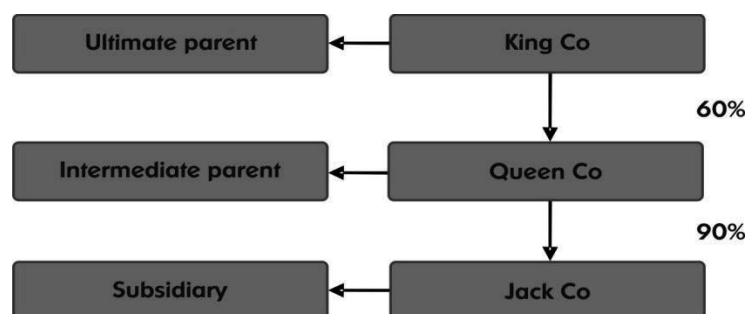


In this example the relationship between the three companies is shown in the above diagram. Fast Co need not prepare consolidated financial statements if:

- Its other owners do not object.
- Its debt or equity instruments are not traded in a public market.
- It has not / is not in the process of filing its financial statements for the purpose of issuing financial instruments in a public market.

Steady Co prepares consolidated financial statements that comply with the requirements of IFRS 10.

Answer to TY 5



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Queen Co can be exempted from preparing its consolidated financial statements only if **ALL** the following conditions are satisfied

1. The parent itself is a wholly or partly owned subsidiary of another entity, and its other owners, do not object.
2. The parent's debt or equity instruments are not traded in a public market
3. The parent has not filed, nor is it in the process of filing, its financial statements for the purpose of issuing any class of instruments in a public market.
4. The ultimate or any intermediate parent of the parent produces consolidated financial statements.

Queen Co satisfies the conditions 1, 2 and 4. However, it does not satisfy condition 3. Hence, Queen Co will have to prepare consolidated financial statements.

Answer to TY 6

Broom Co- Consolidated statement of financial position as at 31 December 20X5

	Tshs'000	Tshs'000
Non-current assets		
Tangible assets		75,000
Current assets		
Inventories (Tshs10,000 + Tshs8,000 + Tshs3,000 according to W1)	21,000	
Receivables (Tshs8,000 + Tshs9,000 – Tshs9,000)	8,000	
Cash at bank (Tshs4,000 + Tshs3,000)	7,000	36,000
Total assets		111,000
Equity and liabilities		
Capital and reserves		
Ordinary shares	63,000	
Retained earnings (Tshs18,000 + Tshs8,500)	26,500	89,500
Non-current liabilities		
Loan stock (W2)		5,000
Current liabilities		
Payables (Tshs14,000 + Tshs8,500 - Tshs6,000)		16,500
Total liabilities		111,000

Workings (Amounts in Tshs'000)

W1 Receivables and payables

Receivables in Vroom Co Tshs9,000
 Payables in Broom Co Tshs6,000

Difference would be goods in transit Tshs3,000, and this is shown as inventory in the consolidated statement of financial position; remaining receivables in Vroom Co (Tshs6,000) and payables in Broom Co (Tshs6,000) cancel each other.



Tip

For the purposes of the exam, you should effectively 'fast forward' delivery of the goods and move Tshs3,000 from receivables into inventory. Think about why: the goods are STILL within the group, therefore should be shown in inventory.

W2 Loan stock

Broom's investment in Vroom Co's loan stock (Tshs5,000) cancels part of Vroom's loan stock balance. The remaining loan stock of Tshs5,000 is assumed to have been issued to other parties and is thus a balance of the group and retained in the consolidated statement of financial position.

Answer to TY 7

In this case, the consideration in Preservative Co is calculated as follows:

3 shares (market price Tshs1,500) in Fruit Co for every 4 shares in Preservative Co = $\frac{3}{4} \times \text{Tshs}1,500$
 Consideration by issue of shares = $(16,000 \times \frac{3}{4} \times \text{Tshs}1,500) = \text{Tshs}18,000,000$. This is accounted for thus:

Dr	Investment		Tshs18,000,000	
		Cr	Share capital	Tshs12,000,000
		Cr	Share premium	Tshs6,000,000

Being consideration in Preservative Co recorded

Answer to TY 8

The following are some examples of circumstances under which a company will be willing to sell its business for an amount lower than the value of its total net assets:

- It knows that the acquirer will have to invest a substantial amount of money to make the subsidiary profitable.
- It is aware that it is not possible for the company to face competition unless it is helped by the technical or managerial competence of the acquirer.
- It is undergoing the liquidation process due to bankruptcy.

Answer to TY 9

Acquiree	Paid by Pineapple Tshs'000	Non-controlling interest Tshs'000	Total Tshs'000	Net identifiable assets Tshs'000	Goodwill Tshs'000	Gain on bargain purchase Tshs'000
Biscuit Co	8,000	1,500	9,500	(7, 500)	2,000	
Cake Co	10,000	2,500	12,500	(13,000)		500
Dessert Co	5,500	4,750	10,250	(2,500)	7,750	

Biscuit Co: goodwill – intangible asset in the consolidated statement of financial position

Cake Co: gain on bargain purchase – other income in the statement of profit or loss

Dessert Co: goodwill – intangible asset in the consolidated statement of financial position

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Answer to TY 10

Black Co - Consolidated statement of financial position as at 31 December 20X5

	Tshs'000	Tshs'000
Non-current assets		
Intangible assets		
Goodwill (W1)		1,500
Tangible assets		
Non-current assets (Tshs60,000 + Tshs35,000)		95,000
Current assets		
Inventories (Tshs10,000 + Tshs8,000 + Tshs3,500 (according to W2))	21,500	
Receivables (Tshs9,000 + Tshs8,000 - Tshs7,500)	9,500	
Cash at bank	4,000	35,000
Total assets		131,500
Equity and liabilities	73,000	
Capital and reserves		
Ordinary shares		
Retained earnings	30,000	103,000
Non-current liabilities		
Loan stock (Tshs10,000 - Tshs5,000)		5,000
Current liabilities		
Bank overdraft	3,000	
Payables (Tshs14,000 + Tshs10,500 - Tshs4,000)	20,500	23,500
Total liabilities		131,500

Workings (Amounts in Tshs'000)

W1 Goodwill on purchase of shares in White at 31 December 20X5

	Tshs'000	Tshs'000
Consideration		30,000
Less: Net assets represented by		
- Equity shares	(16,000)	
- Retained earnings	(12,500)	(28,500)
Goodwill on purchase of shares in White		1,500

W2 Receivables and payables

Receivables in White Co	Tshs7,500
Payables in Black Co	Tshs4,000

Difference between the receivables and payables would be goods in transit Tshs3.5 million, and this is shown as inventory in the consolidated statement of financial position.

Answer to TY 11

In case 1, as the retained earnings is as on the date of acquisition they are pre-acquisition profits. Goodwill is calculated as follows:

	Tshs'000	Tshs'000
Consideration		20,000
Less: Net assets acquired		
- Ordinary shares	10,000	
- Retained Earnings	7,000	(17,000)
Goodwill		3,000

In case 2, goodwill is calculated as follows

	Tshs'000	Tshs'000
Consideration		20,000
Less: Net assets acquired		
Ordinary shares	10,000	
Retained earnings	3,500	(13,500)
Goodwill		6,500

Answer to TY 12**Rose Co - Consolidated statement of financial position as at 31 December 20X5**

	Tshs'000	Tshs'000
Non-current assets		
Intangible assets		
Goodwill (W3)		6,000
Tangible assets (Tshs75,000 + Tshs53,000)		128,000
Current assets		
Inventories (Tshs15,000 + Tshs12,500 + Tshs3,500)	31,000	
Receivables (Tshs20,000 + Tshs20,000 - Tshs10,000)	30,000	
Cash at bank (Tshs8,000 + Tshs4,000)	12,000	
		73,000
Total assets		207,000
Equity and liabilities		
Capital and reserves		
Ordinary shares		
Reserves (W2)	115,000	
	47,000	
		162,000
Non-controlling interest (W4)		18,750
Non-current liabilities		
Loan stock (Tshs12,000 - Tshs10,000)		2,000
Current liabilities		
Payables (Tshs18,250 + Tshs12,500 - Tshs6,500)		24,250
Total liabilities		207,000

Workings (All amounts in Tshs'000)

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W1 % holding

Total shares	40,000
Acquired by Rose	30,000
% holding	75%

W2 Post-acquisition reserves

	Rose	Lotus
	Tshs'000	Tshs'000
At 31/12/20X5	44,750	25,000
Less: Pre-acquisition reserves		(22,000)
		3,000
Share in Lotus 75%	2,250	
To consolidated SOFP	47,000	

W3 Goodwill on purchase of shares in Lotus at 1 October 20X5

	Rose	Lotus
	Tshs'000	Tshs'000
Consideration		50,000
Add: Fair value of 25% of non-controlling interest of Lotus		18,000
		68,000
Less: Net assets represented by		
- Ordinary shares	(40,000)	
- Pre-acquisition reserves	(22,000)	(62,000)
Goodwill on purchase of shares in Lotus		6,000

W4 Non-controlling interest

	Tshs'000
Fair value of non-controlling interest	18,000
Add: Post-acquisition reserves (W2) Tshs3,000 x 25%	750
Total	18,750

W5 Receivables and payables

Receivables from Lotus Co: Tshs10,000
 Payable to Rose Co: Tshs6,500

The difference is goods in transit Tshs3,500, which is shown as inventory in the consolidated statement of financial position.

Answer to TY 13

Hat Co – Statement of statement of profit or loss and other comprehensive income for the year to 31 December 20X9

	Tshs'000
Sales (Tshs125,000 + 1/2 of Tshs67,500)	158,750
Cost of sales (Tshs61,250 + 1/2 of Tshs35,625)	(79,062)
Gross profit	79,688
Administrative expenses (Tshs25,000 + 1/2 of Tshs11,875)	(30,938)
Profit before taxation	48,750
Taxation (Tshs6,750 + 1/2 of Tshs5,000)	(9,250)
Profit for the year	39,500
Other comprehensive income	
Gain on property revaluation	50,000
Total comprehensive income for the year	89,500
Profit attributable to:	
Owners of the parent	35,750
Non-controlling interest	3,750
	39,500
Total comprehensive income attributable to:	73,250
Owners of the parent	16,250
Non-controlling interest	16,250
	89,500

Tshs3,750 - (75% of Tshs15,000)

The brought forward reserves of Cold are not reflected in the consolidated statement of profit or loss and other comprehensive income.

Quick Quiz

1. State the requirements of IFRS as regards year ends of group companies.
2. State the requirements of IFRS as regards accounting policies followed by group companies.
3. What kinds of transactions are eliminated from the consolidation procedure?
4. Is it essential for an entity to satisfy all the conditions laid down by IAS27 in order not to consolidate the accounts of a subsidiary?
5. The accounting treatment for positive goodwill and gain on bargain purchase is the same. Is this statement true or false?

Answers to Quick Quiz

1. IFRS 10 requires that all group companies have **same reporting dates**. However, the accounts of a subsidiary drawn up to another date can be consolidated, if the gap between parent and subsidiary is not more than three months, provided adjustments are made **for** the effects of significant transactions or events that occur between the reporting dates of the subsidiary and the parent.
2. IFRS 10 requires that all group companies have **uniform** accounting policies.
3. Intra-group transactions are eliminated from the consolidation procedure.
4. YES, it is essential for an entity to satisfy ALL the conditions laid down by IFRS 10 in order not to consolidate the accounts of a subsidiary.
5. False.

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- ⓐ Positive goodwill will be treated as intangible asset in the consolidated statement of financial position.
- ⓑ Gain on bargain purchase goodwill will be treated as income in the consolidated statement of profit or loss.

Self-Examination Questions

Question 1

Universal Studios (a film production unit) has invested in Earth Movers Ltd, which is in the business of providing saplings for landscaping. It has shares amounting to Tshs5.5 million out of Earth Movers Ltd's share capital of Tshs12 million. Should Universal Studios include the accounts of Earth Movers Ltd in its consolidated financial statements?

Question 2

State (with an example) why it is essential for parents and subsidiaries to follow similar accounting policies.

Question 3

Comment on the statement - 'Cancellation of transactions is an important aspect of consolidation'.

Question 4

Playful Co acquired 30,000 shares in Serious Co on 1 July 20X5 by issuing 2 shares for every 3 shares in Serious Co. The market price of Playful Co's shares was Tshs3,000. Playful Co has not accounted for this investment.

The statement of financial position for the year ended 31 December 20X5 are as follows:

	Playful Co		Serious Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Tangible assets		63,000		55,000
Investments		25,000		
Current assets				
Inventories	14,000		15,000	
Receivables	20,000		13,000	
Cash at bank	5,500	39,500	-	28,000
Total assets		127,500		83,000
Equity and liabilities				
Capital and reserves				
Ordinary shares (Tshs1,000 each)	85,000		50,000	
Reserves	26,500	111,500	17,000	67,000
Current liabilities				
Payables	16,000		14,000	
Bank overdraft	-		2,000	
Total liabilities		16,000		16,000
		127,500		83,000

Additional information

1. The receivables of Playful Co include Tshs8 million receivable from Serious Co. The payables in Serious Co include Tshs5 million payable to Playful Co.
2. The balance in reserves as on the date of acquisition were Tshs10 million
3. The fair value of the non-controlling interest of 40% is Tshs50 million.

Required:

Prepare a consolidated statement of financial position of the group.

Question 5

The statement of profit or loss of Mandy Co and Sandy Co for the year to 31 December 20X6 are:

	Mandy	Sandy
	Tshs'000	Tshs'000
Turnover	170,000	84,000
Cost of sales	(99,000)	(36,000)
Gross profit	71,000	48,000
Other expenses	(28,000)	(12,500)
Profit before taxation	43,000	35,500
Taxation	(12,900)	(10,600)
Profit after taxation	30,100	24,900

Other information:

	Mandy	Sandy
	Tshs'000	Tshs'000
Reserves brought forward	25,000	16,000
Profit for the year	30,100	24,900
Reserves carried forward	55,100	40,900

Additional information: Mandy Co acquired 60% shares of Sandy Co on 30 September 20X6.

Required:

Prepare a consolidated statement of profit or loss and other comprehensive income for the group.

Answers to Self-Examination Questions**Answer to SEQ 1**

We will have to first ascertain the % holding of Universal Studios in the share capital of Earth Movers Ltd.

Total share capital of Earth Movers Ltd (Tshs million)	12,000
Share of Universal Studios (Tshs million)	5,500
Share of Universal Studios	45.83%

Universal Studio's **does not hold more than 50 % voting power** in Earth Movers

We need to check whether Universal holds power **without a majority of the voting rights**: this could be due to:

- (a) a contractual arrangement between the Universal and other vote holders;
- (b) rights arising from other contractual arrangements;
- (c) the Universal's voting rights, referred to as de facto control (for example, when the investor holds significantly greater voting rights than any other vote holder or organised group of vote holders) (d) potential voting rights (considered only if they are substantive); or (e) a combination of (a)–(d).

In addition to having power as stated above, Universal should also have exposure, or rights, to variable returns from its involvement with Earthmovers; and ability to use its power over Earthmovers to affect the amount of the Universal's returns before we can conclude that Universal controls Earthmover and hence is its parent .

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Answer to SEQ 2

If the parent and subsidiaries did not follow similar accounting policies, then the consolidated financial statements would not reflect a correct picture of the financial status of the group.

This can be explained with the following example:

Plain Inc and Simple Inc are two entities of the same group dealing in the sale of LCD TVs.

They both buy them, from the same source, at the same price and resell them.
The price of LCD TVs increased from Tshs1 million to Tshs1.5 million during the year.

Plain Inc values its inventories by the average cost method. Its year-end inventory is valued at Tshs1.25 million.

Simple Inc uses the FIFO method for valuing inventory. As its year-end inventory consists of the stock bought later in the year, it will be valued at Tshs1.5 million.

Now, if the accounts of Plain Inc and Simple Inc are consolidated, they cannot reflect a correct picture of the financial status of the group. This is because, as there are different accounting policies in use for valuation of inventories, the charge to the statement of profit or loss becomes skewed.

Hence, it is essential for parents and subsidiaries to follow similar accounting policies. If they follow different accounting policies, then adjustments should be made (in the above case) to the accounts of Simple Inc in order to make them suitable for consolidation.

Answer to SEQ 3

Consolidated financial statements requires that an entity combines the financial statements of the parent and its subsidiaries line by line by adding together like items of assets, liabilities, equity, income and expenses.

During this process of addition, all intra-group balances and transactions, including incomes and expenses have to be eliminated in full because:

- (a) If such transactions are not eliminated, then the consolidated financial statements will show an inflated picture of the financial status of the group, which would be misleading.
- (b) It will also be against the very definition of consolidated financial statements, which states that the group is to be considered as one single economic unit: One single economic unit cannot transact with itself.

Hence, 'Cancellation of transactions is an important aspect of consolidation.'

Answer to SEQ 4

Playful Co Group - Consolidated statement of financial position as at 31 December 20X5

	Tshs'000	Tshs'000
Non-Current Assets		
Intangible Assets		
Goodwill (W5)		50,000
Tangible Assets (Tshs63,000 + Tshs55,000)		118,000
Investments		25,000
Current Assets		
Inventories (W3) (Tshs14,000 + Tshs15,000 + Tshs3,000)	32,000	
Receivables (W3) (Tshs20,000 + Tshs13,000 – Tshs8,000)	25,000	
Cash at bank	5,500	62,500
Total Assets		255,500
Equity and Liabilities		
Capital and reserves		
Ordinary shares of Tshs1,000 each (W2)	105,000	
Share premium (W2)	40,000	
Reserves (W4)	30,700	175,700
Non-controlling interest (W6)		52,800
Current Liabilities		
Payables (W3) (Tshs16,000 + Tshs14,000 – Tshs5,000)		25,000
Bank overdraft		2,000
Total Liabilities		255,500

Workings

W1	%holdings	Tshs'000
	Total shares	50,000
	Acquired by Playful	30,000
	%holdings	60%

W2	Consideration in Serious Co	Tshs'000	Tshs'000
	2 shares in Playful for every 3 shares in Serious - market price of Playful's shares Tshs3,000		
	Investments by issue of shares (30,000 x 2/3 x Tshs3,000)		60,000
	The journal entry for recording this transaction is		
	Dr Investment	60,000	
	Cr Share capital		20,000
	Cr Share premium		40,000

W3	Goods-in-transit	Tshs'000
	Receivable from Serious Co	8,000
	Payable to Playful Co	5,000

Difference Tshs3,000,000 is assumed to be goods-in-transit;

This is added to inventory in consolidated statement of financial position;

Receivable from Serious Co (Tshs8,000,000) and payables to Playful Co (Tshs5,000,000) cancel each other.

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W4	Post-acquisition reserves	Playful Co	Serious Co
		Tshs'000	Tshs'000
	At 31/12/20X5	26,500	17,000
	Less: pre-acquisition reserves		(10,000)
			7,000
	Share in S 60%	4,200	
	To consolidated SOFP	30,700	

W5	Goodwill on purchase of shares in S at 01/10/20X5	Tshs'000	Tshs'000
	Consideration		50,000
	Fair value of the non-controlling interest		110,000
	Less:		
	Ordinary shares	(50,000)	
	Pre-acquisition reserves	(10,000)	
	Total	(60,000)	(60,000)
	Goodwill on purchase of shares in S		50,000

W6	Non-controlling interest	Tshs'000
		Fair value of non-controlling interest
	Post-acquisition reserves (W4)7,000 x 40%	2,800
	Total	52,800

Answer to SEQ 5

Mandy Group - Consolidated statement of profit or loss for the year to 31 December 20X6

	Total	Workings	
		Mandy	Sandy 1/4 year
	Tshs'000	Tshs'000	Tshs'000
Turnover	191,000	170,000	21,000
Cost of sales	(108,000)	(99,000)	(9,000)
Gross profit	83,000	71,000	12,000
Other expenses	(31,125)	(28,000)	(3,125)
Profit before taxation	51,875	43,000	8,875
Taxation	(15,550)	(12,900)	(2,650)
Profit after taxation	36,325	30,100	6,225
Share of profit attributable to:			
- Owners of the parent	33,835		
- Non-controlling interest (W1)	(2,490)		
Group profit for the year	33,835		

Note: The consolidated retained earnings will show a balance of Tshs55,100 + Tshs33,835 = Tshs88,935

Workings (Amounts in Tshs'000)

W1 Share of non-controlling interest in post-acquisition profits

Post-acquisition profits of Sandy Co Tshs 6,225
 Non-controlling interest at 40% Tshs 2,490

STUDY GUIDE D2: INTRA-GROUP ADJUSTMENTS AND FAIR VALUE ADJUSTMENTS

Get Through Intro

Intra-group adjustments are an important aspect to be dealt with while consolidating accounts. In real life group entities have numerous transactions with each other. Any error in intra-group adjustments makes consolidated financial statements misleading for its users.

For example if a parent has sold goods worth Tshs20 million to its subsidiary and has made a profit of Tshs5 million on this transaction then it will recognise this profit in its individual financial statement. If these goods remain as inventory with the subsidiary at the end of the reporting date then is it correct to reflect this profit as a profit of the group? From a group perspective, how can the group make a profit trading with itself?

The answer is that this unrealised profit has to be removed from the consolidated financial statements. Then what is the entry to complete this transaction?

Answers to all these questions (and many unasked ones as well) are given in this Study Guide which discusses intra-group adjustments in business combinations.

Learning Outcomes

- a) Explain the need to eliminate intra-group transactions in the consolidation process.
- b) Analyse internal transactions requiring eliminations.
- c) Account for the effects of fair value adjustments to:
 - i. Depreciating and non-depreciating non-current assets
 - ii. Inventory
 - iii. Monetary liabilities
 - iv. Assets and liabilities not included in the subsidiary's own statement of financial position, including contingent assets and liabilities.

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1. Explain the need to eliminate intra-group transaction in the consolidation process. [Learning Outcome a]

1.1 Intra-group transactions

In real life a parent and its subsidiary have numerous transactions with each other in the ordinary course of business.

Intra-group transactions are commercial transactions which take place between entities belonging to the same group, in the ordinary course of business.

While accounting for intra-group transactions **in their individual accounts, the entities do not make any distinction between group entities and other entities. The amount is simply recorded as e.g. a receivable or payable.**



Example

Burger Co is a fully owned subsidiary of Pizza Co. If Pizza Co sells goods worth Tshs2 million to Burger Co, then the journal entry made is:

This transaction of sale and purchase of steel between Burger Co and Pizza is a commercial transaction which takes place between two entities belonging to the same group during the ordinary course of their business

Hence, it is an **intra-group transaction**.

In the books of Pizza Co:	In the books of Burger Co:
Dr Burger Co Tshs2 million Cr Sales Tshs2 million Being goods sold to Burger Co	Dr Purchases Tshs2 million Cr Pizza Co Tshs2 million Being goods bought from Pizza Co

The transaction will be recorded in the same manner regardless of whether Pizza Co and Burger Co belong to the same group or not.



Test Yourself 1

List some areas where group entities could have intra-group transactions.

Consolidated financial statements are prepared by combining the financial statements of the parent and its subsidiaries line by line, by **adding together like items** of assets, liabilities, equity, income and expenses.

1.2 Elimination of intra-group transaction

IFRS 10 requires that **all intra-group balances and transactions, including income and expenses, are eliminated in full**. This is because:

- If such transactions are not eliminated, the consolidated financial statements will **show an inflated and hence misleading picture of the financial status** of the group.
- It will also be against the definition of consolidated financial statements, which states that the **group is to be considered as one single economic unit**: One single economic unit cannot transact with itself. Hence, intra-group transactions are eliminated from the consolidation procedure, as it is impossible for one single economic unit to transact with itself.



Example

To continue with the example given above,

If the group **is to be considered as one, single economic unit**, then there is effectively no Pizza Co and Burger Co So, the transaction of Pizza Co selling goods to Burger Co does not arise.

The consolidated sales figure for the group is Tshs3 million being the **actual sale outside the group**.



Important

It is important to revise again that:

- Merely preparing consolidated financial statements does not establish a single operating unit.
- The group entities are considered to be one single economic unit only for the purpose of consolidation. A group has no legal existence, except for accounting purposes.

1. Analyse internal transactions requiring eliminations.

[Learning Outcome b]



Tip

In this Study Guide journal entries have been given in order to simplify the explanation of how the effects of unrealised profits are eliminated on consolidation.

In real life these journal entries cannot be made because

- at times one part of the entry relates to an item in the books of the subsidiary and
- the other part of the entry relates to an item in the books of the parent and vice versa

So these adjustments are only made on consolidation in the consolidated accounts.

In the previous learning outcome we saw that any transaction between two entities of the same group are called as intra-group transactions. Some intra-group transactions have an in-built element of profit in them. This profit is realised only when the items traded intra-group is sold to a third party.

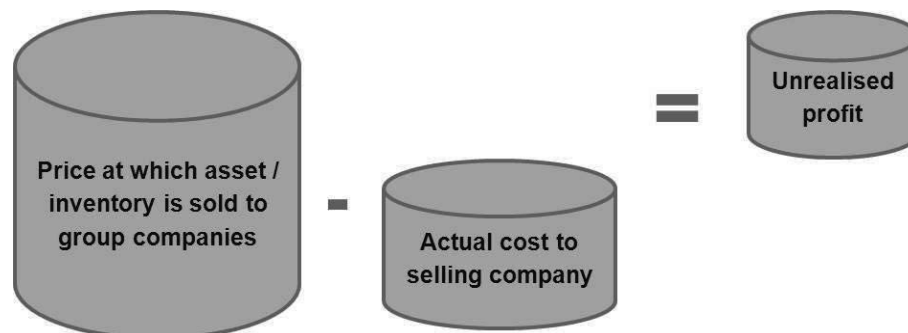


Example

White Co sells goods for Tshs40 million to its parent Red Co. It sells the goods at a profit of 25% of cost.

As both White Co and Red Co are two entities of the same group this transaction of sale of goods is an intra-group transaction. The inbuilt profit in this transaction is Tshs8 million (Tshs40 million x 25/125). This profit will be realised only when Red uses the inventory or sells it to a third party.

Diagram 1: Unrealised profit in intra-group transactions



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2.1 Unrealised profit (URP) in inventory and non-current assets

1. URP in inventory

(a) Effect in the consolidated statement of financial position

(i) Sale by parent to subsidiary

When a parent company sells goods to its subsidiary, URP lies in the

- Inventory of the subsidiary and
- Profit of the parent company

Consolidated financial statements are prepared on the **assumption** that all group entities are one economic unit. As one economic unit cannot make a profit from a sale to itself it **is necessary to remove this URP from inventory as well as from the parent's profit** in the consolidated statement of financial position.

Effectively the following entry is made in order to remove this URP from the consolidated financial statements.

Dr	Group retained earnings (parent)	X	
	Cr	Inventory	X
	Being URP eliminated from inventory		



Example

Black Inc is a parent of Red Inc. The total sales of Black Inc for the year to 31 December 20X6 include a sale of Tshs10 million to Red Inc. There is an in-built profit of Tshs2 million in this sale.

As at 31 December 20X6 the inventory of Red Inc is Tshs12.5 million (including Tshs5 million out of intra-group sales) and that of Black Inc is Tshs25 million.

In this case the URP in inventory is Tshs1 million (Tshs5 million x Tshs2 million/Tshs10 million).

The journal entry is:

Dr	Group retained earnings (parent)	Tshs1 million	
	Cr	Group inventory	Tshs1 million
	Being URP eliminated from inventory		



Tip

In the case of sale by parent to subsidiary, as URP lies in parent's profit, non-controlling interest will not be involved as it has no share in parent's profit.



Test Yourself 2

On 1 July 20X6 Placid Co acquired 75% share in Swift Co. Placid Co exercise control over Swift Co as per IFRS 10. The inventory of Swift Co consists entirely of purchases made from Placid Co on 29 December 20X6. Placid Co sells goods at a mark-up of 20% over cost. The fair value of the 25% non-controlling interest is Tshs8 million. Assume that there was no profit prior to January 20X6. The statements of financial position of Placid Co and Swift Co for the year ended 31 December 20X6 are as follows:

	Placid Co		Swift Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Assets				
Non-current assets				
Tangible assets		33,000		25,000
Investments: Shares in Swift Co		27,000		
Current assets				
Inventories	10,500		9,000	
Others	4,000	14,500	13,000	22,000
Total assets		74,500		47,000
Equity and liabilities				
Capital and reserves				
Ordinary shares	42,000		25,000	
Retained earnings	18,500	60,500	17,000	42,000
Current liabilities				5,000
Payables	14,000	14,000	5,000	
Total liabilities		74,500		47,000

Required:

Prepare consolidated financial statement as at 31 December 20X6 assuming that Swift started trading on 1 January 20X6.

(ii) Sale by subsidiary to parent

When the subsidiary sells goods to the parent:

- URP lies in the inventory of the parent.
- Profit has been recognised in the individual statement of profit or loss of the subsidiary.

This means the subsidiary has made profit. Therefore in the case of the partly-owned subsidiary, NCIs will also have a share in URP.

If the subsidiary is a fully owned one then this poses no problem. We can charge the entire amount of URP to the group retained earnings. Effectively the following entry is made.

Dr Group retained earnings X
 Cr Inventory X
 Being URP eliminated from inventory

 **Example**

Perfect Co buys goods costing Tshs10 million for Tshs20 million from its 100% subsidiary Semi-perfect Co on 29 December 20X6. All these goods form part of the inventory of Perfect Co as at 31 December 20X6.

This means that the individual financial statements of Semi-perfect Co for the year to 31 December 20X6 include this intra-group profit of Tshs10 million. However the group has not earned this profit and so this URP of Tshs10 million should be deducted from the total retained earnings of the group.

The journal entry is:

Dr Group retained earnings Tshs10 million
 Cr Inventory Tshs10 million
 Being URP eliminated from inventory

However if the subsidiary is a partly owned one then we have to determine the treatment to be given for the share of non-controlling interest in URP.

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Journal entry will be as follows:

Dr	Group retained earnings (parent share)	X	
Dr	Non-controlling interest's share)	X	
	Cr Inventory		X



Example

If in the above example Perfect Co owns 75% of the shares of Semi-Perfect Co then the URP of Tshs10 million can be split as

- Parent share (75% of Tshs10 million) - Tshs7.5 million
- Non-controlling share (25% of Tshs10 million) - Tshs2.5 million

In this case, Tshs10 million will be deducted from subsidiaries profit before splitting the profit into parent's share and non-controlling interest's share. By doing this, parent and non-controlling interest will get their share in URP.

As an alternative, after splitting the subsidiary's profit, parent's share in URP will be deducted from group retained earnings and non-controlling interest's share in URP will be reduced from value of non-controlling interest.

Dr	Group retained earnings (parent share)	Tshs7.5 million	
Dr	Non-controlling interest's share)	Tshs2.5 million	
	Cr Inventory		Tshs10 million

(b) Accounting for the effects of intra-group trading in the consolidated statement of profit or loss

Elimination of URP from inventory will have an impact on the costs of sales (and therefore on gross profit). Apart from this, for intra-group transactions, adjustment is also required in the consolidated sales and purchases.



Example

Big Co is the parent of Small Co. Big Co sells goods costing Tshs4.6 million to Small Co for Tshs5 million on 29 December 20X6. All these goods remain unsold by Small Co as at 31 December 20X6.

This transaction will be accounted for as follows:

In the books of Big Co

Dr Small Co	Tshs5 million
Cr Sales	Tshs5 million

In the books of Small Co

Dr Purchases	Tshs5million
Cr Big Co	Tshs5 million

The transaction would have been recorded in the same manner, even if Big Co and Small Co were not group entities.

Intra-group sales and purchases should be eliminated while preparing consolidated statement of financial position.



Test Yourself 3

Continuing with the example of Big Co given above

The total sales of Big Co are Tshs40 million and that of Small Co are Tshs30 million.

Required:

Determine the amount of consolidated sales.

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	Pleasant Co	Sublime Co
	Tshs'000	Tshs'000
Sales	120,000	54,000
Cost of sales	(40,000)	(20,000)
Gross profit	80,000	34,000
Administrative expenses	(22,500)	(12,500)
Profit before taxation	57,500	21,500
Taxation	(15,400)	(4,000)
Profit for the year	42,100	17,500

Prepare the consolidated statement of profit or loss of the group for the year to 31 December 20X6 in the following three cases.

- (i) Pleasant Co sells the goods to Sublime Co – the inventory of Sublime Co does not contain any goods bought from Pleasant Co.
- (ii) Pleasant Co sells the goods to Sublime Co – the inventory of Sublime Co consists of 50% of goods bought from Pleasant Co.
- (iii) Sublime Co sells the goods to Pleasant Co – the inventory of Pleasant Co consists of 50% of goods bought from Sublime Co.

2. URP on sale of non-current assets

If an asset is sold from one company to another within the group, at a profit, then **reduce the URP** in the same manner as explained above and for the same reason.

Effect on depreciation when a non-current asset is sold at a profit

(i) Depreciation in the books of a purchasing company

When a non-current asset is sold at a profit, in the individual books of the purchasing company the asset will have a higher value. The asset will be depreciated using that higher value.

(ii) Depreciation in the group financial statements

For the group as a whole, the cost of the asset will be the carrying value of the asset to the selling entity (remember, not the cost to the purchasing entity as URP will be eliminated). Therefore depreciation should be charged at that value.

However, the depreciation charged in the individual financial statements will be more than that should have been charged by the selling entity. This extra depreciation (depreciation charged on higher value where URP is included) should be eliminated.

Sale by parent to subsidiary (Downstream transaction)

The following journal entry is made:

Dr	Group total retained earnings		X
	Cr	Group non-current assets	X

Being URP eliminated from non-current assets



Example

On 1 January 20X6 Selective Inc sells a car to its subsidiary General Inc for Tshs24 million at a profit of Tshs4 million. The entry made to eliminate URP of Tshs4 million on non-current assets is

Dr	Group total retained earnings	Tshs4 million
	Cr Group non-current assets	Tshs4 million

Being URP eliminated from non-current assets, from a group perspective

This has the effect of decreasing the non-current asset to the book value it was held in Selective’s (the parent’s) books prior to the sale to General. This also takes out the profit that has been unrealised from a group perspective.

If the asset has been sold by the parent to the subsidiary the following entry is made to reduce this additional depreciation:

Dr	Group non-current assets	X
	Cr Group total retained earnings (parent’s share)	X
	Cr Non-Controlling Interest (NCI’s share)	X

Being additional depreciation reduced, from a group perspective

This has the effect of increasing the subsidiary’s reserves (we are effectively charging less depreciation), so this will be split between the parent and the non-controlling interest.



Test Yourself 12

On 1 January 20X6 Pokeman Toys acquired 75% share in Spiderman Toys. On 1 April Pokeman Toys sold non-current assets worth Tshs20 million to Spiderman Toys for Tshs30 million. Spiderman Toys charges depreciation at 10%p.a. The reserves of Spiderman Toys on the date of acquisition are nil. The fair value of 25% non-controlling interest is 12,000.

The individual statements of financial position of Pokeman Toys and Spiderman Toys as at 31 December 20X6 are as follows:

Statement of financial position as at 31 December 20X6

	Pokeman Toys		Spiderman Toys	
	000	000	000	000
Current assets				
Intangible assets		43,000		35,000
Investments: Shares in Spiderman Toys		40,000		
Intangible assets Inventories				
Trade receivables	20,000		9,000	
Trade payables	1,500		12,000	
			1,000	
Intangible assets		31,500		22,000
		114,500		57,000
Equity and liabilities				
Equity and reserves				
Share capital			24,000	
Retained earnings			22,500	
Intangible liabilities				
Trade payables		27,500		2,500
Intangible liabilities		114,500		57,000

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Required:

Prepare consolidated financial statements as at 31 December 20X6.

Sale by subsidiary to parent (Upstream transaction)

The following entries are made

Dr	Group total retained earnings (parent's share)	X	
Dr	Non-controlling interests (NCI's share)	X	
	Cr Non-current assets		X
	Being URP eliminated from non-current assets		

This has the effect of decreasing the subsidiary's reserves (we are effectively reducing the profit that the subsidiary made on selling the asset to the parent), so this will be split between the parent and the noncontrolling interest.

Once we have reduced the value of non-current assets, it becomes necessary to make the necessary adjustments to depreciation as well.

Dr	Group non-current assets	X	
	Cr Group total retained earnings		X
	Being additional depreciation reduced, from a group perspective		



Tip

1. When NCA is sold at a loss, the entries will be opposite of the above.
2. If the subsidiary is fully owned, there will be no non-controlling interest.



Test Yourself 6

On 1 April 20X6 Police Co Toys acquired 60% share in Soldier Co. On 1 July 20X6 Soldier Co sold non-current assets worth Tshs40 million to Police Co for Tshs60 million. Police Co charges depreciation at 20%p.a. The unrealised profit on the sale of non-current assets creates temporary differences. The tax rate applicable to both entities is 20%. The fair value of the non-controlling interest at the date of acquisition is Tshs40 million.

Statement of profit or loss of Police Co and Soldier Co for the year to 31 December 20X6 are

	Police Co Tshs'000	Soldier Co Tshs'000
Sales	240,000	115,000
Cost of sales	(120,000)	(55,000)
Gross profit	120,000	60,000
Other income	-	20,000
	120,000	80,000
Administrative expenses (including depreciation)	(35,000)	(22,500)
Profit before taxation	85,000	57,500
Taxation	(12,000)	(9,000)
Profit for the year	73,000	48,500

Statement of financial position of Police Co and Soldier Co as at 31 December 20X6 are

	Police Co		Soldier Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Assets				
Non-current assets				
Tangible assets		123,000		75,000
Investments: Shares in Soldier Co		60,000		
Current assets				
Inventories	29,000		39,000	
Receivables	25,000		20,000	
Others	7,500		18,500	
		61,500		77,500
Total assets		244,500		152,500
Equity and liabilities				
Capital and reserves				
Ordinary shares	125,000		75,000	
Retained earnings	98,000		62,500	
		223,000		137,500
Current liabilities				
Payables	21,500		15,000	15,000
		21,500		
Total liabilities		244,500		152,500

Note

Balance in the retained earnings as on 1 January 20X6 were:

	Police Co	Soldier Co
	Tshs'000	Tshs'000
Retained earnings	25,000	14,000

Required:

Prepare consolidated financial statements for the group as at 31 December 20X6.

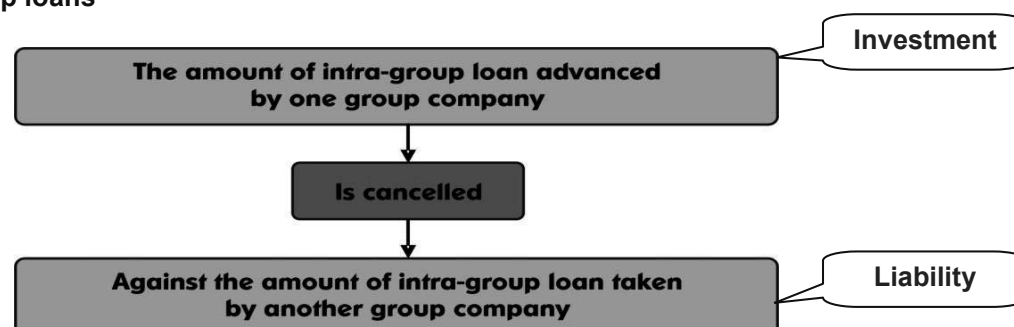
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Tip

Effect on depreciation when a non-current asset is sold at a loss is exactly the opposite of the effect when the asset is sold at a profit.

2.2 Intra-group loans and interest and other intra-group charges

Diagram 3: Intra-group loans



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The mismatch, if any, between the amount of loan given by one Group Company and the amount of loan received by the other then the difference is treated as cash-in-transit.



Test Yourself 7

On 1 January 20X6 Giant Inc has taken a loan of Tshs30 million from its parent Dwarf Inc. On 29 December 20X6 Giant Inc repaid Tshs5 million but this amount was not received by Dwarf Inc until after the year end i.e. until 31 December 20X6.

Required:

State how this transaction is reflected in the consolidated financial statement of the group.

Intra-group interest

While preparing consolidated statement of profit or loss, the amount of **interest** expense of one group company is **cancelled** against the amount of **interest income of another group company**.

SOFP: the amount of interest receivable and payable, if any, should also be eliminated

3. Account for the effects of fair value adjustments to:

- i. **Depreciating and non-depreciating non-current assets**
- ii. **Inventory**
- iii. **Monetary liabilities**
- iv. **Assets and liabilities not included in the subsidiary's own statement of financial position, including contingent assets and liabilities.**

[Learning Outcome c]

IFRS 3 'Business Combinations' states that, goodwill acquired in a business combination should be initially recognised at its cost, i.e.

	Tshs	Tshs
Cost of investment (purchase consideration)		X
Add: Value of non-controlling interest	X	
Add: Acquisition-date fair value of the acquirer's previously held equity interest (in the case of step acquisition)	X	X
Less: Acquisition-date net assets		(X)
Goodwill		X

As stated earlier, IFRS 3 requires that the above items such as purchase consideration should be calculated at fair value. The impact of such calculation is discussed below:



Example

On 1 July 20X6 Apricot Co acquires 100% control over Kiwi Co by investing Tshs25 million. At that time the identifiable assets and liabilities of Kiwi Co are:

	Acquisition date Carrying values	Fair Value
	Tshs'000	Tshs'000
Non-current assets		
Tangible assets	15,000	15,000
Current assets		
Inventories	4,000	5,000
Receivables	3,000	2,500
Cash at bank	2,000	2,000
Total assets	24,000	24,500

	Acquisition date Carrying values	Fair Value
	Tshs'000	Tshs'000
Equity and reserves		
Share capital	15,000	15,000
Retained earnings	3,000	3,500
Current liabilities		
Payables	6,000	6,000
Total liabilities	24,000	24,500

Determine the amount of goodwill:

- (i) based on the fair values of the net assets of Kiwi Co
- (ii) the historical cost of the net assets of Kiwi Co

Answer

Goodwill	At fair values of the net assets		At historical cost of the net assets	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Amount invested by Apricot Co		25,000		25,000
Less: Net assets represented by				
Share capital of Kiwi Co	15,000		15,000	
Retained earnings	3,500	(18,500)	3,000	(18,000)
Goodwill		6,500		7,000

Thus, it can be seen from the above that goodwill calculations based on fair values are more **realistic** as they take into account the **changing prices in the economy**.

IFRS 3 states that the acquirer should recognise separately the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if they satisfy the following criteria at that date:

Asset (other than an intangible asset)	It is probable that any associated future economic benefits will flow to the acquirer, and its fair value can be measured reliably.
Liability (other than a contingent liability)	It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and its fair value can be measured reliably.
Intangible asset	Fair value can be measured reliably.
Contingent liability	Meets the definition of a liability.

3.1 Account for the effects of fair value adjustments to depreciating and non-depreciating non-current assets

If at the date of acquisition, the asset's value has increased / decreased, then the consolidated financial statements must reflect the increase / decrease and show the asset at its fair value.

3.2 The effects of fair value adjustments assets

1. Depreciating non-current assets

(a) Increase in fair value

If at the date of acquisition, the asset's value increases, then the consolidated financial statements must reflect the increase and show the asset at its fair value. From this date on, the asset will always be consolidated at its fair value (as at the date of acquisition, if it has not been subsequently revalued) and depreciation will be based on the fair value, not the book value. Remember these adjustments will happen only on consolidation – the net book values in the subsidiary's books will stay the same.

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The following journal entry will be made to record the increase in the fair value of a non-current asset.

Dr	Group non-current asset	X	
	Cr Goodwill		X

Being a non-current asset brought to fair value, and the effect considered in the goodwill calculation



Tip

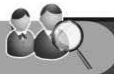
The total difference between fair value and carrying value (also called fair value adjustment) will be considered while calculating goodwill.

Non-controlling interest's share of these fair value adjustments to individual assets / liabilities will be relevant only for calculation of non-controlling interest value using proportionate net assets method. If fair value method is used for non-controlling interest valuation, this need not be separately considered.

Journal entry for the increase in depreciation (in the years subsequent to acquisition) due to increase in value of an asset on acquisition date:

Dr	Group retained earnings (parent share)	X	
Dr	non-controlling interests (NCI share)	X	
	Cr Group non-current asset		X

Being additional depreciation accounted for



Example

Tall Co purchased a 60% share in Short Co on 1 January 20X6 when the book value of the non-current assets of Short Co was Tshs5 million while their fair value was established at Tshs5.4 million. On 31 December 20X6 the retained earnings of Tall Co were Tshs3 million and of Short Co were Tshs2 million. The rate of depreciation of the non-current asset was 10%.

Account for the effect of this fair value adjustments.

Answer

Journal entry for increase in book value:

Dr	Group non-current asset	Tshs0.4 million	
	Cr Goodwill		Tshs0.4 million

Being non-current asset brought to fair value

Journal entry for additional depreciation:

Dr	Group retained earnings (parent share)	Tshs0.024 million	
Dr	Non-controlling interest (minority share)	Tshs0.016 million	
	Cr Group non-current asset		Tshs0.04 million

Being additional depreciation accounted for

Alternatively: The subsidiary's profit can be debited with the total amount and the non-controlling share can be apportioned afterwards.

Consolidated Retained Earnings

	Tall Co Tshs'000	Short Co Tshs'000
According to question	3,000	2,000
Less: Additional depreciation (due to FV adjustments)		(40)
	3,000	1,960
Add: 60% share in Short Co	1,176	
Total	4,176	

(b) Decrease in fair value

To record a **decrease** in fair value of a non-current asset on acquisition date:

Dr Goodwill X
 Cr Group non-current asset X
 Being a reduction in carrying amount of non-current asset accounted for from a group perspective

The journal entry for a decrease in depreciation (in subsequent years) due to a decrease in the value of an asset on the acquisition date:

Dr Group non-current asset X
 Cr Group retained earnings (parent's share) X
 Cr Non-controlling interests (NCI share) X
 Being excess depreciation charged earlier written back

 **Test Yourself 8**

Perfect Co acquired 80% of Smart Co on 1 January 20X6. The carrying amount of Smart Co's non-current assets on 1 January 20X6 was Tshs6.5 million and their fair value was established at Tshs6 million. The depreciation rate was 5%. The retained earnings on 31 December 20X6 of Perfect Co were Tshs4.25 million and of Smart Co was Tshs2.2 million.

Determine the consolidated reserves of the group as at 31 December 20X6.

2. Non-depreciating non-current assets

In the case of non-depreciating assets, entry will be made only to record the change in fair value on the acquisition date. No subsequent entry will be required as there will be no depreciation on such an asset.

Dr Group non-current asset X
 Cr Goodwill X
 Being a non-current asset brought to fair value, and the effect considered in the goodwill calculation

 **Example**

Wet Co purchased 70% share in Dry Co on 1 July 20X5 when the book value of the non-current assets of Dry Co was Tshs8 million while their fair value was established at Tshs6.2 million. On 30 June 20X6 the retained earnings of Wet Co was Tshs9.5 million and of Dry Co was Tshs2.8 million.

Account for the effect of this fair value adjustment and determine the group consolidated reserves as at 30 June 20X6.

Answer

Journal entry to be made for the **decrease** in book value:

Dr Goodwill Tshs1.8 million
 Cr Group non-current asset Tshs1.8million
 Being a reduction in the book value of non-current assets accounted for, from a group perspective

Consolidated retained earnings

	Wet Co Tshs'000	Dry Co Tshs'000
According to question	9,500	2,800
Add: 70% share in Dry Co	1,960	
Total	11,460	



Tip

No entry will be required in the subsequent years as the asset is a non-depreciating asset.



Test Yourself 9

Heavy Co purchased 70% share in Light Co on 1 January 20X6 when the book value of the non-current assets of Light Co was Tshs16.5 million while their fair value was established at Tshs18 million. On 31 December 20X6 the retained earnings of Heavy Co was Tshs24.25 million and of Light Co was Tshs22.2 million.

Required:

Determine the consolidated reserves of the group as at 31 December 20X6 and account for the effect of this fair valued adjustment.

3.3 Account for the effects of fair value adjustments to inventory

The journal entry for an increase in the carrying amount of inventory will be the same as for a non-depreciating asset. A journal entry will be made only for change in the value of the asset and no subsequent accounting is required.

Journal entry for a decrease in carrying amount of inventory:

Dr Group inventory	X	
Cr Goodwill		X

Being inventory brought back to face value, from a group perspective

Journal entry for a decrease in carrying amount of any inventory:

Dr Goodwill	X	
Cr Group inventory		X

Being reduction in carrying amount of inventory accounted for, from a group perspective



Test Yourself 10

Warm Co purchased 70% share in Cool Co as at 1 April 20X5 when the book value of the inventory of Cool Co was Tshs5.45 million while its fair value was established at Tshs5.6 million. On 31 March 20X6 the retained earnings of Warm Co was Tshs12.05 and of Cool Co was Tshs8.96 million.

Required:

Determine the consolidated reserves of the group as at 31 December 20X6 and account for the effect of the fair value adjustment.

3.4 Account for the effects of fair value adjustments to monetary liabilities

A monetary liability is the promise to pay a specified amount of money, the sum of which is unaffected by inflation or deflation. There is normally an increase or decrease in a monetary liability if foreign exchange is involved in the transaction.

If as a result of fair value adjustments there is an **increase** in any monetary liability on the acquisition date, then:

Journal entry for increase in carrying amount

Dr Goodwill	X	
Cr Group monetary liability		X

Being an increase in the carrying amount of a liability accounted for, from a group perspective

If as a result of fair value adjustments there is a **decrease** in the carrying amount of any monetary liability on the date of acquisition, then:

Journal entry for decrease in carrying amount

Dr Group monetary liability	X	
Cr Goodwill		X

Being reduction in carrying amount of a monetary liability accounted for, from a group perspective

3.5 Account for the effects of fair value adjustments to assets and liabilities not included in the subsidiary’s own statement of financial position

1. Assets not included in subsidiary’s own statement of financial position

The accounting treatment for fair value adjustments to assets not included in the subsidiary’s own statement of financial position is **identical** to accounting treatment for fair value adjustments which result in an increase in the book value of the asset.

Internally generated intangible asset is a common example of the assets which are not included in a subsidiary’s own SOFP. This is because, in such cases, it is not possible to determine the fair value of the assets. These assets if separable and fair value determinable, should be recognised in the consolidated SOFP.

An asset which has a carrying amount of zero (as not recognised earlier) will now have a fair value of some amount above zero. This means that there is an increase in the carrying amount of the asset.

The journal entry to be made **for fair value adjustments to assets not included in the subsidiary’s own statement of financial position** is:

Dr Group asset	X	
Cr Goodwill		X

Being assets not included in subsidiary’s SOFP, now recognised in the consolidated financial statements

Alternatively, the group reserve can be credited with the total amount and the non-controlling share can be apportioned afterwards.

 **Example**

Near Co owns 60% share in Far Co on 1 June 20X6. In the course of the process of consolidation, it was noticed that development costs (for a new product) of Tshs2.5 million were accounted as expenses by Far Co before acquisition. Near Co decides that these need to be shown as an asset as Near Co has the cash resources to ensure that the development costs do meet the criteria of development expenditure.

The retained earnings of Near Co on 31 December 20X6 were Tshs23.45 and of Far Co were Tshs18.50 million (post acquisition).

Required:

State how development costs will be accounted for in the consolidated financial statements and determine the consolidated retained earnings of the group as at 31 December 20X6.

Answer

The journal entry **for capitalising development expenses** is:

Dr Group asset	Tshs2.5 million	
Cr Goodwill calculation		Tshs2.5 million

Being development expenses not capitalised by Far Co, capitalised for consolidation purposes from the group perspective.

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Consolidated retained earnings

	Near Co Tshs'000	Far Co Tshs'000
According to question	23,450	18,500
Add: 60% share in Far Co	11,100	
Total	34,550	

There will be no impact on the retained earnings of Far co as the cost was correctly charged to the statement of profit or loss.

2. Liabilities including contingent liabilities not included in subsidiary's own SOFP

Accounting treatment, for fair value adjustments to liabilities not included in subsidiary's own statement of financial position is **identical** to accounting treatment, for fair value adjustments which result in an increase in the book value of a liability. This is because a liability with a carrying amount of zero will now have a fair value of some amount above zero. This means that there is an increase in the carrying amount of the liability.

The journal entry to be made **for fair value adjustments to liabilities not included in the subsidiary's own SOFP:**

Dr Goodwill X
 Cr Group liability X
 Being liabilities not included in subsidiary's SOFP, now recognised in the consolidated financial statements



Example

Old Co owns 75% share in Young Co. In the process of consolidation, it was noticed that a tax liability which was under litigation and had fair value of Tshs3.5 million was not included in Young Co's statement of financial position. The retained earnings of Old Co were Tshs23.45 and of Young Co was Tshs18.50 million.

Required:

State how the tax liability will be accounted for in the consolidated financial statements.

The journal entry to be made for inclusion of this liability in the statement of financial position is:

Dr Goodwill calculation Tshs3.5 million
 Cr Group liability Tshs3.5 million
 Being contingent liability of Young Co included in group accounts.

Consolidated retained earnings

	Old Co Tshs'000	Young Co Tshs'000
Per question	23,450	18,500
Add: 75% share in Young Co	13,875	
Total	37,325	

There will be no impact on the consolidated retained earnings.

3.6 Effect of fair value adjustments related to individual assets / liabilities on consolidated goodwill

IFRS 3 requires that the fair values of net assets be considered when calculating goodwill. As goodwill is the difference between the consideration paid for assets / liabilities and the fair value of those assets / liabilities, it follows that, the higher the (fair) value of assets, the smaller the 'difference' and hence the lower the goodwill.

Goodwill calculations based on fair values are more **realistic** as they take into account the **changing prices**.

The four possible outcomes of fair value adjustments and their impact on goodwill are as follows:

Increase in value of asset	Value of goodwill decreases
Decrease in value of asset	Value of goodwill increases
Increase in value of liabilities	Value of goodwill increases
Decrease in value of liabilities	Value of goodwill decreases

1. Decrease in the value of goodwill due to fair value adjustments



Example

On 1 January 20X7 Red Co acquires full control over Green Co by paying Tshs55 million. The book value and fair values of its assets and liabilities on that date are given below:

	Book Value Tshs'000	Fair Value Tshs'000
Assets		
Non-current assets		
Tangible assets	24,000	25,000
Current assets		
Inventories	7,500	9,000
Receivables	20,000	22,000
Goods in transit	3,000	
Cash at bank	2,500	
Total assets	57,000	
Equity and liability		
Equity		
Share capital	25,000	
Retained earnings	15,000	
Non-current liabilities		
Loan stock	3,000	
Current liabilities		
Payables	14,000	12,000
Total equity and liabilities	57,000	

Required:

Calculate the value of goodwill:

- (i) based on book value of net assets
- (ii) based on fair values of net assets

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Answer

(i) Goodwill

	Based on book values		Based on fair values	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Consideration of shares in Green Co		55,000		55,000
Add: Non-controlling interest in Green Co		0		0
		55,000		55,000
Less: Net assets represented by				
Share capital	(25,000)		(25,000)	
Retained earnings	(15,000)		(15,000)	
Increase in FV of non-current assets			(1,000)	
Increase in FV of inventories			(1,500)	
Increase in FV of receivables			(2,000)	
Decrease in FV of payables			(2,000)	
100% share		(40,000)		(46,500)
Goodwill		15,000		8,500

2. Increase in the value of goodwill due to fair value adjustments

The corollary to the above is that **the value of goodwill increases with a decrease in the fair value of assets and an increase in the fair value of liabilities.**



Test Yourself 11

On 1 January 20X7 Earnest Inc acquires full control over Grim Co by paying Tshs40 million. The book value and fair values of its assets and liabilities on that date are given below:

	Book Value	Fair Value
	Tshs'000	Tshs'000
Assets		
Non-current assets		
Tangible assets	30,000	25,000
Current assets		
Inventories	9,500	8,000
Receivables	26,000	25,000
Cash at bank	4,000	
Total assets	69,500	
Equity and Liabilities		
Equity		
Share capital	25,000	
Retained earnings	12,000	
Non-current liabilities		
Loan stock	8,000	
Current liabilities		
Payables	24,500	26,000
Total equity and liabilities	69,500	

A contingent liability which a present obligation and meets the definition of a liability of Tshs1.5 million is to be included.

Required:

Calculate the amount of goodwill using both book values and fair values.

3.7 Effect of measuring non-controlling interest at fair value

The effect of fair value adjustments to the non-controlling interest is different from that related to the individual assets and liabilities. When the fair value method is followed for non-controlling interest, the goodwill is calculated as:

	Tshs
Consideration paid by the parent	X
Add: Fair value of NCI	X
Add: Acquisition-date fair value of the acquirer's previously held equity interest in the acquiree	X
Less: The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed	(X)

It can be seen that if the fair value of non-controlling interest increases, the value of goodwill will increase. On the other hand, if the fair value of non-controlling interest decreases, the value of goodwill will decrease.



Example

Long Co has acquired 60% of Short Co shares on 1 January 20X6 for Tshs4 million. Fair value of the noncontrolling interest is Tshs2.5 million.

Statement of financial position of short co (subsidiary)

	Tshs'000
Assets	5,000
Equity and liabilities	
Share capital	3,000
Retained earnings	2,000
	5,000

Investment in Short Co's shares in parent's statement of financial position Tshs4 million.

Analysis of fair value changes in individual assets/ liability

	Total	Parent's share	NCI's share
	Tshs'000	Tshs'000	Tshs'000
Fair value of assets	5,400	3,240	2,160
Less: Book value of net assets (given)	(5,000)	(3,000)	(2,000)
Increase in the value of assets	400	240	160

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Option 1: If proportionate net assets method is followed for non-controlling interest (goodwill on partial basis)

Calculation of goodwill and NCI	Total	Parent's share	NCI's share
	Tshs'000	Tshs'000	Tshs'000
Consideration	4,000	4,000	
Proportionate share of non-controlling interest in net assets	2,160		2,160
	6,160		
Less: Fair value of net assets	(5,400)	(3,240)	(2,160)
Goodwill	760	760	0

Analysis of goodwill

	Tshs'000
Consideration	4,000
Less: Parent's share of net assets	(3,240)
Goodwill	760

Note: When this method is followed, goodwill calculation as well as the amount of non-controlling interest is similar to the method according to the earlier IFRS 3.

Journal entry

Dr Individual assets / liabilities Tshs0.4 million
 Cr Revaluation surplus Tshs0.4 million
 Being the entry to record the increase in the value of net assets

Entry for transfer of different accounts to non-controlling interest

Dr Share capital of subsidiary (eliminate) Tshs1.2 million
 Dr Pre-acquisition reserves of subsidiary (eliminate) Tshs0.8 million
 Dr Revaluation surplus recorded earlier (eliminate) Tshs0.16 million
 Cr Non-controlling interest Tshs2.16 million
 Being the entry to transfer the equity related to non-controlling interest

Entry for adjustment of parent's share

Dr Share capital of subsidiary (eliminate) Tshs1.8 million
 Dr Pre-acquisition reserves of subsidiary (eliminate) Tshs1.2 million
 Dr Revaluation surplus Tshs0.24 million
 Dr Goodwill Tshs0.76 million
 Cr Non-controlling interest Tshs4.0 million
 Being the entry to adjust the investment in subsidiary with parent's share of assets

Option 2: If fair value method is followed for non-controlling interest

Calculation of goodwill and NCI		Parent's share	NCI's share
		Tshs'000	Tshs'000
Consideration	4,000	4,000	
Add: Fair value of non-controlling interest	2,500		2,500
	6,500		
Less: Fair value of net assets	(5,400)	(3,240)	(2,160)
Goodwill	1,100	760	340



Tip

In this method, goodwill value is higher than the partial method by TShs0.34 million, i.e. the difference between the fair value of non-controlling interest and its share of net assets (Tshs2.5 million - Tshs2.16 million). The amount of non-controlling interest is also higher by this amount.

Accounting entries

Entry for fair value changes of individual assets /liabilities

Dr Individual assets / liabilities Tshs0.4 million
 Cr Revaluation surplus Tshs0.4 million
 Being the entry to record the increase in the value of net assets

Entry for transfer of different accounts to non-controlling interest

Dr Share capital of subsidiary (eliminate) Tshs1.2 million
 Dr Pre-acquisition reserves of subsidiary (eliminate) Tshs0.8 million
 Dr Revaluation surplus recorded earlier (eliminate) Tshs0.16 million
 Dr Goodwill Tshs0.34 million
 Cr Non-controlling interest Tshs2.5 million
 Being the entry to transfer the equity related to non-controlling interest

Entry for adjustment of parent’s share

Dr Share capital of subsidiary (eliminate) Tshs1.8 million
 Dr Pre-acquisition reserves of subsidiary (eliminate) Tshs1.2 million
 Dr Revaluation surplus recorded earlier (eliminate) Tshs0.24 million
 Dr Goodwill Tshs0.76 million
 Cr Non-controlling interest Tshs4 million
 Being the entry to adjust the investment in subsidiary with parent’s share of assets

Impact of the value of NCI on goodwill

If only the fair value of non-controlling interest is changed, there is a change in the value of goodwill too (if fair value method is used). Let us change the fair value of non-controlling interest to Tshs4 million.



Example

Continuing the above example of Long Co,

Statement of financial position of Short co (subsidiary)

	Tshs'000
Assets	5,000
Equity and liabilities	
Share capital	3,000
Retained earnings	2,000
	5,000
	4,000

Investment in short co's shares in parent's statement of financial position – Tshs4 million

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Option 2: If fair value method is followed for non-controlling interest

Calculation of goodwill and NCI		Parent's share	NCI's share
	Tshs'000	Tshs'000	Tshs'000
Consideration	4,000	4,000	
Fair value of non-controlling interest	4,000		4,000
	8,000		
Fair value of net assets	5,400	3,240	2,160
Goodwill	2,600	760	1,840

Accounting entries:

Entry for fair value changes of individual assets /liabilities

Dr Individual assets / liabilities Tshs0.4 million
 Cr Revaluation surplus Tshs0.4 million
 Being the entry to record the increase in the value of net assets

Entry for transfer of different accounts to non-controlling interest

Dr Share capital of subsidiary (eliminate) Tshs1.2 million
 Dr Pre-acquisition reserves of subsidiary (eliminate) Tshs0.8 million
 Dr Revaluation surplus recorded earlier (eliminate) Tshs0.16 million
 Dr Goodwill TShs1.84 million
 Cr Non-controlling interest Tshs4.0 million
 Being the entry to transfer the equity related to non-controlling interest

Entry for adjustment of parent's share

Dr Share capital of subsidiary (eliminate) Tshs1.8
 Dr Pre-acquisition reserves of subsidiary (eliminate) Tshs1.2 million
 Dr Revaluation surplus recorded earlier (eliminate) Tshs0.24 million
 Dr Goodwill Tshs0.76 million
 Cr Investment in subsidiary Tshs4 million
 Being the entry to adjust the investment in subsidiary with parent's share of assets

Answers to Test Yourself

Answer to TY 1

Group entities could have intra-group transactions in the following areas:

- Sale / purchase of goods
- Sale / purchase of non-current assets
- Loans advanced / taken from each other
- Rent paid / received from each other

Answer to TY 2

Placid Co - Consolidated statement of financial position as at 31 December 20X6

	Tshs'000	Tshs'000
Non-current assets		
Goodwill (W3)		1,500
Tangible assets (33,000 + 25,000)		58,000
Current assets		
Inventories (W2)	18,000	
Others (4,000 + 13,000)	17,000	
		35,000
Total assets		94,500
Equity and liabilities		
Capital and reserves		
Ordinary shares	42,000	
Retained earnings (W1)	23,375	
		65,375
Non-controlling interest (W4)		10,125
Current liabilities		
Payables (14,000 + 5,000)	19,000	
		19,000
Total equities and liabilities		94,500

Workings

W1 Retained earnings

	Placid Co Tshs'000	Swift Co Tshs'000
According to question	18,500	17,000
Less: pre-acquisition retained earnings (50% of Tshs17,000)		(8,500)
Post-acquisition retained earnings		8,500
Less: URP in inventory (W2)	(1,500)	
	17,000	
Add: 75% share in Swift Co	6,375	
To consolidated SOFP	23,375	

(Profit is in the books of the parent – so URP deducted from retained earnings of parent – so non-controlling interest not involved).

W2 Inventory

	Placid Co Tshs'000	Swift Co Tshs'000
According to question	10,500	9,000
Less: URP (20/120 x Tshs9,000)		(1,500)
		7,500
Add: inventory of Swift Co	7,500	
To consolidated SOFP	18,000	

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(Inventory is in the books of the subsidiary – hence URP deducted from inventory of subsidiary)

W3 Goodwill

	Tshs'000	Tshs'000
Investment in Swift Co		27,000
Fair value of the 25% non-controlling interest		8,000
		35,000
Less: net assets represented by Ordinary shares	(25,000)	
Pre-acquisition retained earnings (W1)	(8,500)	
	33,500	33,500
Goodwill		1,500

W4 Non-controlling interest

	Tshs'000
Fair value of the 25% non-controlling interest	8,000
Post acquisition profits (W1) 8,500 x 25%	2,125
	10,125

Answer to TY 3

	Tshs'000
Sales of Big Co	40,000
Add: Sales of small Co	30,000
	70,000
Less: Intra-group sale	(5,000)
Consolidated sale	65,000

Answer to TY 4

Pleasant Co - Consolidated statement of profit or loss for the year to 31 December 20X6

	Case (i)		Case (ii)		Case (iii)	
	Workings	Tshs'000	Workings	Tshs'000	Workings	Tshs'000
Turnover	(120 + 54 - 10)	164,000	(120 + 54 - 10)	164,000	(120 + 54 - 10)	164,000
Cost of sales	(40 + 20 - 10)	(50,000)	(40 + 20 - 10 + 1)	(51,000)	(40 + 20 - 10 + 1)	(51,000)
Gross profit		114,000		113,000		113,000
Administrative expenses	(22.5 + 12.5)	(35,000)	(22.5 + 12.5)	(35,000)	(22.5 + 12.5)	(35,000)
Profit before tax		79,000		78,000		78,000
Taxation	(15.4 + 4)	(19,400)	(15.4 + 4)	(19,400)	(15.4 + 4)	(19,400)
Profit after tax		59,600		58,600		58,600
Attributable to						
Share of NCI	20% of 17.5	3,500	20% of 17.5	3,500	20% of (17.5 - 1)	3,300
Group share		56,100		55,100		55,300
Group profit		59,600		58,600		58,600

Answer to TY 5

Pokeman Toys - Consolidated statement of financial position as at 31 December 20X6

	Tshs'000	Tshs'000
Non-current assets		
Goodwill (W3)		28,000
Tangible assets (W2)		68,750
Current assets		
Inventories	29,000	
Receivables	22,000	
Others	2,500	
Total assets		53,500
Equity and liabilities		150,250
Capital and reserves		
Ordinary shares	45,000	
Retained earnings (W1)	49,438	
		94,438
Non-controlling interest (W4)		17,812
Current liabilities		
Payables		38,000
Total equity and liabilities		150,250

Workings

W1 Retained earnings

	Pokeman Toys (Tshs'000)	Spiderman Toys (Tshs'000)
According to question	42,000	22,500
Less: URP on sale of NCA (Tshs30,000 - Tshs20,000)	(10,000)	
	32,000	
Add: additional depreciation written back (10% x Tshs10,000 x 9/12)		750
		23,250
Add: 75% share in Spiderman Toys (75% x Tshs23,250)	17,438	
To consolidated SOFP	49,438	

(Profit is in the books of the principal – so URP deducted from retained earnings of principal)

(Additional depreciation has been charged in the subsidiary's books – so split between parent and noncontrolling)

W2 Non-current assets

	Pokeman Toys (Tshs'000)	Spiderman Toys (Tshs'000)
According to question	43,000	35,000
Less: URP on sale of NCA (Tshs30,000 - Tshs20,000)		(10,000)
Add: additional depreciation written back (10% x Tshs10,000 x 9/12)		750
		25,750
Add: Spiderman Toys	25,750	
To consolidated SOFP	68,750	

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W3 Goodwill

	Tshs	Tshs
Investment in Spiderman Toys		40,000
Fair value of non-controlling interest		12,000
		52,000
Less: Net assets represented by Ordinary shares	24,000	
Pre-acquisition retained earnings	-	
	24,000	24,000
Goodwill		28,000

W4 Non-controlling interest

	Tshs
Fair value of non-controlling interest	12,000
Post acquisition profits (W1) 23,250 x 25%	5,812
	17,812

Answer to TY 6

Police Co- Consolidated statement of profit or loss for the year to 31 December 20X6

	Tshs'000
Turnover (Tshs240,000 + 9/12 of Tshs115,000)	326,250
Cost of sales (Tshs120,000 + 9/12 of Tshs55,000)	(161,250)
Gross profit	165,000
Other income (Tshs20,000 - Tshs20,000)	-
Profit before administrative expenses	165,000
Administrative expenses (including depreciation) (W1)	(49,875)
Profit before taxation	115,125
Taxation (Tshs12,000 + 9/12 of Tshs9,000)	(18,750)
Profit for the year	96,375
Share of profit for the year attributable to	
- Owners of parent	87,825
- Non-controlling interest (W2)	8,550
	96,375

(*) - Tshs20,000 (Tshs60,000 - Tshs40,000) relates to the post-acquisition period as it has been earned on account of sale of non-current tangible assets on 1 July 20X7 – removed totally as it is profit on intra-group sale of non-current asset.

Police Co- Consolidated statement of financial position as at 31 December 20X6

	Tshs'000	Tshs'000
Non-current assets		
Goodwill (W4)		3,875
Tangible assets (W6)		180,000
Current assets		
Inventories	68,000	
Receivables	45,000	
Others	26,000	139,000
Total assets		322,875
Equity and liabilities		
Capital and reserves		
Ordinary shares	125,000	
Retained earnings (W3)	112,825	237,825
Non-controlling interest (W5)		48,550
Current liabilities		
Payables	36,500	
		36,500
Total liabilities		322,875

Workings (Amounts in Tshs'000)

W1 Administrative expenses (including depreciation)

	Police Co Tshs'000	Soldier Co Tshs'000
According to question	35,000	22,500
Less Additional depreciation written back (20% x Tshs20,000 x 1/2)	(2,000)	
	33,000	
Add: 9/12 of Soldier Co	16,875	
To consolidated statement of profit or loss	49,875	

W2 Share of non-controlling interest in consolidated statement of profit or loss

	Tshs'000
Profit after tax of Soldier Co	48,500
Less: URP on sales of non-current assets	(20,000)
	28,500
Share of non-controlling interest in consolidated SOPL 9/12 x Tshs28,500 x 40 %	8,550

W3 Retained earnings

	Police Co Tshs'000	Soldier Co Tshs'000
According to question	98,000	62,500
Less: Pre-acquisition earnings (W3 A)		(21,125)
		41,375
Less: URP on sale of NCA (Tshs60,000 - Tshs40,000)		(20,000)
		21,375
Add: Additional depreciation written back (20% x Tshs20,000 x 1/2)	2,000	
Add: 60% share in Soldier Co (60% x Tshs21,375)	12,825	
Consolidated retained earnings	112,825	

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NCI share 40% of Tshs21,375 = Tshs8,550

(Profit is in the books of the subsidiary – so URP deducted from retained earnings of subsidiary - split between parent and non-controlling).

(Additional depreciation has been charged in the parent's books – so added back to profits (reduced from administrative expenses) of parent.

W3 A Pre-acquisition retained earnings

	Tshs'000	Tshs'000
Brought forward reserves		14,000
For the year	48,500	
Less: Post-acquisition – (other income)	(20,000)	
	28,500	
3/12 of Tshs28,500		7,125
Total pre-acquisition retained earnings		21,125

W4 Goodwill

	Tshs'000	Tshs'000
Investment in Soldier Co		60,000
Fair value of non-controlling interest		40,000
		100,000
Less: net assets represented by		
Ordinary shares	(75,000)	
Pre-acquisition retained earnings	(21,125)	
		(96,125)
Goodwill		3,875

W5 Non-controlling interest

	Tshs'000
Fair value of non-controlling interest	40,000
Post acquisition profits (W3) Tshs21,375 x 40%	8,550
	48,550

W6 Non-current assets

	Police Co Tshs'000	Soldier Co Tshs'000
According to question	123,000	75,000
Less: URP on sale of NCA (Tshs60,000 - Tshs40,000)		(20,000)
Add: Additional depreciation written back (20% x Tshs20,000 x 1/2)	2,000	
	125,000	55,000
Add: Soldier Co	55,000	
To consolidated SOFP	180,000	

Answer to TY 7

	Tshs
Loan given (asset in Dwarf Inc's books)	30,000
Less: Loan taken (Liability in Giant Inc's books Tshs30,000 – Tshs5,000)	(25,000)
Difference treated as cash-in-transit (asset in consolidated SOFP)	5,000

Answer to TY 8

Journal entry for decrease in carrying amount

Dr Goodwill calculation (parent share) Tshs0.5 million
 Cr Group non-current assets (Tshs6.5 million - Tshs6 million) Tshs0.5 million
 Being a reduction in the carrying amount of non-current asset accounted for, from a group perspective

Journal entry for decrease in depreciation due to decrease in carrying amount

Dr Group non-current asset (Tshs0.5 million x 5%) Tshs0.025 million
 Cr Group retained earnings (parent's share) Tshs0.020 million
 Cr Non-controlling interest (non-controlling share) Tshs0.005 million
 Being excess depreciation charged earlier written back

Consolidated retained earnings

	Perfect Co	Smart Co
	Tshs'000	Tshs'000
According to question	4,250	2,200
Add: Excess depreciation written back (due to FV adjustments)		25
		2,225
Add: 80% share in Smart Co	1,780	
Total	6,030	

Answer to TY 9

Journal entry for increase in carrying amount

Dr Group non-current asset Tshs1.5 million
 Cr Goodwill Tshs1.5 million
 Being a non-current asset brought back to fair value, from a group perspective

Consolidated retained earnings

	Heavy Co (Tshs'000)	Light Co (Tshs'000)
According to question	24,250	22,200
Add: 70% share in Light Co	15,540	
Total	39,790	

Note: As no information has been given about depreciation, it has been assumed that the non-current assets are non-depreciating assets.

Answer to TY 10

Journal entry to be passed for increase in carrying amount

Dr Group inventory Tshs0.15 million
 Cr Goodwill Tshs0.15 million
 Being inventory brought back to face value, from a group perspective

Consolidated retained earnings

	Warm Co Tshs'000	Cool Co Tshs'000
According to question	12,050	8,960
Add: 70% share in Cool Co	6,272	
Total	18,322	

There will be no impact on the consolidated retained earnings.

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Answer to TY 11

Goodwill based on carrying amounts

	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Amount invested by Earnest Inc		40,000		40,000
Non-controlling interest		0		0
		40,000		40,000
Less: Net assets represented by				
Ordinary shares	25,000		25,000	
Retained earnings	12,000		12,000	
Decrease in FV of non-current assets			(5,000)	
Decrease in FV of inventories			(1,500)	
Decrease in FV of receivables			(1,000)	
Increase in FV of payables			(1,500)	
Contingent liability to be included			(1,500)	
	37,000		26,500	
		(37,000)		(26,500)
Goodwill		3,000		13,500

Quick Quiz

1. Why are intra-group transactions eliminated from the consolidation process?
2. 'Parent's share in dividend paid out of pre-acquisition profits of the subsidiary is added to the group consolidated reserves'. Is this statement true or false?
3. What are the effects of fair value adjustments on goodwill?
4. Blue Inc is a 60% subsidiary of Ink Inc. Ink Inc sells non-current assets amounting to Tshs30 million to Blue Inc at a profit of Tshs4 million. The rate of depreciation is 10%. How will this transaction be accounted for in the consolidated financial statements?

Answers to Quick Quiz

1. Intra-group transactions are eliminated from the consolidation process because:
 - Otherwise the consolidated financial statements become inflated and misleading.
 - A group is assumed to be a single entity and a single entity cannot have transactions with itself.
2. False. Parent's share in dividend paid out of pre-acquisition profits of the subsidiary is deducted from the cost of the investment.
3. The effects of fair value adjustments on goodwill are:
 - If the value of asset increases and / or value of liabilities decrease, the value of goodwill decreases. This is because, with the same investment, an investor is getting more assets or fewer liabilities.
 - If the value of asset decreases and / or value of liabilities increase, the value of goodwill increases. This is because, with the same investment, an investor is getting fewer assets or more liabilities.

4. This transaction will be accounted for in the consolidated financial statements, as follows:

- Reduce the consolidated non-current asset by Tshs4 million (the intra-group profit element)
- Reduce depreciation by Tshs0.4 million (Tshs4 million x 10%)
- Transfer non-controlling interest share (Tshs0.4 million x 40% = Tshs0.16 million) in reduced depreciation to non-controlling interest.

Self-Examination Questions

Question 1

The statement of financial position of Low Co and its subsidiary High Co as on 31 December 20X5 are:

	Low Co		High Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Tangible assets		80,000		45,000
Investments: Ordinary shares of High Co		40,000		
Current assets				
Inventories	10,000		12,500	
Receivables	20,000		20,000	
Cash at bank	8,000	38,000	4,000	36,500
Total assets		158,000		81,500
Equity and liabilities				
Capital and reserves			50,000	
Ordinary shares	75,000			
Retained earnings	64,750	139,750	20,000	70,000
Current liabilities				11,500
Payables		18,250		
Total equity and liabilities		158,000		81,500

Additional information

1. Low Co acquired 60% of the shares of High Co. The retained earnings on the date of acquisition were Tshs15 million.
2. The inventory of High Co comprises goods bought from Low Co. Low Co had sold goods worth Tshs25 million to High Co during the year which had cost it Tshs20 million.
3. The fair value of the non-controlling interest at the date of acquisition is Tshs26 million.

Required:

Prepare a consolidated statement of financial position for the group.

Question 2

Slow Co owns 70% of the shares in Fast Co. On 1 January 20X6, it has sold non-current assets amounting to Tshs20 million to Fast Co. The cost of these non-current assets to Slow Co was Tshs15 million.

The retained earnings as at 31 December 20X6 are:

Slow Co Tshs25 million (including profit of Tshs5 million on sale of non-current asset)

Fast Co Tshs20 million (after charging depreciation of 10% on non-current asset)

Required:

Determine the group consolidated retained earnings as at 31 December 20X6.

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Question 3

Fair Co acquires control over Square Co by investing Tshs90 million on 31 December 20X6 when the carrying amount of its identifiable assets and liabilities are:

Statement of financial position of Square Co as at 31 December 20X6

	Tshs'000
Non-current assets	
Tangible assets	60,000
Current assets	
Inventories	32,000
Receivables	18,000
Total Assets	110,000
Equity and reserves	
Ordinary shares	70,000
Retained earnings	10,000
Current liabilities	
Payables	20,000
Bank overdraft	10,000
Total liabilities	110,000

On the date of acquisition the fair values were:

- Inventories: Tshs36 million
- Receivables: Tshs17 million
- Payables: Tshs18 million

Required:

Calculate the amount of goodwill and state the accounting treatment to be applied.

Question 4

Patient Inc acquired 55% shares in Smart Inc on 1 January 20X6. The retained earnings on the date of acquisition were nil. The fair value of the non-controlling interest on the date of acquisition was Tshs21.50 million.

The statements of financial position of Patient Inc and Smart Inc as at 31 December 20X6 are:

	Patient Inc		Smart Co	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Assets				
Non-current assets				
Tangible assets			10,000	
Land	-			
Property, plant and equipment	33,000	33,000	15,000	25,000
Investments: Shares in Smart Co		27,000		
Current assets				
Inventories	10,500		9,000	
Others	4,000	14,500	13,000	22,000
Total assets		74,500		47,000
Equity and liabilities				
Equity				
Ordinary shares	42,000		25,000	
Retained earnings	18,500	60,500	17,000	42,000
Current liabilities				5,000
Payables	14,000	14,000	5,000	
Total equity and liabilities		74,500		47,000

The directors of Patient Inc carried out a fair value exercise on the net assets of Smart Co on the date of acquisition. The following matters arose from the exercise:

1. On the date of acquisition, the fair value of Smart Co's land was Tshs5 million more than its carrying amount and that of its plant was Tshs10 million more than its carrying amount of Tshs5 million. Smart Co charges depreciation at 10% (straight line method).
2. Inventories were included at cost to Smart Inc of Tshs7 million. The selling price of the inventories was estimated at Tshs9 million and a reasonable allowance for profit on the sale was Tshs1.4 million. All the inventories as at 1 January 20X6 had been sold by 31 December 20X6.
3. On 1 January 20X6, Smart Inc had a brand name that was protected legally, but was not included in the statement of financial position because Smart Inc's directors considered that it did not meet the recognition criteria for internally-developed intangible assets. The directors of Patient Inc considered that the brand name had a market value of Tshs4 million on 1 January, 20X6 and that it would give competitive advantage for 5 years from that date.

Required:

Prepare the consolidated financial statements for the group.

Answers to Self Examination Questions

Answer to SEQ 1

Consolidated statement of financial position as at 31 December 20X5

	Tshs'000	Tshs'000
Non-current assets		
Intangible assets		
Goodwill (W3)		1,000
Tangible assets (80 + 45)		125,000
Investments: Ordinary shares of High Co		
Current assets		
Inventories (W2) (10 + 12.5 – 2.5)	20,000	
Receivables (20 + 20)	40,000	
Cash at bank (8 + 4)	12,000	72,000
Total assets		198,000
Equity and liabilities		
Capital and reserves		
Ordinary shares	75,000	
Retained earnings (W1)	65,250	140,250
Non-controlling interest (W4)		28,000
Current liabilities		
Payables (18.25 + 11.5)		29,750
Total equity and liabilities		198,000

474: Preparing Consolidated Financial Statements

Workings

W1 Post-acquisition reserves

	Low	High
	Tshs'000	Tshs'000
At 31/12/20X5 (per question)	64,750	20,000
Less: pre-acquisition profits		(15,000)
Post-acquisition profits	3,000	5,000
60% share		
	67,750	
Less: URP in inventory (W2)	(2,500)	
To consolidated SOFP	65,250	

W2 URP in inventory

	Tshs'000
On sales of Tshs25,000 there is a profit of Tshs5,000 (Tshs25,000 – Tshs20,000); so on inventory of Tshs12,500, profit =	2,500

W3 Goodwill

	Tshs'000	Tshs'000
Consideration		40,000
Fair value of the non-controlling interest		26,000
		66,000
Less: Ordinary shares	(50,000)	
Pre-acquisition reserves	(15,000)	
Total	(65,000)	65,000
Goodwill on purchase of shares in High Co		1,000

W4 Non-controlling interest

	Tshs'000
Fair value of the non-controlling interest	26,000
Post-acquisition reserves (W1) 5,000 x 40%	2,000
Total	28,000

Answer to SEQ 2

This is a sale by the parent to the subsidiary.

Group retained earnings

	Slow Co Tshs'000	Fast Co Tshs'000
Per question	25,000	20,000
Less: URP on sale of NCA (Tshs20,000 - Tshs15,000)	(5,000)	
	20,000	
Add: additional depreciation written back (10% x Tshs5,000)		500
		20,500
Add: 70% share in Fast Co (70% x Tshs20,500)	14,350	
To consolidated SOFP	34,350	

(Profit is in the books of the principal – so URP deducted from retained earnings of principal).

(Additional depreciation has been charged in the subsidiary's books – so split between parent and non-controlling).

Answer to SEQ 3

Goodwill on acquisition of shares in Square Co

	Tshs'000	Tshs'000
Consideration		90,000
Fair value of Non-controlling interest		-
		90,000
Less: Identifiable net assets represented by:		
Ordinary shares of Square Co	(70,000)	
Pre-acquisition reserves (W1)	(15,000)	(85,000)
Goodwill on purchase of shares in Square Co		5,000

This is positive goodwill which will be treated as an intangible asset in the consolidated statement of financial position as at 31 December 20X6.

Workings

W1 Pre-acquisition reserves

	Tshs'000
Per question	10,000
Add: per revaluation account (W2) Pre-acquisition reserves	5,000
	15,000

W2 Revaluation account

	Tshs'000		Tshs'000
Receivables	1,000	Inventories	4,000
Balance to pre-acquisition reserves (W1)	5,000	Payables Total	2,000
Total	6,000		6,000

476: Preparing Consolidated Financial Statements

Answer to SEQ 4

Consolidated statement of financial position as at 31 December 20X6

	Tshs'000	Tshs'000
Non-current assets		
Goodwill (W2)	3,900	
Intangible assets (W5)	3,200	
Land (Tshs10,000 + Tshs5,000)	15,000	
Property, plant and equipment (Tshs33,000 + Tshs15,000 +Tshs10,000 – Tshs1,000 (10% of Tshs10,000))	57,000	79,100
Current assets		
Inventories (Tshs10,500 + Tshs9,000)	19,500	
Others (Tshs4,000 + Tshs13,000)	17,000	36,500
Total assets		115,600
Equity and liabilities		
Capital and reserves		
Share capital	42,000	
Retained earnings (W1)	26,530	68,530
Non-controlling interest (W3)		28,070
		96,600
Current liabilities		
Payables (Tshs14,000 + Tshs5,000)		19,000
Total equity and liabilities		115,600

Workings

W1 Retained earnings

	Patient Inc	Smart Inc
	Tshs'000	Tshs'000
Per question	18,500	17,000
Less: Fair value adjustments Post-acquisition reserves		(2,400)
		14,600
55% share in Smart Inc	8,030	
To consolidated SOFP	26,530	

W2 Goodwill

	Tshs'000	Tshs'000
Investment in Smart Co		27,000
Fair value of the NCI of 45%		21,500
		48,500
Less: Net assets represented by Ordinary shares	(25,000)	
Fair value adjustments (W4)	(19,600)	(44,600)
		3,900

W3 Non-controlling interest

	Tshs'000
Fair value of the NCI of 45%	21,500
Post-acquisition reserves W1 (14,600 x 45%)	6,570
	28,070

W4 Fair value adjustments for goodwill

	Carrying value	Fair value	Difference
	Tshs'000	Tshs'000	Tshs'000
Land	10,000	15,000	5,000
Plant and equipment	5,000	15,000	10,000
Inventories	7,000	7,600	600
Brand name		4,000	4,000
	22,000	41,600	19,600

W5 Fair value changes during the year

	Acquisition date	Reporting date	Change
	Tshs'000	Tshs'000	Tshs'000
Land	5,000	5,000	-
Plant and equipment	10,000	9,000	1,000
Inventory	600	-	600
Brand name	4,000	3,200	800
	19,600	17,200	2,400

STUDY GUIDE D3: BUSINESS COMBINATIONS - ASSOCIATES

Get Through Intro

In the last three Study Guides we have seen how to consolidate accounts of a parent company and its subsidiaries. What happens if the reporting company has less than 50% of the voting rights of another entity? Is it alright to treat it as an ordinary investment or is there any other treatment for such investments?

Let us consider the following case – In the financial year 20X5 - 06 Nandi Co owned a 55% share in Mandi Co. As Mandi Co was its subsidiary, its accounts were included in the consolidated financial statements.

In the financial year 20X6 – 07 Nandi Co sold some of its shares in Mandi Co and now it holds only 45% of the shares of Mandi Co. Mandi Co is no longer a subsidiary of Nandi Co. So should Nandi Co show its investment in Mandi Co as an ordinary investment? Can Nandi Co still control Mandi Co?

A 45% share is no small amount. Although Nandi Co would no longer be able to dictate terms, it would still be able to significantly influence the functioning and management of Mandi Co. Then how should Nandi Co treat Mandi Co? Mandi Co is an associate of Nandi Co and the equity method will be used for consolidation of accounts.

This Study Guide discusses the technique of preparation of consolidated financial statements including a subsidiary and an associate.

A systematic approach is required in the preparation of consolidated financial statements. This Study Guide explains how to approach the question (you can always expect one in the examination) and work your way through all the adjustments that you would be expected to master.

Examiners will always include new adjustments in the question, in order to test your knowledge. You must work on the basics you have learnt in this Section, use your knowledge about elements that relate to other areas of the syllabus, to deal with such adjustments.

Learning Outcomes

- a) Define associates and explain the accounting treatment for associate companies
- b) Solve the problems of accounting for multinational groups.
- c) Draft, compile and present the consolidated financial statements or their extracts in accordance with selected accounting policies and the requirements of IFRS.

1. Define associates and explain the accounting treatment for associate companies.
 [Learning Outcomes a]

1.1 Definition of associate

 **Definition**

An **associate** is an entity over which the investor has significant influence.

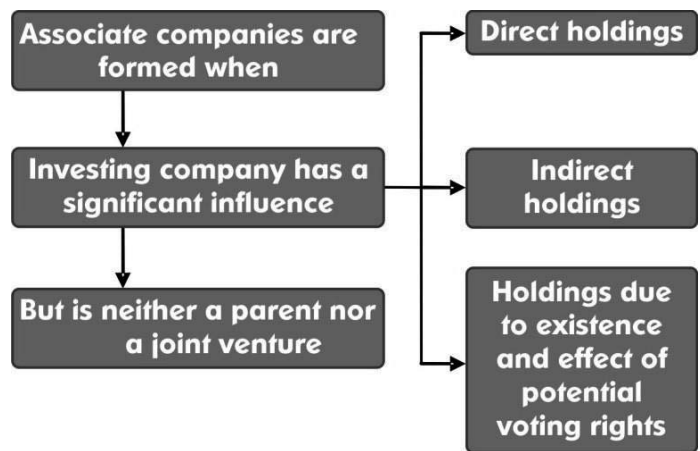
Significant influence is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.

IAS 28 Para 3

A company exercises significant influence over another when:

It **cannot dictate terms** yet the other entity **has to consider** what it says.

Diagram 1: Formation of associate companies



1. Direct holdings

An entity becomes an associate of another entity, when it directly holds **20% or more but less than 50% of the voting rights** in another entity.

2. Indirect holdings

An entity becomes an associate of another entity when indirectly through subsidiaries it holds more than 20% but less than 50% of the voting rights in another entity.

3. Holdings due to the existence and effect of potential voting rights

It has been already discussed that an entity may own share warrants, share call options or debt or equity instruments that can be converted into ordinary shares of another entity.

It could also have similar instruments which have the potential, if the right is exercised or converted, to increase the share of its voting power or reduce the share of some other's voting power over the financial and operating policies of the other entity.

 **Definition**

Potential voting rights are rights which when exercised or converted either increase or decrease a party's voting rights in another party.

It is essential to ascertain whether the existence and conversion of potential voting rights lead to a change in the shareholding pattern, resulting in the formation of an associate.

In ascertaining whether potential voting rights lead to formation of an associate, potential voting rights of all the company's shareholders must be taken into consideration.

The entity has to examine all facts and circumstances (including terms of any agreements, or contractual arrangements) that affect potential voting rights, except the intention of management and the financial ability to exercise the conversion.



Test Yourself 1

Sun Co holds 12% shares of Moon Co and Sun Co also holds debt instruments which have the potential to be converted into ordinary shares of Moon Co. If and when these are converted, Sun Co will acquire power over 10% of the voting rights of Moon Co.

Required:

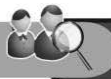
Determine whether Moon Co is an associate of Sun Co.

4. Significant Influence can exist even if the shareholding is less than 20%.

Even though the shareholding is below 20%, significant influence can still exist, but only if the entity can clearly demonstrate that it has significant influence over the other entity.

5. Holdings of associate companies compared with holdings of other companies in associate companies

A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.



Example

Good Co holds 70% of Excellent Co and Fair Co hold 20% of Excellent Co.

Then, Good Co is the parent of Excellent Co (as it holds **more than 50%**); But this does not stop Excellent Company from being an associate of Fair Company (as Fair Co **directly holds more than 20% and less than 50% of** Excellent Co). It also means that while Good can control what Excellent does, Good should also take note of Fair's views, as Fair still exerts significant influence.

1.2 Rights enjoyed in the associate

A company will be able to use its right of significant influence in its associate company by:

- Being present on the board of directors or equivalent governing body of the associate company
- Participating in policy-making processes, including decisions about dividends or other distributions
- Having material transactions with its associate company
- Interchanging managerial personnel
- Provision of essential technical information

1.3 Equity accounting

IAS 28 states that **investments in associates** should be accounted for using the **equity method**. The equity method of accounting is used because the investment in an associate is actually the non-controlling interest.



Definition

Equity Method is a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

IAS 28 Para 3

Equity method is adopted since proportional consolidation is not suitable for an associate as the investor does **not have control** over the assets and liabilities of the associate company. Proportionate consolidation would depict a misleading picture of the assets and liabilities of the group.

Principles of equity accounting

Under this method:

1. In the consolidated statement of financial position

- (a) **On date of acquisition:** The investment in the associate company is stated at cost.
- (b) **After acquisition:** Every year, the investment in associate company will be reflected in the consolidated statement of financial position after making the following adjustments:
- If the associate makes a profit: Group share of profit will be added to investment
 - If the associate makes a loss: Group share of loss will be deducted from investment

The procedures used for determining the profit/loss under the equity method are similar to those used for determining profit/loss under the full consolidation method.

2. In the consolidated statement of profit or loss

- ⑩ The **group's share** in the **pre-acquisition profits** of the associate company:

On the date of acquisition, the pre-acquisition profits have to be revised, to incorporate all fair value adjustments. The group's share in this revised profit will be **deducted from consideration** in arriving at **goodwill**. (The goodwill calculation is explained later in this section).

- ⑩ The **group's share** in the **post-acquisition profits** of the associate company is included in the consolidated statement of profit or loss.



Test Yourself 2

Silk Co owns 35% in Cotton Co. The profits of Cotton Co **as on the date of acquisition**, after making all fair value adjustments, are Tshs2.5 million.

Required:

What part of these profits will be included as income in the consolidated statement of profit or loss?



Test Yourself 3

Summer Co owns 40% in Winter Co. The **post-acquisition profits** of Winter Co are Tshs3.65 million.

Required:

What part of these profits will be included as income in the consolidated statement of profit or loss?

3. Procedures to be followed for the equity method of accounting:

(a) Eliminate group’s share in **unrealised intra-group profits**

(i) **Downstream transactions**

If the sale of goods / assets is made by **the investor to the associate**, it is known as a **downstream transaction**.

The journal entry to eliminate group’s share in **unrealised intra-group profits** when there are **downstream transactions** and the goods are still held by the associate, is:

Dr	Cost of sales (reflected in consolidated SOPL)	X	
	Cr	Investment in associate (reflected in consolidated SOFP)	X

Being the elimination of group’s share in unrealised intra-group profits

This will have the effect of eliminating the investor company’s share of the profit made on the sale to the associate. Remember that a part of the profit has been realised, as the associate is owned by other third parties. Only the portion which is related solely to the investor should be eliminated. The above journal entry would be reversed in case of an intra-group loss.



Test Yourself 4

Tea Co invested Tshs20 million and holds 30% of Coffee Co. Tea Co’s share in the post-acquisition profit of Coffee Co is Tshs2 million.

The inventory of Coffee Co includes Tshs2.35 million of purchases made from Tea Co. Tea Co has made a profit of Tshs0.2 million on this sales to Coffee Co.

Required:

Determine whether there is any intra-group transaction and state the adjustment required for consolidation to give the ‘investment in associate’ in the consolidated statement of financial position.



Tip

Only the **group’s share in unrealised profits has to be eliminated** from profits when accounting for associates using the equity method of accounting.

Do not make the common error of deducting unrealised profits in full.



Test Yourself 5

Yellow Co invested Tshs20 million and holds 30% in Orange Co. The post-acquisition profit of Orange Co is Tshs2 million.

The inventory of Orange Co includes Tshs2.35 million of purchases made from Yellow Co. Yellow Co has made a loss of Tshs0.15 million on this sale to Orange Co.

Required:

Determine the investment in associate which will be shown in the consolidated statement of financial position.

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(ii) Upstream transactions

If the sale of goods / assets at profit is made by **the associate to the investor**, it is known as an **upstream transaction**.

The adjustment made to eliminate group's share in **unrealised intra-group profits**, when there are **upstream transactions** and the inventory is still held by the associate, is

Dr	Cost of sales	XX	
	Cr Inventory		XX
	Being reduction in URP on inventory due to upstream transactions		

This will have the effect of reducing the inventory's cost in the statement of financial position and correspondingly in the statement of profit or loss too. The above journal entry would be reversed in case of an intra-group loss.



Test Yourself 6

Joyful Co invested Tshs20 million and holds 30% of Content Co. The post-acquisition profit of Content Co is Tshs2 million.

The inventory of Joyful Co includes Tshs1.5 million of purchases made from Content Co. Content Co has made a profit of Tshs0.3 million on this sale to Joyful Co.

Required:

Determine the group share of associated company profit.

Summary of URP adjustment for an associate

Elimination of URP	Debit	Credit
Sale of goods from investor to associate	Cost of sales	Investment in associate
Sale of goods from associate to investor	Cost of sales	Inventory



Tip

In the case of downstream transactions, URP is included in the associate's inventory. However associate's inventory is not shown in the investor's financial statements as it does not consolidate the accounts of the associate. Therefore the URP should be eliminated from the investment and not from inventory. In the upstream transaction, URP is in the investor's inventory which we show in the consolidated financial statements, and therefore it should be eliminated from the inventory. The corresponding effect will always be in cost of sales / retained earnings.

(b) Goodwill

Goodwill for an associate is calculated as follows:

	Tshs
Cost of investment	X
Less: investor's share of the net fair value of the associate's identifiable net assets	(X)
Goodwill / gain on bargain purchase	X

Accounting treatment

- **Positive goodwill** is already included in the cost of investment, and so needs no further accounting treatment.
- **Gain on bargain purchase** is added to the carrying amount of the investment and is instead included as income in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired.



Example

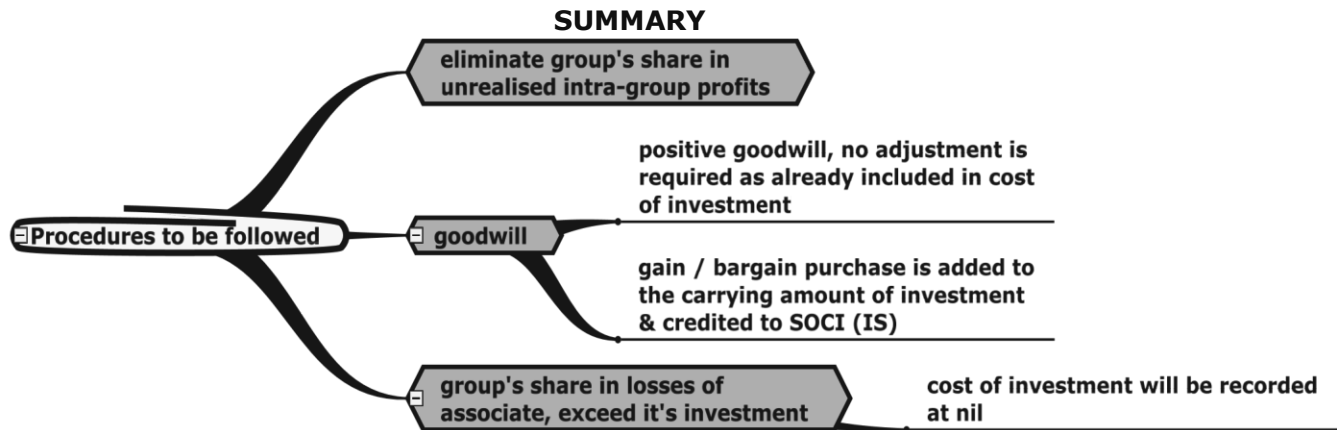
Igloo Co has acquired 40% shares of Hut Co for Tshs10 million. On the acquisition date, fair value of net assets of Hut Co was Tshs27 million.

	Tshs'000
Cost of investment	10,000
Less: investor's share in the net fair value of the associate's identifiable net assets (27,000 x 40%)	(10,800)
Gain on bargain purchase	(800)

The gain on bargain purchase of Tshs0.8 million will be added to the carrying amount of investment. Therefore in the consolidated financial statements, investment in associate i.e. Hut Co will be shown at Tshs10.8 million (Tshs10 million + Tshs0.8 million).

All adjustments made for goodwill impairment and fair value changes in accounting for subsidiaries are also made in accounting for associates.

If the group's share in the losses of the associate exceeds its investment in the associate, then the investor has to stop accounting for further losses. The cost of investment will be recorded at nil in the consolidated financial statements. Any further losses will be reflected in the consolidated financial statements only if the investor has directly made some payment or guarantees on behalf of the associate.



Test Yourself 7

Pacific Inc owns 25% of Atlantic Inc at a cost of Tshs20 million. The post-acquisition loss of Atlantic Inc amounts to Tshs100 million.

Required:

State how the investment is reflected in the consolidated statement of financial position.

2. Solve the problems of accounting for multinational groups.

Draft, compile and present the consolidated financial statements or their extracts in accordance with selected accounting policies and the requirements of IFRS.

[Learning Outcomes b and c]

486: Preparing Consolidated Financial Statements



Tip

In the exam, you will be asked to prepare a consolidated statement of financial position or consolidated statement of profit or loss and statement of changes in equity. While doing this, remember the following summary of the accounting treatment:

Investment	Type	Accounting treatment
Investment > 50% -- Control	Subsidiary	Full consolidation
20% < Investment < 50% -- Significant influence	Associate	Equity method

Before looking at a detailed consolidation question, let us set out the steps to be taken in preparing consolidated financial statements (to include a single subsidiary and an associated company)

1. Establish the relationship between the companies given in the question.
 2. Carefully read the additional information given and link it to the items that need adjustment. Be careful some items in the individual financial statements may need more than one adjustment.
 3. Read the requirements, prepare a proforma (suggested proforma given below) of the consolidated financial statements (consolidated SOFP or Consolidated SOPL and OCI, whichever is asked for), and write at least the main headings. The subheadings can be added to the extent shown by items in the individual financial statements given in the question.
 4. Do not forget to add one line in the proforma for goodwill, one for non-controlling interest and for deferred tax liability / asset if acquired from subsidiary.
 5. Prepare proforma of following workings:
 - Goodwill
 - Retained earnings
 - Consideration in subsidiary (if not given directly in the question) Non-controlling interest
- The others depend upon the additional information given in the question, the common ones being:
- URP in inventory
 - Goods / cash in transit
 - Fair value adjustments
6. Read the items in the financial statements given in the question and also the relevant additional information, if any, one by one:
 - Apply the correct IFRS provisions.
 - Cancel any intra-group transactions and transfer balances to workings / consolidated financial statements if there are part-cancellation items.
 - Link workings to the consolidated financial statements.
 - Transfer the result of the workings to the financial statements.
 - Mark the items in the question that have been dealt with up to this point.
 7. Add the remaining like items from the individual financial statements and write them at the appropriate places in the consolidated financial statements.
 8. Balance or total the individual components of the consolidated financial statements.
 9. Cross-check with the other components where a link is expected e.g. consolidated statement of profit or loss to consolidated statement of financial position.
 10. If the consolidated statement of financial position does not balance, quickly recheck whether all the items have been taken and/or calculated correctly.

The proforma of the statement of profit or loss and other comprehensive income and the statement of financial position have been dealt with in detail in Study Guide C1. The following proforma will guide you to solve some important working while dealing with questions involving a parent, subsidiary and an associate

(a) Retained earnings

	Parent	Subsidiary	Associate
According to question	X	X	X
Less: at acquisition		(X)	(X)
Post-acquisition profit		X	X
Less adjustments		(X)	(X)
Balance		X	X
Add: share of Subsidiary (%)	X		
Add: share of Associate (%)	X		
Less: adjustments	(X)		
To consolidated SOFP	X		

(b) Goodwill

Proforma - Goodwill on purchase of shares in _____	Tshs	Tshs
Consideration		X
Fair value of Non-controlling interest at the date of acquisition		X
		X
Less: net assets represented by		
Equity shares	X	
Share premium	X	
Fair value adjustments	X	
All other pre-acquisition reserves	X	
Deferred tax asset / (liability)	X/(X)	
Total	X	(X)
Goodwill on purchase of shares in _____		X
Less: Impairment loss (if any)		(X)
To consolidated SOFP		X



Tip

Positive goodwill – recognise as intangible non-current asset in the consolidated statement of financial position.

Gain on bargain purchase goodwill – recognise as income in the consolidated statement of profit or loss and other comprehensive income.

(c) Non-controlling interest

Proforma - Non-controlling interest of _____	Tshs	Tshs
Fair value/share in fair value of net assets (NCI's share) at the acquisition date	X	
Post-acquisition reserves (NCI's share)	X	
Total	X	X



Tip

Both the pre and post-acquisition portion of all the reserves of the subsidiary are included while determining the non-controlling share in the net assets and liabilities of the subsidiary.

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(d) Consideration (if not given directly in the question)

Sometimes consideration is discharged by issuing shares of the parent company in exchange for the shares of the subsidiary company. In such a case, the amount of consideration should be calculated by using the exchange ratio given and the acquisition-date market value of the parent's shares.



Example

High Co has acquired 5,000, Tshs1,000 shares in Low Co by issuing 3 of its Tshs1,000 shares for every 5 shares in Low. The market value of High's shares is Tshs6,000 and that of Low's is Tshs3,000. Therefore the consideration will be calculated as follows:

Number of shares of High = $Tshs5,000 \times \frac{3}{5} = 3,000$ shares

Consideration = $3,000 \text{ shares} \times Tshs6,000 = Tshs18,000,000$



Tip

The journal entry for this transaction is –

Dr	Investment		X	
	Cr Share capital			X
	Cr Share premium (if acquired at a premium)			X
Being investment in _____ accounted for				

Add any more workings according to the adjustments given in the question.

Let us now use the above knowledge gained in Section D, to solve problems of some multinational groups



Test Yourself 8

Harden acquired 800,000 of Solder's equity shares (each worth Tshs1,000) on 1 October 19X8 for Tshs2,500 million. One year later, on 1 October 19X9, Harden acquired 200,000 (Tshs1,000 each) equity shares in Active for Tshs800 million. The fair value of the non-controlling interest is Tshs750 million.

The statements of financial position of the three companies at 30 September 20X0 are shown below:

	Harden		Solder		Active	
	Tshs million					
Non-current assets						
Property, plant and equipment		3,980		2,300		1,340
Patents		250		420		nil
Investments - in Solder	2,500					
- in Active	800					
- others	150	3,450		200		60
		7,680		2,920		1,400
Current assets						
Inventories	570		400		300	
Trade receivables	420		380		400	
Bank	nil	990	150	930	120	820
Total assets		8,670		3,850		2,220
Equity and liabilities						
Capital and reserves						
Equity shares of Tshs1,000 each		2,000		1,000		500
Reserves						
Share premium	1,000		500		100	
Retained earnings	4,500	5,500	1,900	2,400	1,200	1,300
		7,500		3,400		1,800
Non-current liabilities						
Deferred tax		200		nil		80
Current liabilities						
Trade payables	750		450		280	
Taxation	140		nil		60	
Overdraft	80	970	nil	450	nil	340
		8,670		3,850		2,220

The following information is relevant:

(i) The balances of the retained earnings of the three companies were:

	Harden Tshs million	Solder Tshs million	Active Tshs million
At 1 October 19X8	2,000	1,200	500
At 1 October 19X9	3,000	1,500	800

At the date of its acquisition, the fair values of Solder's net assets were equal to their book values, with the exception of a plot of land that had a fair value of Tshs200 million in excess of its book value.

(ii) On 26 September 20X0, Harden processed an invoice for Tshs50 million in respect of an agreed allocation of central overhead expenses to solder. At 30 September 20X0, Solder had not accounted for this transaction. Prior to this, the current accounts between the two companies had been agreed at Solder owing Tshs70 million to Harden (included in trade receivables and trade payables respectively).

(iii) During the year, Active sold goods to Harden at a selling price of Tshs140 million, which gave Active a profit of 40% on cost. Harden had half of these goods in inventory at 30 September 20X0.

Required:

Prepare the consolidated statement of financial position of Harden as at 30 September 20X0.

490: Preparing Consolidated Financial Statements

Answers to Test Yourself

Answer to TY 1

If and when these are converted, Sun Co will acquire power over 10% of the voting rights of Moon Co, Sun Co **has the potential to acquire power** over 22% (12% + 10%) of the voting rights of Moon Co.

Then, by passing the '**test of control due to potential voting rights**' Moon Co is an associate of Sun Co, even though Sun Co holds less than 20% shares of Moon Co.

Answer to TY 2

Silk Co's share in the adjusted pre-acquisition profits of Cotton Co is 35% x Tshs2.5 million = Tshs0.875 million. However, these profits will **not** be included in the consolidated statement of profit or loss. Tshs0.875 million will be **included in the net assets** when calculating **goodwill**. On the end of the reporting period, the postacquisition profits will be revised to incorporate all fair value adjustments. The group's share in the revised postacquisition profits is **included in the consolidated statement of profit or loss**.

Answer to TY 3

Summer Co's share in the adjusted post-acquisition profits of Winter Co is Tshs1.46 million (40% x Tshs3.65 million). Tshs1.46 million will be included in the consolidated statement of profit or loss.

Answer to TY 4

In this case:

- As Tea Co owns 30% of Coffee Co, they are associated companies.
- This sale of goods is a downstream transaction.
- The unrealised intra-group profit in the inventory of Coffee Co is Tshs0.2 million.
- The group share is 30% of Tshs0.2 million = Tshs 0.06 million.

The journal entry to be passed is

Dr	Cost of sales (reflected in consolidated SOPL)	Tshs0.06 million		
	Cr Investment in associate (reflected in consolidated SOFP)	Tshs0.06 million	Being	
	reduction in URP due to downstream transaction			

In the consolidated statement of financial position, the group share in associated company will be:

	Tshs'000	Tshs'000
Amount invested		20,000
Add: Post-acquisition profit	2,000	
Less: group share in unrealised profit	(60)	
		1,940
Investment in consolidated SOFP		21,940

Answer to TY 5

As Yellow Co owns 30% share in Orange Co, Orange Co is an associate of Yellow Co. The sale of goods is a downstream transaction. The unrealised intra-group **loss** in the inventory of Orange Co is Tshs0.15 million. **Group share** is 30% of Tshs0.15 million = Tshs0.045 million. The journal entry to be passed is

Dr Investment in associate Tshs0.045 million
 Cr Cost of sales Tshs0.045 million

In the consolidated statement of financial position, the Group share in associated company will be:

	Tshs'000	Tshs'000
Amount invested		20,000
Add: Post-acquisition profit (Tshs2,000 x 30%)	600	
Add: group share in unrealised loss	45	645
Group share of associated company profit		20,645

Answer to TY 6

Joyful Co owns 30% share in Content Co. Hence, Content Co is an associate of Joyful Co. The sale of goods is an upstream transaction. URP in the inventory of Joyful Co is Tshs0.3 million.

Group share = 30% x Tshs0.3 million = Tshs0.09 million.

The journal entry to be passed is:

Dr Cost of sales Tshs0.09 million
 Cr Inventory Tshs0.09 million

Being elimination of URP for sale of goods from Content to Joyful

Joyful's share in profit of Content will be TShs0.6 million (Tshs2 million x 30%) and Tshs0.09 million will be reduced from the consolidated retained earnings.

The amount of investment in Content will be shown in the consolidated statement of financial position as:

	Tshs'000
Amount invested	20,000
Add: Post-acquisition profit (Tshs2,000 x 30%)	600
	20,600

Answer to TY 7

The group share in Atlantic Inc (associate) in the consolidated statement of financial position will be:

	Tshs'000
Amount invested	20,000
Less: Post-acquisition loss (25% of Tshs100,000)	(25,000)
Group share in Atlantic's post acquisition loss	(5,000)

As the share of Pacific Inc in the loss of Atlantic Inc exceeds its investment in Atlantic Inc, the group share of Atlantic Inc in the consolidated statement of financial position will be **NIL**. Any further losses will be reflected in the consolidated financial statements only if the investor has directly made some payment or guarantees on behalf of the associate.

492: Preparing Consolidated Financial Statements

Answer to TY 8

Consolidated statement of financial position of Harden as at 30 September 20X0

	Tshs million	Tshs million
Non-current assets		
Intangible assets		
Goodwill (W3)	350	
Patents (Tshs250 + Tshs420)	670	1,020
Tangible assets		
Property, plant and equipment (Tshs3,980 + Tshs2,300 + Tshs200)	6,480	
Investments – in Solder (Tshs2,500 - Tshs2,500)	-	
– in Active (W6)	960	
– Others (Tshs150 + Tshs200)	350	7,790
Current assets		
Inventory (Tshs570 + Tshs400 – Tshs8 (according to W7))	962	
Accounts receivable (Tshs420 + Tshs380 - Tshs120)	680	
Bank	150	1,792
Total assets		10,602
Equity and liabilities		
Capital and reserves		
Ordinary shares of Tshs1,000 each	2,000	
Share premium	1,000	
Retained earnings (W2)	5,172	8,172
Non-controlling interest (W4)		880
		9,052
Non-current liabilities		
Deferred tax		200
Current liabilities		
Trade payable (Tshs750 + Tshs450 - Tshs70)	1,130	
Taxation	140	
Overdraft	80	1,350
Total equity and liabilities		10,602

Workings (Amounts in Tshs million)

W1 Holding

	Solder	Active
Total shares of Solder	1,000,000	500,000
Shares acquired	800,000	200,000
%	80%	40%
Status	Subsidiary	Associate

W2 Retained Earnings

	Harden Tshs million	Solder Tshs million	Active Tshs million
According to question	4,500	1,900	1,200
Less: at acquisition		(1,200)	(800)
Post-acquisition profit		700	400
Less: management charges	520	(50)	
Balance		650	
Share of Solder (80%)			
Share of Active (40%)	160		
	5,180		
Less: URP in inventory (W7)	(8)		
To consolidated SOFP	5,172		

W3 Goodwill on purchase of shares in Solder

	Solder Tshs million		Active Tshs million	
Consideration		2,500		800
Non-controlling interest in solder		750		-
		3,250		800
Less:				
Equity shares	(1,000)		(500)	
Share premium	(500)		(100)	
Fair value adjustments (Note ii)	(200)		-	
Pre-acquisition reserves	(1,200)		(800)	
Total	(2,900)	2,900	(1,400)	
NCI share in Active (40%)				(560)
Goodwill on purchase of shares in Solder		350		240

As goodwill is positive, it is already included in the cost of investment for the associate (Active).

W4 Non-controlling interest of Solder

	Tshs million
Fair value of net assets acquired	750
Post-acquisition reserves (20% x 650)	130
Total	880

W5 Receivables of Harden

	Tshs million
Receivable of Harden	120
Payables of Solder	(70)
Management charge (W2)	(50)
(These cancel each other)	-

494: Preparing Consolidated Financial Statements

W6 Investment in associate

	Tshs million
Cost	800
Add: Post-acquisition profits (W2)400 x40%	160
Total	960

W7 URP in inventory – sales by Active to Harden

	Tshs million
Profit on total sale $40 / 140 \times \text{Tshs}140 = \text{Tshs}40$. Half total sale is in inventory. Hence URP in inventory	20
Harden's share (40% x Tshs20)	8

Quick Quiz

1. Emkac Inc holds 18% shares of Dimkac Inc. Can Dimkac Inc be classified as an associate of Emkac Inc?
2. Which method of accounting is used to account for an associates?

Answers to Quick Quiz

1. Generally, an entity is classified as an associate of another entity only when the other entity holds 20% or more of the shares of another entity. However, even if the shareholding is less than 20%, the entity can still be classified as an associate of another entity if and only if it can be demonstrated that it has significant influence over the entity. Hence, Dimkac Inc can be classified as an associate if significant influence can be demonstrated.
2. An associate is always accounted in accordance with equity method described by IAS 28 Investment in Associates and joint venture.

Self-Examination Questions

Question 1

On 1 October 20X5 Pumice acquired the following non-current investments:

- 80% of the equity share capital of Silverton at a cost of TShs13.6 million.
- 50% of Silverton's 10% loan notes at par.
- 1.6 million Equity shares in Amok at a cost of Tshs6.25 each.
- The fair value of the 20% non-controlling interest is Tshs2,500.

The summarised draft statements of financial position of three companies at 31 March 20X6 are:

	Pumice Tshs'000	Silverton Tshs'000	Amok Tshs'000
Non-current assets			
Property, plant and equipment	20,000	8,500	16,500
Investments	26,000	Nil	1,500
	46,000	8,500	18,000
Current assets	15,000	8,000	11,000
Total assets	61,000	16,500	29,000
Equity and liabilities			
Equity			
Equity shares of Tshs1,000 each	10,000	3,000	4,000
Retained earnings	37,000	8,000	20,000
	47,000	11,000	24,000
Non-current liabilities			
8% loan note	4,000	-	-
10% loan note	-	2,000	-
Current liabilities	10,000	3,500	5,000
Total equity and liabilities	61,000	16,500	29,000

The following information is relevant:

1. The fair value of Silverton's assets was equal to their carrying amounts, with the exception of land and plant. The land had a fair value of Tshs400,000 in excess of its carrying amount and plant had a fair value of Tshs1.6 million in excess of its carrying amount. The plant had a remaining life of four years (straight-line depreciation) at the date of acquisition.
2. In the post-acquisition period, Pumice sold goods to Silverton at a price of Tshs6 million. These goods had cost Pumice Tshs4 million. Half of them were still in Silverton's inventory at 31 March 20X6. Silverton had a balance of Tshs1.5 million owing to Pumice at 31 March 20X6, which agreed with Pumice's records.
3. The net profit after tax for the year ended 31 March 20X6 was Tshs2 million for Silverton and Tshs8 million for Amok. Assume profits accrued evenly throughout the year.
4. An impairment test at 31 March 20X6 concluded that consolidated goodwill was impaired by Tshs400,000 and the investment in Amok was impaired by Tshs200,000.
5. No dividends were paid during the year by any of the companies.

Required

Prepare the consolidated statement of financial position for Pumice as at 31 March 20X6.

496: Preparing Consolidated Financial Statements

Question 2

The statement of profit or loss and summarised statements of changes in equity of Big, Medium and Small for the year ended 30 September 20X9 are given below:

Statement of comprehensive income

	Big	Medium	Small
	Tshs'000	Tshs'000	Tshs'000
Revenue	150,000	120,000	108,000
Cost of sales	(84,000)	(72,000)	(61,200)
Gross profit	66,000	48,000	46,800
Other operating expenses	(24,000)	(18,000)	(18,000)
Income from investments	10,800	6,000	5,400
Finance costs	(13,200)	(9,600)	(9,000)
Profit before tax	39,600	26,400	25,200
Income tax expense Profit for the year	(10,800) 28,800	(7,200) 19,200	(6,480) 18,720

Summarised statement of changes in equity

	Big	Medium	Small
	Tshs'000	Tshs'000	Tshs'000
Balance at 01/10/20X8	132,000	72,000	67,200
Profit for the year	28,800	19,200	18,720
Dividends paid	(16,800)	(6,000)	-
Balance at 30/9/20X9	144,000	85,200	85,920

Notes:

Note 1

- (i) On 1 October 20X5 Big purchased an 80% equity shareholding in Medium. The equity of Medium as shown in its own financial statements at that date was Tshs42 million.

At the date of acquisition, Medium owned land with a book value of Tshs30 million and a market value of Tshs42 million, and plant with a book value of Tshs14.4 million and a market value of Tshs19.2 million.

The plant is depreciated on a straight line basis and the remaining useful economic life of the plant at 1 October 20X5 was estimated at four years.

- (ii) On 1 February 20X9, Big purchased a 75% shareholding in Small. At the date of acquisition, Small had registered a brand name that had a fair value of Tshs32.4 million. Small had not recognised this amount in its own individual financial statements. The directors of Big estimated that this brand would provide Small with significant competitive advantage for a 15-year period from 1 February 20X9.
- (iii) Big presents depreciation and amortisation charges as part of cost of sales.
- (iv) Other than mentioned in notes (i) and (ii) above, there were no fair value adjustments necessary on acquisition of Medium or Small.
- (v) In addition to the equity investments made by Big in Medium and Small, on 1 January 2009, Big lent Tshs24 million to Medium at an effective annual interest rate of 8%.
- (vi) No impairment of goodwill on acquisition of either company has been identified up to and including 30 September 20X9.
- (vii) Big has not adopted the method of calculation of full goodwill under the revised IFRS 3, but has decided to retain the previous method of calculation of goodwill.
- (viii) Big has credited the dividend and interest from Medium to its

Note 2

Big supplies products used by Medium and Small. Sales of the products to Medium and Small during the year ended 30 September 20X9 were as follows (all sales were made at a mark-up of 25% on cost)

- Sales to Medium: Tshs12 million.
- Sales to Small (all in the post-acquisition period): Tshs3.6 million.

At 30 September 20X9 and 30 September 20X8, the inventories of Medium and Small included the following amounts in respect of goods purchased from Big.

Amount of inventory

	30/09/20X9	30/09/20X8
	Tshs'000	Tshs'000
Medium	2,400	1,440
Small	1,200	-

Required:

Prepare the consolidated statement of profit or loss and summarised consolidated statement of changes in equity for Big for the year ended 30 September 20X9. Ignore deferred tax.

Answers to Self Examination Questions**Answer to SEQ 1****Consolidated statement of financial position of Pumice group at 31 March 20X6**

	Tshs'000	Tshs'000
Non-current assets		
Intangible assets		
Goodwill (W4)		3,700
Tangible assets		
Property, plant & equipment (W5) (Tshs20,000 + Tshs8,500 + Tshs1,800)		30,300
Investments		
In associate company (W10)		11,400
Others (W8)		1,400
Current assets (W11) (Tshs15,000 + Tshs8,000 – Tshs2,500)		20,500
Total assets		67,300
Equity and liabilities		
Capital and reserves		
Ordinary shares of Tshs1 each		10,000
Retained earnings (W2)		37,720
		47,720
Non-controlling interest (W7)		2,580
Non-current liabilities		
8% loan note	4,000	
10% loan note	1,000	5,000
Current liabilities		12,000
Total equity and liabilities		67,300

498: Preparing Consolidated Financial Statements

Workings (Amounts in Tshs'000)

W1 % holding in Amok

	Tshs'000
Total shares of Amok	4,000
Acquired by Pumice	1,600
% holding $(1,600 / 4,000) \times 100$	40
Status	Associate

W2 Post-acquisition profits

	Pumice	Silverton	Amok
	Tshs'000	Tshs'000	Tshs'000
Per question (Tshs2,000/2) / (Tshs8,000/2)	37,000	1,000	4,000
Less: Additional depreciation (W5)		(200)	
Share of Silverton (80%)	640	800	4,000
Share of Amok (40%)	1,600		
URP in inventory (W6)	39,240		
	(1,000)		
Goodwill impairment – Silverton (80% of Tshs400)	(320)		
Investment impairment - Amok	(200)		
To consolidated SOFP	37,720		

W3 Pre-acquisition reserves

	Silverton	Amok
At 31 March 20X6	8,000	20,000
Less: Post-acquisition (Tshs2,000/2) and (Tshs8,000/2)	(1,000)	(4,000)
	7,000	16,000

W4 Goodwill on purchase of Silverton shares

	Tshs'000	Tshs'000
Consideration		13,600
Add: Non-controlling interest in Silverton		2,500
		16,100
Less: Fair value of net assets acquired represented by		
- Equity shares	3,000	
- Fair value adjustments (W5)	2,000	
- Pre-acquisition reserves (W3)	7,000	(12,000)
Goodwill on purchase of shares in Silverton		4,100
Less: Impairment of goodwill		(400)
Goodwill		3,700

W5 Fair value adjustments

	Tshs'000	Tshs'000
Land	400	
Add: Plant	1,600	2,000
Less: Additional depreciation on plant $1,600/4 = 400$ per year, 6 months post-acquisition (Tshs400/2 years) to consolidated SOFP		(200)
		1,800

W6 Unrealised profit (URP) in inventory

	Tshs'000
Profit on total sale Tshs2m (Tshs6 – Tshs4). Half total sale is in inventory. Hence URP = Tshs2,000 x 1/2	1,000

W7 Non-controlling interest in Silverton

	Tshs'000
Fair value of NCI of 20%	2,500
Post-acquisition reserves (W2) (20% of Tshs800)	160
Goodwill Impairment – Silverton (20% of Tshs400)	(80)
Total	2,580

W8 Other investments of Pumice

	Tshs'000	Tshs'000
As per question		26,000
Less: Silverton	(13,600)	
Amok (1.6m x Tshs6.25)	(10,000)	
Intra-group loan note (50% of Tshs2,000)	(1,000)	
		(24,600)
To consolidated SOFP		1,400

W9 Goodwill on purchase of shares in Amok

	Tshs'000	Tshs'000
Consideration		10,000
Less: Proportionate share in net assets of associate		
Equity shares	(4,000)	
Retained earnings 20,000 – (8,000/2)	(16,000)	
Total	(20,000)	
40% share		(8,000)
Goodwill on purchase of shares in Active		2,000

As goodwill is positive, it is already included in the cost of investment

W10 Investment in associate

	Tshs'000
Cost	10,000
Add: Share of post-acquisition profits (W2)	1,600
Less: Impairment	(200)
To consolidated SOFP	11,400

W11 Adjustments to current assets

	Tshs'000
URP in inventory (W6)	1,000
Add: Intra-group balance in current account	1,500
Total	2,500

500: Preparing Consolidated Financial Statements

Answer to SEQ 2

Consolidated statement of profit or loss of Big Group for the year ended 30 September 20X9

	Tshs'000
Revenue (Tshs150,000 + Tshs120,000 + 8/12 x Tshs108,000 – Tshs12,000 - Tshs3,600)	326,400
Cost of sales (balancing figure)	(184,272)
Gross profit (W1)	142,128
Other operating expenses (Tshs24,000 + Tshs18,000 + 8/12 x Tshs18,000)	(54,000)
Income from investments (W2)	14,160
Finance costs (W3)	(27,360)
Profit before tax	74,928
Income tax expense (Tshs10,800 + Tshs7,200 + 8/12 x Tshs6,480)	(22,320)
Profit for the year	52,608
Share of profit attributable to:	
Owners of the parent	46,248
Non-controlling interest (W4)	6,360
	52,608

Summarised consolidated statement of changes in equity for the year ended 30 September 2009

	Group	Non-controlling shareholders	Total
	Tshs'000	Tshs'000	Tshs'000
Balance at 1 October 20X8 (W5 & W6)	152,832	17,040	169,872
Add: Profit for the year	46,248	6,360	52,608
Less: Dividends paid	(16,800)	(1,200)	(18,000)
Add: Increase due to acquisition (W7)		26,460	26,460
Balance at 30 September 20X9	182,280	48,660	230,940

Workings

W1 Gross profit

	Tshs'000
Big + Medium + 8/12 x Small	145,200
Provision for unrealised profit	
Medium 25/125 x (Tshs2,400 – Tshs1,440)	(192)
Small 25/125 x Tshs1,200	(240)
Extra depreciation:	
Medium plant (1/4 x Tshs19,200 - Tshs14,400)	(1,200)
Small brand (1/15 x Tshs32,400 x 8/12)	(1,440)
	142,128

W2 Income from investments

	Tshs'000
Big + Medium + 8/12 x Small	20,400
Dividend from Medium to Big (80% of Tshs6,000)	(4,800)
Interest from Medium to Big (Tshs24,000 x 9/12 x 8%)	(1,440)
	14,160

W3 Finance costs

	Tshs'000
Big + Medium + 8/12 x Small	28,800
Interest from Medium to Big (W2)	(1,440)
	27,360

W4 Non-controlling Interest

	Tshs'000
Medium 20% x Tshs19,200 – Tshs1,200)	3,600
Small 25% x ((Tshs18,720 x 8/12) – Tshs1,440)	2,760
	6,360

W5 Group equity at 1 October 2008 (opening)

	Tshs'000
Big – per financial statements	132,000
Medium:	
Group share of post-acquisition movement per FS (80% (Tshs72,000 – Tshs42,000)	24,000
Additional depreciation-fair value adjustment (plant) (80% (Tshs19,200 – Tshs14,400) x ¾)	(2,880)
Opening URP in inventory (25/125 x Tshs1,440)	(288)
	152,832

W6 Non-controlling interest in equity at 1 October 2008 (opening)

	Tshs'000
Per financial statements (20% x Tshs72,000)	14,400
Net increase in fair value of land (Tshs42,000 – Tshs30,000) x 20%	2,400
Net increase in fair value of plant (20%(Tshs19,200– Tshs14,400) x 1/4	240
	17,040

W7 Non-controlling interest in equity of Small at 1 February 2009

	Tshs'000
Equity of Small per FS at 01 October 2008	67,200
Increase per FS at 31 January 2009 (Tshs18,720 x 4/12)	6,240
Fair value adjustment	32,400
	105,840
NCI share is 25% of Tshs105,840	26,460

STUDY GUIDE E1: FINANCIAL STATEMENT ANALYSIS AND EVALUATION

Get Through Intro

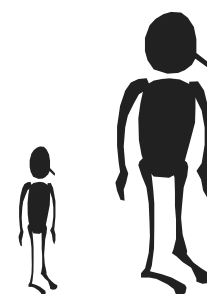
Throughout this book we have seen that International Accounting Standards ensure that **financial statements** reflect a true and fair picture **of a company's financial position**. We are also aware that financial statements are used by **different types of users**.

Two questions which normally come to mind are:

How can financial statements, which are basically just scientifically prepared lists of items computed and presented in a prescribed manner, reflect the financial position of a company? How can the same list of items be useful to different categories of users?

The answer to these questions lies to a large extent in **accounting ratios and ratio analysis**. Accounting ratios and ratio analysis is **the key to analysing and interpreting financial statements**. They add life to a set of numbers in such a way that numbers reveal those details which even words would find difficult to reveal.

You should devote considerable time to your work on this Study Guide, which takes you through the fascinating world of ratios and ratio analysis.



This will help you **tackle any related question in the examination** with confidence, it will help you in your **professional life** when you might have to give advice on investment decisions, and it will help you **amass wealth in your own life** as well, by ensuring that your personal investment decisions do not turn sour!

Learning Outcomes

- Calculate basic financial ratios and assess the financial results and position of a single entity.
- Explain financial statement analysis and its objectives.
- Describe the focus of financial statement analysis.
- Identify techniques for financial statements analysis and evaluation
- Explain the limitation of using ratio analysis.
- Analyse various methods for business valuation.

504: Financial Statement Analysis and Evaluation

1. Calculate basic financial ratios and assess the financial results and position of a single entity.
2. Explain financial statement analysis and its objectives.
3. Describe the focus of financial statement analysis.
4. Identify techniques for financial statements analysis and evaluation.

[Learning Outcomes a, b, c and d]

1.1 Introduction

Financial statements by themselves reveal only **partial information** about the performance, liquidity, gearing etc. of an entity. They **provide all the basic required financial data of an entity for a period or as at the end of the reporting period.**

Analysing this data in order to help the user obtain relevant information is the function of accounting ratios and ratio analysis.



Example

The financial statements of Pineapple Inc give the following information:

	20X7		20X6	
	Tshs'000		Tshs'000	
Sales		40,000		30,000
Cost of sales		(20,000)		(10,000)
Gross profit		20,000		20,000
Selling expenses	7,500		5,000	
Administrative expenses	10,000	(17,500)	8,000	(13,000)
Net profit		2,500		7,000

The above information reveals the following facts:

Sales have gone up, gross profit has remained constant and net profit has fallen between the two years. Cost of sales, selling expenses and administrative expenses have all gone up.

However, it does not tell us **why** net profit has fallen by Tshs4.5 million when sales have increased by Tshs10 million.

If an analyst were to make decisions on the basis of the information given in the financial statements alone, he might say that the company should reduce its sales to make profits.

The solution however, cannot be as simple as that as well as being counter intuitive. The management of Pineapple Inc has to discover the reasons for the loss of profit in spite of an increase in sales. This is because, if the company has to grow, it definitely needs to increase sales but it cannot afford to have profits fall.

Accounting ratios and ratio analysis help unearth problems and provide solutions.

In this section, we shall discuss how different financial statements are analysed and interpreted with the help of financial ratios. Further we will discuss the various ratios **from the focus of various stakeholders such as bankers, creditors, investment analysts, etc.**



Definition

The result of dividing one **financial statement** item by another is a **financial ratio**.

Financial statement analysis is as a process of understanding the risk and profitability of a business by analysing the financial information reported in the statement of profit or loss and the statement of financial position.

Ratios help analysts interpret financial statements by focussing on specific relationships. It is possible to compute an unlimited number of ratios from the financial statements. However, this would be of no use. The user of financial statements has to compute only those ratios which are suited to his needs and which represent meaningful figures.

These ratios are then compared with similar ratios of:

- a different reporting period of the entity
- another similar entity for the same reporting period
- industry average ratios

The user then needs to analyse them and interpret the results. Analysis of ratios is not an exact science; **there can be no hard and fast rules**. The analysis and interpretation will depend upon the circumstances of each entity.

Factors on which analysis and interpretation of financial ratios depend include:

- the size of the business
- the state of the economy
- the policies of management
- the company philosophy
- the industry norms
- government rules and regulations

1.2 Objectives of financial statement analysis

The objective of a financial statement analysis broadly includes the following:

1. Assessment of past and current performance

Financial statement analysis of past financial statements helps in predicting future trends. Also financial statement analysis of past data can be used to set a benchmark in the assessment of current performance.

2. Aid in decision making

Financial statements on their own may not reveal important financial information required for decision making. Financial statement analysis uses various ratios to perform analysis and get the desired information for business decision making. For example a company may analyse the various investor performance ratios and take decision as to whether dividend needs to be declared during the year.

3. Prediction of profitability and growth prospects

Financial statement analysis helps to predict the growth prospects and profitability of a company by doing a trend analysis and also through industry comparison (these techniques are discussed later in this Study Guide)

4. Prediction of bankruptcy and failure

Financial statement analysis helps in assessing and predicting bankruptcy and probability of business failure.

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5. Assessment of the operational efficiency

Financial statement analysis helps in judging the company's efficiency in terms of its operations and management. They help judge how well the company has been able to utilize its assets and earn profits.

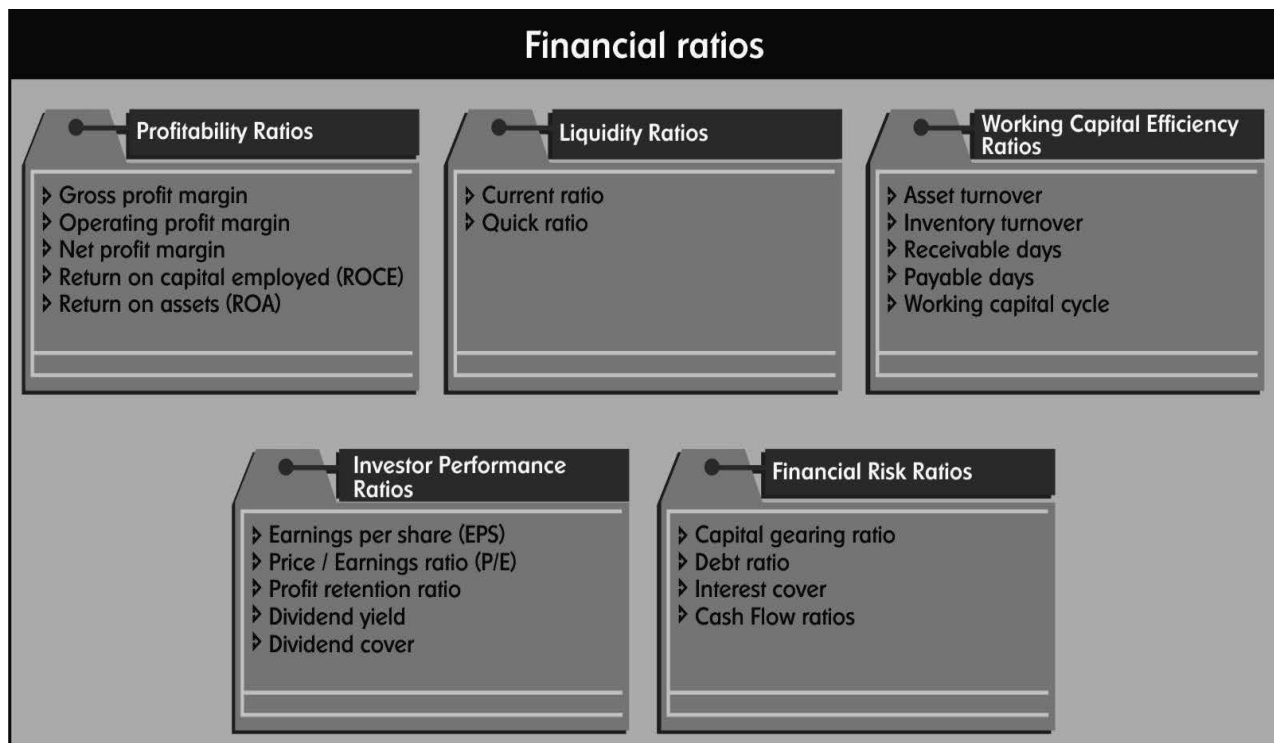
1.3 Tools of financial statements analysis

There are several techniques of financial statement analysis. We will be discussing the following popular techniques in this Study Guide:


1. Ratio analysis
2. Vertical analysis
3. Horizontal analysis
4. Industry comparison
5. Trend analysis


1.4 Classification of financial ratios

Diagram 1: Financial ratios



A summary of the ratios which are discussed below is provided below for a ready reference.

	Key accounting Ratios	Formula	Interpretation	Favourable situation	
				High	Low
A Profitability ratios					
1	Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$	Reflects gross margin made on sales	√	
2	Operating profit margin	$\frac{\text{Operating profit}}{\text{Sales revenue}} \times 100$	Reflects operating margin made on sales	√	
3	Net profit margin	$\frac{\text{Net profit (PBT)}}{\text{Sales revenue}} \times 100$	Reflects net margin made on sales	√	
4	Return on capital employed	$\frac{\text{Operating profit}}{\text{Capital employed}} \times 100$	Reflects relationship between profits earned and size of company (measures overall performance of company)	√	
5	Return on assets	$\frac{\text{Operating profit}}{\text{Total assets}} \times 100$	Reflects relationship between profits earned and total assets	√	

B Liquidity ratios					
1	Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Measures ability to pay current liabilities from the current assets	√	
2	Quick ratio	$\frac{\text{Quick assets}}{\text{Current liabilities}}$	Indicates the ability to pay all current liabilities if they become due for payment immediately	√	
C Working capital efficiency ratios					
1	Asset turnover	$\frac{\text{Sales revenue}}{\text{Total assets}}$ (times p.a.)	Shows how much revenue generated by a Tshs1,000 worth of assets	√	
2	Inventory turnover	$\frac{\text{Cost of sales}}{\text{Inventory}}$ (times p.a.)	Indicates how many times the inventory is being turned over in a year	√	

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3	Receivable days	$\frac{\text{Receivables}}{\text{Credit sales}} \times 365 \text{ days}$	Reflects the number of days it takes for a customer to pay		√
4	Payable days	$\frac{\text{Payables}}{\text{Credit purchases}} \times 365 \text{ days}$	Reflects the number of days it takes for a company to settle its bills		√
5	Working capital cycle	Inventory turnover days + receivable days - payable days	Approximate number of days it takes to purchase the inventory, sell the inventory and receive cash.		√

D	Investor performance ratios			
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1	Earnings per share (EPS)	$\frac{\text{Profits available for distribution to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding}}$	Amount which an entity has earned per share for the given period.		√
2	Price / Earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings per share}}$	Helps to assess the relative risk of an investment		√
3	Profit retention ratio	$\frac{\text{Profit after dividend}}{\text{Profit before dividend}} \times 100$	Measures the proportion of retained profits to the profits earned by the entity		√
4	Dividend yield	$\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$	Measures the return on capital investment as a percentage of market prices		√
5	Dividend cover	$\frac{\text{Profit after tax}}{\text{Dividend}}$	Measures the ability of the company to maintain its existing levels of dividends		√

E	Financial risk ratios			
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1	Capital gearing ratio	$\frac{\text{Total long - term debt}}{\text{Shareholders' funds}} \times 100$	It expresses the relationship between a company's borrowings and its own funds	-	
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2	Debt ratio	$\frac{\text{Total liabilities}}{\text{Total assets}}$	Indicates the percentage of assets financed with debt		
3	Interest cover	$\frac{\text{Profit before interest and taxes}}{\text{Interest expenses}}$	Indicates the number of times, the profit covers the interest charge	√	
4	Cash flow ratios				
(i)	Ratio of longterm borrowings to cash generated from operations	$\frac{\text{Long – term borrowings}}{\text{Cash generated from operations}}$	Measures the ability of the company to meet its longterm obligations from its operating activities		
(ii)	Ratio of net cash from operating activities to capital expenditure	$\frac{\text{CF Operatinig activities}}{\text{Capital expenditure}} \times 100$	Helps decide the extent to which the operating activities of a company can finance its capital expenditure	√	

1.5 Computation of financial ratios

The following are the extracts of statement of profit or loss and statement of financial position of Air Ltd. Using the information from these statements, in this section, we shall discuss how the different financial ratios are computed, analysed and interpreted

Extracts of statement of profit or loss of Air Ltd for 20X7 and 20X8

	20X7		20X8	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Sales turnover		290,000		350,000
Cost of sales		260,000		320,000
Gross profit		30,000		30,000
Administrative expenses	(5,000)		(5,000)	
Depreciation	(3,000)		(4,000)	
Selling and distribution expenses	(5,000)		(6,000)	
Finance cost (interest cost)	(3,000)	(16,000)	(3,000)	(18,000)
Net Profit before tax		14,000		12,000
Tax		2,800		2,400
Profit after tax		11,200		9,600

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Details of dividends paid

	20X7		20X8	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Equity dividend	700		900	
Preference dividend	600	1,300	600	1,500

Extracts of statement of financial position of Air Ltd for 20X7 and 20X8

	20X7		20X8	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Tangible assets		20,000		27,000
Current assets				
Inventory	24,000		21,000	
Trade Receivables	32,500		20,500	
Cash		56,500	600	42,100
Total assets		76,500		69,100
Equity and liabilities				
Ordinary share capital (Tshs1,000 each)	9,000		9,000	
10% irredeemable preference shares (Tshs1,000 each)	6,000		6,000	
Accumulated profits	9,900	24,900	8,100	23,100
Non-current liabilities				
Loans from banks		11,000		11,000
Current liabilities				
Payables	25,000		35,000	
Bank overdraft	15,600	40,600	-	35,000
Total equity and liabilities		76,500		69,100

1. Profitability ratios

Profitability ratios help to **analyse the profitability of a company**. The best way to start an analysis of the profitability of a company is by examining the revenue it earns.

(a) Gross Profit Margin

This ratio **reflects the gross margin** that a company makes on its **sales** and is calculated as:

$$\text{Gross Profit Margin} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$



Example

Referring to the financial statements of Air Ltd the gross profit margin is calculated as follows:

	20X7	20X8
	Tshs'000	Tshs'000
Sales	290,000	350,000
Cost of sales	(260,000)	(320,000)
Gross profit	30,000	30,000
Gross profit margin is	$\frac{30,000}{290,000} \times 100$	$\frac{30,000}{350,000} \times 100$
	10.34%	8.57%

Sales have increased by 20.69% however the cost of sales has increased by 23.08%. Hence, although the amount of gross profit has remained constant, the profitability of the company has declined because of an increase in the cost of sales. This is the reason for the fall in the gross profit margin.

Some of the variables which affect this ratio are:

- the sales mix, the rise or fall in **selling prices**, the rise or fall in **sales volumes**.
- variations in **direct expenses** like the rise or fall in **purchase costs, labour cost**.



Important

The higher this ratio

- the **more efficient** is the **performance of the company**.
- the more efficient it is in **controlling direct costs**. the better is its **sales mix and its performance**.

(b) Operating profit (Net profit before interest and tax) margin

This ratio reflects the **operating margin** that a company makes on its **sales** and is calculated as:

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{\text{Sales revenue}} \times 100$$

The variables which affect this ratio are:

- all variables which affect the **gross profit**
- variations in **selling expenses, distribution expenses** and **administrative expenses**
- changes in **depreciation** (which depends upon variations in non-current assets, accounting policies etc).



Example

Referring to the financial statements of Air Ltd the operating profit margin is calculated as follows:

	20X7	20X8
	Tshs'000	Tshs'000
Sales	290,000	350,000
Cost of sales	(260,000)	(320,000)
Gross profit	30,000	30,000
Selling & distribution expenses	(5,000)	(6,000)
Administrative expenses	(5,000)	(5,000)
Depreciation	(3,000)	(4,000)
Net profit before interest and tax (Operating profit)	17,000	15,000
In this example Operating profit margin is	$\frac{17,000}{290,000} \times 100$	$\frac{15,000}{350,000} \times 100$
	5.86%	4.28%

The decrease in the operating margin ratio during 20X8 as compared to 20X7 is mainly on account of the increase in the cost of sales by 23% when the sales have increased by 21%.



Important

The higher this ratio

- the **more efficient** is the **performance of the company**.
- the more efficient it is in **controlling selling and administration costs**.

(c) Net profit margin

This ratio reflects the **net margin** (before tax) that a company makes on its **sales** and is calculated as:

$$\text{Net profit margin} = \frac{\text{Net profit (PBT)}}{\text{Sales revenue}} \times 100$$

The variables which affect this ratio are:

- all variables which affect the **net profit**
- variations in **finance costs** and **taxation**



Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the net profit margin for the year 20X8 is calculated as follows:

	Air Ltd
	Tshs'000
Sales	350,000
Net profit	12,000
Net profit margin	3.43%

Now let's say we compare the financials of Air Ltd with another company Water Ltd (a company operating in similar industry).

	Air Ltd	Water Ltd
	Tshs'000	Tshs'000
Sales	350,000	400,000
Cost of sales	(320,000)	(365,720)
Gross profit	30,000	34,280
Gross profit margin	8.57%	8.57%
Selling and other costs	(18,000)	(25,000)
Net profit	12,000	9,280
Net profit margin	3.43%	2.32%

The gross profit margins of both the companies are identical. However, the net profit margin of Air Ltd is more than that of Water Ltd.

This is mainly on account of the lower indirect costs of Air as compared to Water. This means that Air is more efficient than Water Ltd in controlling its selling and administration costs. In fact, this efficiency has helped Air Ltd to operate at a better net profit margin than Water Ltd, in spite of lower sales.



Tip

Sometimes, net profit is considered to be the profit before interest and tax and so **operating profit margin** is the same as **net profit margin**. In the examination, you will have to specify what you mean by 'net profit'.



Important

The higher this ratio

- the **more efficient** is the **performance of the company**
- the more efficient it is in **controlling its borrowings and borrowing costs**

(d) Return on capital employed (ROCE)

This is **the most important ratio** as it **measures the overall performance of the company**. It reflects the relationship between **the profits earned by a company and the size of the company i.e., the capital employed by the company**. It is calculated as:

$$\text{Return on capital employed} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100$$

Profit used in this calculation is **profit before interest and tax**.



Tip

Capital employed includes **shareholders' equity and all long-term borrowings** (non-current liabilities) or **Total assets – Current liabilities**.

In this ratio, we are measuring the relationship between capital and profit. It is important that **the two are consistent with each other**. We include **long-term borrowings in capital**, so the profit being used should be **before deducting interest** (and tax) as interest is the cost of loan capital.



Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the ROCE is calculated as follows:

	20X7	20X8
	Tshs'000	Tshs'000
Operating profit (Profit before interest and tax)	17,000	15,000
Capital employed		
Ordinary share capital	9,000	9,000
10% non-redeemable preference shares	6,000	6,000
Accumulated profits	9,900	8,100
Loans from banks	11,000	11,000
Total capital employed	35,900	34,100
ROCE	$\frac{17,000}{35,900} \times 100$	$\frac{15,000}{34,100} \times 100$
	47.35%	43.99%

The reason for the decrease in the ROCE during 20X8, as compared to 20X7 is on account of the decrease in both the operating profits as well as the capital employed in the business.



Important

The **higher the ratio**, the **more efficiently the business** is being managed. This is on account of optimum generation of profits from the available resources.

(e) Return on assets (ROA)

This reflects the relationship between **the profits earned by a company and its total assets**. It is calculated as:

$$\text{Return on assets} = \frac{\text{Operating profit}}{\text{Total assets}} \times 100$$

Operating profit = profit before interest and taxes

Operating profit = Profit before interest and tax
Total assets = Total of the SOFP



Important

The **higher the ratio**, the **more efficiently the assets are managed**. This means the entity is generating optimum profits from the available resources.

Asset turnover is explained in detail under working capital efficiency ratios.

The Return on Assets is a combination of two ratios:

$$\text{Return on assets} = \text{Operating profit margin} \times \text{Asset turnover}$$

This can be explained by showing the formulae used to calculate the two ratios:

$$\frac{\text{Operating profit}}{\text{Total assets}} \times 100 = \frac{\text{Operating profit}}{\text{Revenue}} \times 100 \times \frac{\text{Revenue}}{\text{Total assets}}$$



Test Yourself 1

The following information is received from the financial statements of Brian Ltd.

Extracts of statement of profit or loss	Tshs'000
Revenue	350,000
Cost of sales	(126,500)
Selling and administrative expenses	(98,200)
Profit	125,300
Interest	(20,000)
Taxes	(30,000)
Net profit	75,300

Extracts of statement of financial position	Tshs'000
Ordinary shares	300,000
Preference shares	125,000
Trade payables	34,000
Long-term loans from banks	150,000
Non-current assets	495,000
Current assets	95,000

Other information

	Tshs'000
Operating profit is	125,300
Capital employed is	
Ordinary shares	300,000
Preference shares	125,000
Long-term loans from banks	150,000
	575,000

Note: Brian had a 25% return on assets in the earlier year

Required:

Using the information relating to Brian, calculate and interpret the return on assets ratio.

Liquidity ratios

Liquidity ratios help to **assess the liquidity and cash position of the company**. It is an indicator of whether the business has the capacity to pay its **trade payables, expenses, loans** as well as **current liabilities** at the correct point of time.

(a) Current ratio

This ratio helps decide whether the **current assets** will be able to generate **sufficient cash** to pay off the **current liabilities** as and when they **fall due**.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

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Referring to the financial statements of Air Ltd the current ratio is calculated as follows:

	20X7 Tshs'000	20X8 Tshs'000
Total current assets	56,500	42,100
Total current liabilities	40,600	35,000
The Current Ratio is	(56,500/40,600) = 1.39:1	(42,100/35,000) = 1.20:1

This means that Air Ltd has Tshs1,200 of current assets for each Tshs1,000 of current liabilities in the year 20X8. Furthermore there is deterioration in the company's liquidity position during 20X8, when compared to the last year. This implies that the company may face serious problems if liabilities fall due, since the company would not be having adequate assets to convert them into cash, and pay the liabilities.

(a) Quick ratio (Acid test ratio)

This is another ratio used to test the **liquidity position** of a company.

$$\text{Quick ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$



Example

Where quick assets is calculated as: The conversion of inventory into cash can take a considerable amount of time. That is why inventory is deducted.

$$\text{Quick assets} = \text{Current assets} - \text{Inventory}$$

This ratio helps decide whether the **quick assets of a company will be able to generate sufficient cash to pay off the current liabilities as and when they fall due.**



Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the quick ratio is calculated as follows:

	20X7 Tshs'000	20X8 Tshs'000
Trade receivables	32,500	20,500
Cash	-	600
Total quick assets	32,500	21,100
Total current liabilities	40,600	35,000
Quick ratio	32,500/40,600 = 0.80:1	21,100/35,000 = 0.60:1

This means that Air Ltd has Tshs600 of quick assets for each Tshs1,000 of liabilities. Furthermore there is deterioration in the company's liquidity position during 20X8, when compared to the last year. This is not a good position to be in since, when the liabilities fall due, the company will not have adequate liquid assets to convert into cash and thereby pay the liabilities.



Important

The **higher the current ratio and the quick ratio**, the better the cash flow of the company. As a conventional rule a current ratio of 2:1 is considered to be satisfactory. The logic is that even in a worse situation if the value of assets becomes half, the entity will still be able to meet its obligation. However an arbitrary ratio of 2:1 should not be blindly followed since it also depends upon the industry in which a firm operates.

Warning: high liquidity could indicate that the company is not able to invest its cash into more profitable investments. Hence absolute ratios have no meaning, unless they are compared with the past performance of the company or the industry average.

2.Working capital efficiency ratios

This set of ratios help us **analyse how efficiently the assets of a company are being used in generating revenue.**

(a) Asset turnover

It **shows how much revenue is generated by each Tsh worth of assets (or each \$ worth of asset)** and is calculated as:

This calculation is not expressed as a percentage but as number of times.

$$\text{Asset turnover} = \frac{\text{Sales revenue}}{\text{Total assets}} \text{ (times p.a.)}$$

This ratio can be further split to calculate:

$$\text{Non – current asset turnover} = \frac{\text{Sales revenue}}{\text{Non-current assets}} \text{ (times p.a.)}$$

$$\text{Current asset turnover} = \frac{\text{Sales revenue}}{\text{current assets}} \text{ (times p.a.)}$$



Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the asset turnover ratio is calculated as follows:

	20X7	20X8
	Tshs'000	Tshs'000
Sales	290,000	350,000
Non-current assets	20,000	27,000
Current assets	56,500	42,100
Total assets	76,500	69,100
Asset Turnover is	290,000/76,500	350,000/69,100
	= 3.79 times	= 5.06 times
Non-current Asset Turnover is	290,000/20,000	350,000/27,000
	= 14.50 times	= 12.96 times
Current Asset Turnover is	290,000/56,500	350,000/42,100
	= 5.13 times	= 8.31 times

The fall in the ratio during 20X8 as compared to 20X7 is mainly on account of the significant fall in the current assets (25%) during 20X8.It indicates that Air is not utilising its assets efficiently



Important

The higher the ratio, the more efficiently the assets are being used to generate revenues.

(b) Inventory turnover

The Inventory Turnover ratio is expressed with reference to cost of sales and is calculated as:

This is another turnover ratio, so the calculation is expressed as number of times. Also the numerator is not sales!

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventory}} \text{ (times p.a.)}$$

This indicates how many times the inventory is being turned over in a year.

Referring to the financial statements of Air Ltd the inventory turnover ratio is calculated as follows:

	20X7	20X8
	Tshs'000	Tshs'000
Cost of sales	260,000	320,000
Inventory	24,000	21,000
In this example:		
Inventory Turnover is	260,000/24,000	320,000/21,000
	10.83 times	15.24 times

The increase in the ratio during 20X8 as compared to 20X7 is mainly on account of reduction of inventory although the cost of sales has risen.



Important

The higher the ratio, the more quickly inventory is being sold.

Remember, this ratio has the word period, which means you need to multiply it with 365.

The Inventory Turnover ratio can also be reversed to find the number of days of inventory that has been held in the warehouse.

$$\text{Inventory turnover} = \frac{\text{Period inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$



Example

(Amounts in Tshs'000)

Continuing with the above example of inventory turnover (no of times)

	20X7	20X8
Inventory turnover period is	$\frac{24,000}{260,000} \times 365$	$\frac{21,000}{360,000} \times 365$
	= 34 days	= 24 days



Important

The lower the number of days, the more quickly inventory is being sold.

**Tip**

The above ratios have been calculated using the figures at year end. Since the level of inventories fluctuate over the year, average figures of inventory will give a more realistic ratio. To determine the average inventory, the amount of inventory at the beginning and end of the period are considered.

In the above example, inventory turnover of Air Ltd using average inventory figures for 20X8 will be:

$$\text{Average Inventory} = (\text{Tshs}24,000 + \text{Tshs} 21,000)/2 = \text{Tshs}22,500$$

$$\text{Inventory turnover} = \frac{\text{Average inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

$$\text{Inventory turnover} = \frac{\text{Tshs} 22,500}{\text{Tshs} 260,000} \times 365 \text{ days} = 32 \text{ days}$$

(c) Receivable days

This reflects the **number of days it takes for a customer to pay**. It is calculated as:

$$\text{Receivable days} = \frac{\text{Receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

This ratio can also be calculated using average receivables. It reflects the number of days it takes for an average customer to pay. In other words the receivables collection period provides an indication of the efficiency of the debt collection process.

**Example****(Amounts in Tshs'000)**

Referring to the financial statements of Air Ltd the receivable days is calculated as follows:

Assume that the entire amount of sales during the year is on a credit basis. The following information is available from the financial statements:

	Tshs'000
Trade receivables as of 31 March 20X7	32,500
Trade receivables as of 31 March 20X8	20,500
Credit sales for year ended 31 March 20X8	350,000

The receivables days would be: (Amounts in Tshs'000)

$$= 27.63 \text{ days}$$



Important

The **lower the number of days**, the faster is the recovery of receivables.

(d) Payable days

This reflects the **number of days it takes for a company to settle its bills**. It is calculated as:

$$\text{Payable days} = \frac{\text{Payables}}{\text{Credit purchases}} \times 365 \text{ days}$$

This ratio can also be calculated using average payables. In that case it reflects the number of days it takes on average for a company to settle its bills.

Referring to the financial statements of Air Ltd the payables days is calculated as follows:

Assume that the entire amount of purchases (cost of sales) during the year is on a credit basis. The following information is available from the financial statements:

	Tshs'000
Trade payables as of 31 March 20X7	25,000
Trade payables as of 31 March 20X8	35,000

Opening inventory + Purchase – Closing inventory = cost of sales

Tshs24,000 + Purchase – Tshs21,000 = 320,000

Therefore Purchases = 317,000 (assumed entirely to be credit purchase)

The payables days would be:

$$\text{Payable days} = \frac{\text{Payables}}{\text{Credit purchases}} \times 365 = \frac{30,000}{317,000} \times 365 \text{ days} = 35 \text{ days}$$



Important

The greater the number of payable days, the better it is for the company as it provides a source of free finance to the company. An ideal strategy would be to defer the payables for as long as possible. But it should be borne in mind that the company may not get any cash settlements or discounts from suppliers. Also excessive delays in payment may also hamper the trade relations with the suppliers.

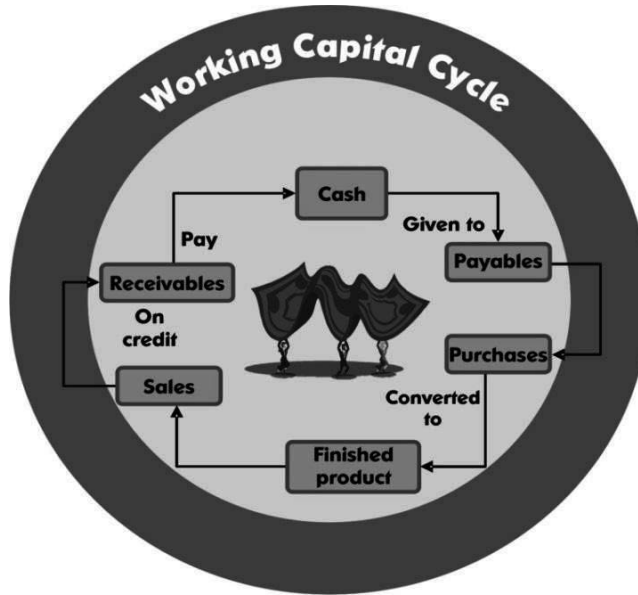
(e) The working capital cycle

The working capital cycle is the **approximate number of days it takes to purchase the inventory, sell the inventory and receive cash**.

Cash, inventories, receivables and payables comprise the **working capital cycle**.

Inventory is purchased by cash and on credit. **Credit purchases** give rise to **payables**. **Inventories** are sold for cash or on credit. **Credit sales** give rise to **receivables**. When receivables pay, a company gets cash to pay its payables and so the cycle continues.

Diagram 2: Working capital cycle



This working capital cycle can be converted into number of days by using the receivable days and payable day's ratios as follows:



Important

The **lesser the length of this cycle**, the more solvent the business.

$$\text{Working capital cycle} = \text{Inventory turnover} + \text{Receivable days} - \text{Payable days}$$



Test Yourself 2

The following information is available from the financial statements of Herb Ltd:

	20X6	20X5
	Tshs'000	Tshs'000
Inventory	35,000	22,500
Trade receivables	40,000	30,000
Trade payables	33,000	22,500
Credit sales	200,000	175,000
Credit purchases	160,000	125,000
Cost of sales	147,500	135,000

Required:

Determine the length of the working capital cycle in 20X6.

3. Investor performance ratios

(a) Earnings Per Share (EPS)

EPS is the amount which an entity has earned per share for the given period.

**Definition**

Basic earnings per share shall be calculated by dividing **profit or loss attributable to ordinary equity holders of the parent entity** (the numerator) by **the weighted average number of ordinary shares outstanding** (the denominator) during the period.

IAS 33, Para 10

$$\text{Earnings Per Share} = \frac{\text{Profits available for distribution to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding}}$$

Remember: Profit available for distribution to ordinary shareholders = Profit after interest and taxes – Preference dividend

Referring to the financial statements of Air Ltd the earnings per share for 20X8 is calculated as follows:

	Tshs'000
Profits after interest and tax	9,600
Preference dividend	(600)
Profits available for distribution to ordinary shareholders	9,000
Number of shares of Tshs1,000 each	9,000 shares

$$\text{Earnings Per Share} = \frac{\text{Tshs } 9,000,000}{9,000} = 1,000 \text{ Shares}$$

This means that each share earns a profit of Tshs1,000.

**Important**

The higher the ratio the better it is for the investor.

(b) Price / Earnings ratio (P/E)

This ratio helps assess the relative risk of an investment. It is calculated as:

$$\text{Price / Earnings ratio (P/E)} = \frac{\text{Current market price per share}}{\text{Earnings per share}}$$

**Example**

If the current market price of the shares of Air Ltd is Tshs1,750 and the earnings per share is Tshs1,000 then:

$$\text{P/E ratio} = 1,750/1,000 = 1.75$$

**Important**

The higher the ratio the better it is. This means that the shareholders have **more confidence** in the **company's ability to increase EPS**. Hence the shareholders' investments are **less risky**.

(c) Profit retention ratio

This ratio measures the extent of retained profits of an entity. It is calculated as

$$\text{Profit retention ratio} = \frac{\text{Profit after dividend}}{\text{Profit before dividend}} \times 100$$



Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the profit retention ratio for 20X8 is calculated as follows:

	Tshs'000
Profits after interest and tax	9,600
Dividend	(1,500)
Profits after dividend	8,100

$$\text{Profit retention ratio} = \frac{\text{Tshs } 8,100}{\text{Tshs } 9,600} \times 100 = 84.37\%$$



Important

The higher the ratio, the better the expected growth. This is because shareholders expect the company to retain more profits for further growth. This means that the **higher the ratio, the higher the expected growth.**

(d) Dividend yield

Dividend yield ratio measures the return on capital investment as a percentage of market prices. It is calculated as:

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$



Example

Referring to the financial statements of Air Ltd the dividend yield is calculated as follows:

The market price per share is Tshs1,750.

Number of shares 9,000

Dividend Tshs900,000 + Tshs600,000 = Tshs1,500,000

Dividend per share = Tshs167 (Tshs1,500,000/9,000)

$$\text{Dividend retention ratio} = \frac{\text{Tshs167}}{\text{Tshs1,750}} \times 100 = 9.54\%$$



Tip

The dividend yield is the return a shareholder expects currently on his investment. **The lower the ratio, the lower the return he expects.**

Warning:

The parameters used for calculating the numerator and denominator are highly subjective in nature.

It is possible that the **management** may declare a **low dividend** in spite of the company making a **sufficient amount of profit** as it wishes to **retain the profits for expansion purposes.**

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Conversely, management could declare a **high dividend** in spite of the company **not making sufficient profit** as it wishes to **maintain the level of dividend** declared in previous years.

The **market price** is influenced by **factors** beyond the **control of the company**.



Example

Continuing with the above example of Air Ltd

If the management paid a dividend of Tshs2,000,000 instead of Tshs1,500,000 then the dividend yield would have been 12.7% as follows:

Dividend per share = Tshs222.22 (2,000,000/9,000)

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$$

$$\text{Dividend yield} = \frac{\text{Tshs } 222.22}{\text{Tshs } 1,750} \times 100 = 12.7\%$$

This shows that, in spite of the fact that the dividend yield could have been better (12.7%), the **management decision to retain funds** has led to a lower Dividend Yield of 9.71%.

(e) Dividend cover

Dividend cover measures the ability of the company to maintain its existing levels of dividends. It is calculated as:

$$\text{Dividend cover} = \frac{\text{Profit after tax}}{\text{Dividend}}$$



Example

Referring to the financial statements of Air Ltd the dividend cover for 20X8 is calculated as follows:

	Tshs'000
Profits after interest and tax	9,600
Less: Dividend	(1,500)
Profits after dividend	8,100

$$\text{Profit retention ratio} = \frac{\text{Tshs } 9,600}{\text{Tshs } 1,500} = 6.4 \text{ times}$$



Important

The **higher the ratio** the **more likely it will be** for the company to **maintain the Dividend Yield** and level of dividends declared in the past.

4. Financial risk ratios

These ratios help determine the stability of the company and the ability of the company to repay its long-term debts.

(a) Capital gearing ratio

This ratio is an important measure of the company's risk and stability because it expresses the relationship between a company's borrowings and its own funds. It is calculated as:

Use this formula for calculating the ratio unless otherwise specified.

$$\text{Capital gearing ratio} = \frac{\text{Total long – term debt}}{\text{Shareholders' funds}} \times 100$$



Tip

Total long-term debt includes all items that have to be classified as debts according to the requirements of IAS 32 and IFRS 9. Debts include long-term borrowings, debentures and redeemable preference shares.

Shareholders' funds include all items that have to be classified as equity according to the requirements of IAS 32 and IFRS 9. Shareholders' funds include equity share capital, irredeemable preference shares, and reserves.



Example

Referring to the financial statements of Air Ltd the capital gearing ratio for 20X8 is calculated as follows:

$$\text{Capital gearing ratio} = \frac{\text{Total long – term debt}}{\text{Shareholders' funds}} \times 100$$

Long term debt = Tshs6,000,000 + Tshs11,000,000 = Tshs17,000,000
Shareholders funds = Tshs15,000,000

$$\text{Capital gearing ratio} = \frac{17,000,000}{15,000,000} \times 100 = 113.33\%$$

The capital gearing ratio can also be calculated as a relation between the long-term debts and the total long-term funds (equity + long-term debts) of a company. This is calculated as:

$$\text{Capital gearing ratio} = \frac{\text{Total long – term debt}}{\text{Shareholders' funds} + \text{long – term debt}} \times 100$$

In this case, the capital gearing ratio shows how much long-term borrowing the company has for every Tshs100 of shareholders' funds and long-term debt taken together.



Test Yourself 3

The following information is available for Cell Ltd:

	Tshs'000
Ordinary share capital	450,000
8% non-redeemable preference share capital	100,000
Debentures	100,000
Long-term borrowings	400,000
Bank overdraft	50,000
Reserves	125,000

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Required:

Calculate the capital gearing ratio showing the relation between long-term debt and total long-term funds (Equity + Long-term debt) of Cell Ltd.



Important

There can be no rule of thumb or limit for this ratio. It has to be analysed keeping in mind the circumstances under which a company operates.

The **higher the ratio, the more geared the company is**. This means that it **relies heavily on debts for conducting its business**. This is fine for a company which is **certain of making consistent profits and has an adequate asset base to offer as security**. The profit available for distribution to shareholders depends upon the level of borrowings as fixed amount have to be paid as interest due to which less profit is available for distribution to shareholders.

A **high capital gearing ratio** is suitable for a company which have a good asset base to backup as security. For example a hotel or a car manufacturer has tangible assets which they can use as security and thus can prefer a high capital gearing ratio.

A **low capital gearing ratio** is suitable for companies which have **erratic sales / erratic profits and an insufficient asset base**. For example, companies in the consultancy business do not have tangible non-current assets as security. Their main assets are their manpower resources which they own.



Example

Consider the following information pertaining to Hope and Wish Company:

	Company Hope	Company Wish
Gearing ratio	40%	60%
	Tshs'000	Tshs'000
Case 1		
PBIT	60,000	60,000
Interest	(20,000)	(35,000)
Profit after interest	40,000	25,000
Tax at 30%	(12,000)	(7,500)
Profit after tax (available for distribution among shareholders)	28,000	17,500

Case 2		
PBIT	50,000	50,000
Interest	(20,000)	(35,000)
Profit after interest	30,000	15,000
Tax at 30%	(9,000)	(4,500)
Profit after tax (available for distribution among shareholders)	21,000	10,500
Conclusion (Case 1 versus Case 2)		
Fall in PBIT	10,000	10,000
In % terms	(17)%	(17)%
	(10,000/60,000 x 100)	(10,000/60,000 x 100)
Fall in profit after tax (available for distribution among shareholders)	7,000	7,000
In % terms	(25)%	(40)%
	(7,000/28,000 x 100)	(7,000/17,500 x 100)

This shows that the **more geared a company is, the more volatile will be the profits available for distribution among the shareholders.** This is primarily because interest paid on borrowed funds is tax deductible expenditure. Furthermore, a company having a high capital gearing may also find that no banks are willing to lend it any more funds, as it has too much debt. The worry is that it will not be able to pay the loan interest or capital.

(b) Debt ratio

It is the ratio of total liabilities (total debt) to total assets. It is percentage of total funds obtained from trade payables. The debt ratio can help investors to determine whether to invest in a particular company would be risky. It is calculated as:

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$



Important

For trade payables – Lower debt equity ratio will be favourable as it will ensure high safety margin.

For investors – Higher debt equity ratio will be favourable as rate of dividend can be accelerated by increasing the debt component. This is because the debt component carries a fixed interest charge after which the entire profits are available for distribution among the equity shareholders.

Warning

Interpretation of debt-equity ratio needs caution. In case of few companies certain contingent obligations are not shown in the statement of financial position and are disclosed only through the notes to accounts. For example there may be certain legal case pending for decision against the company. They should not be ignored while analysing financial leverage and risk of the firm.



Example

(Amounts in Tshs'000)

Referring to the financial statements of Air Ltd the debt ratio for 20X8 is calculated as follows:

$$\text{Debt ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

$$\text{Debt ratio} = \frac{35,000 + 11,000}{69,100} = 0.66$$

(c) Interest cover

This indicates how many times the profit covers the interest charge. It is calculated as:

$$\text{Interest cover} = \frac{\text{Profit before interest and taxes (operating profit)}}{\text{Interest expenses}}$$



Example

Referring to the financial statements of Air Ltd the interest cover for 20X8 is calculated as follows:

	Tshs'000
Profit before interest and tax	15,000
Interest	3,000
Interest Cover	15,000/3,000 = 5 times



Important

The **higher the ratio** the better; the **company is in a better position to pay the fixed charge of interest.**

(d) Cash flow ratios

These are the ratios used to analyse the statement of cash flow. Cash flow ratio includes

(i) Ratio of long-term borrowings to cash generated from operations

It measures the ability of the company to meet its long-term obligations from its operating activities. It is calculated as:

$$\frac{\text{Long – term borrowings}}{\text{Cash generated from operations}}$$



Example

If the cash generated from operations is TShs24 million and the long-term borrowings are Tshs240 million, then the ratio of long-term borrowings to cash generated from operations is $\frac{240,000}{24,000} = 10$ years



Important

If the **number of years** is **lower** than the **number of years of the agreed repayment schedule (of debts)**, then management **can invest the excess funds** (if any, after payment of taxes and interest costs) in more profitable ventures.

If the **number of years** is **higher** than that **in the agreed repayment schedule**, management will have to **take more loans** to repay the original loans and pay the interest costs.



Example

Rain Ltd has a loan of Tshs60 million and its cash generated from operations is Tshs12 million.

This means that it will take $60,000/12,000 = 5$ years for the operating activities of the company to generate cash which will be sufficient to repay the loan.

However, if the agreed repayment schedule is 7 years, then the company will be able to generate some cash for investing activities (if there remains any excess after paying taxes and interest costs).

Furthermore, if the agreed repayment schedule is 3 years, then the company will have to take a new loan in order to repay this loan.

(ii) Ratio of net cash from operating activities to capital expenditure

It helps decide the extent to which the operating activities of a company can finance its capital expenditure. It is calculated as:

$$\frac{\text{Net cash from Operating activities}}{\text{Capital expenditure}} \times 100$$

Capital expenditure = Capital expenditure incurred for the operating activities of the company during the period.

For example, purchase of machinery, technical know-how, etc. will qualify for capital expenditure. However expenditure on purchase of land for investing purposes should not be considered as capital expenditure for the purpose of this formula.

1.6 Analysis and interpretation of financial statements with the help of financial ratios

Analysis of financial statements includes conducting a ‘vertical’ analysis of them by **expressing relevant figures as a percentage of one key figures.**

If the statement of profit or loss is to be analysed, then usually the **key figure is sales revenue**, and the other figures are expressed as a percentage of this. A vertical analysis of the statement of profit or loss **helps identify the causes of increase or decrease in profits assessed against sales revenue.**

If the statement of financial position is to be analysed, then usually the **key figure is total assets or total debts or total equity.** A vertical analysis of the statement of financial position helps analyse the efficiency of the management in using its total assets, as well as the liquidity and the capital gearing of the company.



Example

The following information is available for Summer Inc:

	Tshs'000	Tshs'000
Sales revenue		400,000
Cost of sales		(250,000)
Gross profit		150,000
Selling expenses:		
Transportation	25,000	
Advertisement	45,000	
Bad debts	40,000	(110,000)
Administration expenses		
Salaries	50,000	
Office expenses	76,000	(126,000)
Operating profit / (loss)		(86,000)
Depreciation		(25,500)
Net profit / (loss)		(111,500)

(Amounts in Tshs'000)

A vertical analysis of these figures reflects the following:

$$\text{Gross Profit Margin} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100 = \frac{150,000}{400,000} \times 100 = 37.5\%$$

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{\text{Sales revenue}} \times 100 = \frac{(86,000)}{400,000} \times 100 = 21.5\%$$

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This analysis shows that the **selling and distribution expenses are quite high** and are **affecting profitability**. This analysis could be further continued to express each expense against sales revenue.

Vertical analysis by itself is **insufficient** to serve the purpose of ratio analysis and interpretation. This is because there is no other set of ratios against which these ratios can be compared. Hence it may **not be able to pinpoint 'cause and effect' relationships**.

In the above example, we know that the gross profit ratio of Summer Inc for the current year is 37.5% and that its operating profit ratio is 21.5%.

However, **we have no clue** whether this is more or less than the gross profit ratio and operating profit ratio of

- Summer Inc in previous years
- the competitors of Summer Inc the industry average

Hence, **we are unable to decide** whether Summer Inc needs to control its cost of sales or its selling and distribution expenses in order to reduce its losses and eventually make profits.

For ratio analysis to be of any use, it becomes **necessary to compare one set of financial ratios with another set of ratios**.

Such a comparison will have to be done as per the demands of the situation keeping in mind the rules of thumb for analysis purposes and warnings listed above.

The broad guidelines which have to be kept in mind while making such comparisons are listed below:

1. While comparing an entity's performance and financial position with its previous period's financial statements, it is essential to **assess the impact** of the following **events** and **make necessary adjustments /allowances** if necessary.

- (a) Changes in the economic conditions of society at large
- (b) Changes / current trends in the industry within which the entity operates
- (c) Any large scale disposal or purchase of non-current assets, especially towards the end of any year
- (d) Any new issue of equity / debt, especially towards the end of any year
- (e) Unusual events such as a fire in the factory leading to unusual losses in the current year. (f) Unusual / seasonal events leading to unusual profits in the current year.

2. When comparing an entity's performance and financial position with another similar entity for the same reporting period, it is still essential to assess the impact of all events listed at (i) to (vi) above.

However, you also need to take into account differences between the entities and make relevant adjustments. Some are mentioned below:

- differences in size and scale of operations
- equity capital
- differences in management thoughts and goals inherent **advantages / disadvantages**



Example

Coal Inc and Diamond Inc are both involved in the manufacture of electronic goods.

On a sales turnover of Tshs5,000,000, Coal Inc has a gross profit ratio of 40% while Diamond Inc has a gross profit ratio of 25% on a sales turnover of Tshs50,000.

The reasons for Coal Inc's higher ratio could include better bargaining power because of the large scale of operation or lower fixed costs per unit sold.

It would be unfair to expect Diamond Inc to operate at this level of efficiency.

3. In situations such as in the example above, it would be more beneficial for the management of Diamond Inc to compare its ratios with the industry average ratios.

This is **because industry average ratios are calculated across the cross-section of the industry and would be a better yardstick**. However, it should be remembered that all types of companies – big and small, prosperous and failing – are considered when arriving at an industry average.

Hence the **ratios depend upon the characteristics of those companies which constitute the majority in the industry**.



Example

Glitter Inc is in the candle-making industry. This industry comprises mainly of small-scale businesses, so the industry average will have an influence of norms for industries of that size.

The average gearing ratio of this industry is 30%.

However, Glitter Inc is a large-scale candle-maker exporting more than 75% of its produce. It relies heavily on borrowings and its gearing ratio is 60%.

In this case, even though the gearing ratio of Glitter Inc is way above the average gearing ratio of 30%, it could be correct for the scale of operations at which Glitter Inc performs.

While comparing an entity's performance and financial position with industry average ratios, it is essential to make allowances for any situations which **specifically affect the company** and which other companies in the industry may not have to face / may not benefit from.

4. In practice, a combination of all the types of assessments explained above are undertaken while analysing an **entity's performance and financial position** with the help of financial ratios. However, it should be remembered that the results derived from such an analysis are highly subjective and will differ from situation to situation.



Test Yourself 4

Shine Inc is in the business of producing tyres. Its Working Capital Cycle is only 20 days while the average Working Capital Cycle of this industry is 30 days. Shine Inc sells all its finished goods to Plain Inc, which is also its parent company.

Required:

Is management justified in saying that it has excellent management techniques because of which the company's Working Capital Cycle is lower than that of the average for the industry?

1.7 Focus of financial statement analysis

Financial statements are used by a wide range of users in order to take economic decisions. They are analysed differently by different users in order to generate information which suits their requirements.

The most important matter that one must remember is that ratios have to be considered together. Taking decisions on the basis of just one favourable ratio may prove to be incorrect.

The different users of financial statements and how they use financial ratios to interpret the financial statements of an entity are discussed below:

1. **Investors and potential investors:** primarily concerned with knowing whether their actual or potential investment is sound and what yield they can expect to get from it. They would be interested in the following ratios:

➤ Earnings Per Share

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- Price / Earnings ratio
- Profit Retention ratio
- Dividend Cover

The performance of the company is also of importance to them because, if a company does not maximise its returns (use its resources optimally), then the actual or potential investment in such a company will not prove to be beneficial in the long run. For this purpose they would be interested in the following ratios:

Return on Capital Employed Return on Assets

They would not be really concerned with the profitability ratios as they are not really worried about how the company earns its profits.

Another ratio which is of importance to them is **Capital Gearing**. A company has to borrow funds; without these, it will become difficult for the company to undertake its expansion programmes. To this extent, the shareholders would expect some borrowings.

However, the more the borrowings, the more the borrowing costs in the form of interest which has to be paid compulsorily. This eats into the profit available for distribution as dividends.

They are not directly concerned with the liquidity ratios. The only liquidity ratio which interests them is **Interest Cover**. The **higher the Interest Cover**, the better it is for the investor because the **company is in a better position to pay the fixed charge of interest**.

The most important thing that one must remember is that these **ratios have to be considered in conjunction with each other**.



Example

Peter wishes to invest Tshs25 million in the shares of either Whale Inc or Dolphin Inc. He scrutinises the financial statements and finds out that the EPS of Whale Inc is higher than that of Dolphin Inc and decides to invest in the shares of Whale Inc.

He does not take note of the other ratios which are as follows:

	Whale Inc	Dolphin Inc
EPS	Tshs560	Tshs450
Capital Gearing	74%	36%
Interest Cover	1.5 times	4 times
Profit Retention ratio	80%	50%

In this example,

Peter may not have taken a wise decision because, along with the EPS, he should have considered other ratios like the Price Earnings ratio, Dividend Cover, the Profit Retention ratio, Return on Capital Employed (and Return on Assets), Capital Gearing and Interest Cover before making his investment decision.

It is possible that the EPS of Whale Inc is higher because the company's scale of operations is much larger. Whale Inc may have borrowed funds for this large scale of operations.

An analysis of the other ratios shows that the high Capital Gearing ratio of Whale Inc has led to a fall in Interest Cover. As dividends cannot be paid unless interest is paid, even a small fall in profits could lead to no profit being left for distribution to shareholders. Dolphin Inc has a low Capital Gearing, which is why Interest Cover ratio is high. This is good news for potential investors.

If Peter is looking for capital appreciation, then the high Profit Retention ratio (80%) of Whale Inc is what he would want, as the retained money would be used for expansion programmes, which would lead to capital appreciation. However, if he is looking for returns in the form of dividends, then the low Profit Retention ratio (50%) of Dolphin would suit him as the chances of earning regular dividends will increase.

The performance of the company is also important because, without an adequate Return on Capital Employed, the other ratios would be of no use.

2. Lenders and potential lenders: this category of users is primarily concerned with whether the company is in a position to repay the loan along with interest. For this purpose, they will be interested in the **Interest Cover**.

They will also be interested in the **Capital gearing ratio**. If this is too high, then it will be riskier for them to lend money. In such a case, they may either not lend money or charge a higher rate of interest for the loan advanced.

They will also be interested in assessing the performance of the company because, if a company is not performing well, it will not be able to sustain its liquidity. For this purpose, they will be interested in the **Return on Capital Employed** and **Return on Assets**.

They would check the **profitability ratios** as these help determine the **Return on Capital Employed**.



Test Yourself 5

Help Tom decide whether he should lend money to Love Inc or Warmth Inc on the basis of the following financial information:

	Love Inc Tshs'000	Warmth Inc Tshs'000
Sales	300,000	400,000
Cost of sales	170,000	200,000
Interest	24,000	48,000
Total capital employed	425,000	575,000
PBIT	100,250	125,000
Long-term borrowings	300,000	400,000
Current ratio	2:1	2.5:1
Net profit	76,250	77,000



Test Yourself 6

In the above question, why is the Interest Cover of Love Inc much higher than that of Warmth Inc, when longterm borrowings equal sales turnover in both cases?

3. Payables and other suppliers: this category of users is primarily concerned with the liquidity position of the company because they want to know whether the company is solvent enough to repay its dues on time. For this purpose, they will be interested in the **Current ratio**, **Quick ratio**, **Payable days** and the **Working capital cycle**.



Test Yourself 7

Hot Inc has received an order to supply goods worth Tshs45 million on credit to Cool Inc. It wants to take up this order as it is a big one for the company. However, its cash flow position is tight and a credit period of more than 30 days would be dangerous for this newly-created business.

Hot Inc wants your advice about what would be the correct length of the credit period it should offer. The following information is available from the latest financial statement of Cool Inc.

	Tshs'000
Payables as at 31 December 20X6	60,000
Payables as at 31 December 20X7	70,000
Total credit purchases	527,000

4. **Customers**, especially those dependent on the company for after-sales services, are concerned with whether it will still be functioning when they need its services. For this purpose, they will be interested in analysing its performance and would rely on the profitability ratios and performance ratios (e.g. **Profit Margins and Return on Capital Employed**).



Example

Jane wishes to buy a car. She wants to purchase car Zoom but has heard that the demand for it has gone down and so she may not now receive after-sales service.

In this example, Jane should obtain the financial results of the company for the past two to three years and check whether the Profit Margins and Return on Capital Employed (ROCE) have decreased. She should also check whether the sales of car Zoom have really fallen and whether the company produces only car Zoom.

She should then make her final decision by using the following guidelines:

1. If the profit margins, ROCE and sales of car Zoom have not declined, she can buy the car.
2. If the profit margins and ROCE have not declined but the sales of car Zoom have gone down, this suggests that the company produces other cars as well and has no intentions of shutting down in the near future. She can buy the car.
3. If the profit margins, ROCE and sales of car Zoom have all declined, this suggests that the company is not doing well and may shut down. She would be better off buying some other car.

5. **Management:** this category of users does have access to much more detailed financial information than that which appears in the financial statements. However, management would be interested in a comparison with competitors, especially in the ratios which affect their sphere of work.



Example

A purchase manager would be interested in the cost of sales, sales revenue ratio, whereas a personnel manager would be interested in the salaries, sales revenue ratio.

Top management would of course be **interested** in the **whole set of financial ratios** including those which analyse the cash flow statements.



Test Yourself 8

Management of Happy Inc needs to make capital expenditure of Tshs200 million in the next two years in order to achieve its targeted market share. Its Capital Gearing ratio is already 64% and it wants to fund as much as possible of this new expenditure from its internal sources.

The following information about the last year is available:

Cash generated from operating activities	Tshs67.45 million
Net profit	Tshs42 million
Capital expenditure	Tshs130 million
Interest Cover	2.5 times
Return on Capital Employed	46%
Net cash from operating activities	Tshs50.25 million

Required

Which ratio will the management use to decide the amount it needs to borrow externally?

**Tip****Tips on solving a problem on ratio analysis**

In the examination, it is essential to understand **which 'aspect' of the company is to be analysed**.

Only those **ratios** which **satisfy** the **requirements** of the question have to be **calculated and analysed**. Calculating and producing the **entire set of ratios** will **not earn you any extra marks but will definitely lead to wastage of time**.

If the question asks you to analyse the performance of the entity, then there is no point in calculating all the liquidity ratios, the investors' ratios or Capital Gearing.

The answer should be restricted to the calculation of the profitability ratios, the Return on Capital Employed and Return on Assets and, if required, the activity ratios.

Some more tips

- If the ratios are already given in the question then there is no need to calculate them again. Showing the calculations of these ratios will not fetch any bonus marks.
- Explain how the ratios are analysed and the rules for analysis only if specifically asked for.
- Write your **interpretation of the ratios clearly**. Remember that the whole purpose of ratio analysis is to reveal the truths of those numbers who are hiding behind veils. **Ratios have to spill the beans**.
- In this interpretation you can subtly include the rules of analysis as well as the limitations of the relevant ratios.
- If the question requires you to write a report then ratios should be included as an appendix to the main report. The workings of the ratios can follow the appendix.
- Any report should have a **conclusion** and may also include a **suggested future course of action** / steps to redress the situation.
- If you feel that it is difficult to interpret a ratio or arrive at any conclusion you should specifically state why you feel so. You also need to **specify the type of information** (e.g. industry averages, competitor's ratios) which **you feel is needed in order to arrive at a definite conclusion**.
- Remember ratio analysis is **highly subjective in nature**. Your interpretation of the same ratio could be significantly different from the interpretation of the examiner. You must mention all the reasons why you interpret a ratio in any particular manner so as to help the examiner understand your point of view. **If you manage to convince the examiners you will get some marks**.

**Test Yourself 9**

If you are asked to analyse financial data of a company on behalf of a prospective lender of funds, which ratios will you use for your analysis?

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Using all the tips, explanations and illustrative answers given above now solve the following question:



Test Yourself 10

The financial statements for the years ended 31 December 20X6 and 20X7 are shown below. They show that profits have increased dramatically because of the increase in sales.

Income and expenditure account	20X7	20X6
	Tshs'000	Tshs'000
Sales	425,000	80,000
Cost of sales	(252,000)	(28,800)
Gross profit	173,000	51,200
Selling expenses	(40,500)	(12,000)
Administration expenses	(21,000)	(1,440)
Depreciation	(31,200)	(4,640)
Interest	(28,800)	(960)
Net profit	51,500	32,160
Balance brought forward	58,320	26,160
	109,820	58,320

Statement of financial position	20X7		20X6	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Non-current assets				
Premises	66,150		36,000	
Plant	237,620	303,770	47,200	83,200
Current assets				
Inventory	35,700		2,400	
Receivables	87,450		6,640	
Bank	-	123,150	960	10,000
Total assets		426,920		93,200
Equity and liabilities				
Share capital	41,200		20,000	
Reserves	109,820		58,320	
Redeemable preference shares	8,000	159,020	4,000	82,320
Non-current liabilities				
Loans from banks	240,000	240,000	8,000	8,000
Current liabilities				
Payables	26,250		2,880	
Bank overdraft	1,650	27,900	-	2,880
Total equity and liabilities		426,920		93,200

In 20X6, the directors of Wine Inc have invested heavily in non-current assets. This helped the company increase its production, which in turn increased their sales turnover.

With the help of accounting ratios, report on whether the performance of the company has improved in the year 20X7.

1.8 Other techniques of financial statement analysis

1. Vertical analysis

Vertical analysis of a financial statement identifies the relationship of each item to its base amount (base amount is assumed to be 100%). Every other item on the financial statement is computed as a percentage of that base.

Vertical analysis is already discussed previously in this Study Guide.

2. Horizontal analysis

Horizontal analysis spotlights trends and establishes relationships between items that appear on the same row of a comparative statement. Horizontal analysis discloses changes on items in financial statements over time. Each item (such as sales) on a row for one fiscal period is compared with the same item in a different period. Horizontal analysis can be carried out in terms of changes in dollar amounts, in percentages of change, or in a ratio format. A sample horizontal analysis is given below for your understanding.

	Tshs'000	Tshs'000	Tshs'000	%
	2012	2011	Amount	
Shareholders' equity				
Share capital	200,000	200,000	-	-
Retaining earnings	205,200	186,500	18,700	10%
Total stockholders' equity	405,200	386,500	18,700	5%

3. Industry comparison

This involves comparison of ratios of a firm with similar firms or with industry averages. The intention behind these comparisons is to determine whether the firm is performing well as compared to its competitors. Industry averages can be obtained from firms involved in similar research, professional articles, membership of trade associations, etc.

4. Trend analysis

Trend analysis involves comparison of a firm's present ratio with its past and expected future ratios to determine whether the company's financial position is improving or deteriorating over time. Horizontal analysis is an example of trend analysis.

A horizontal analysis involves comparing financial ratios or line items in a financial statement over a period of time. The time analysed is generally chosen based on the purpose of analysis. This technique is also referred to as comparative analysis.

For example, management takes decision based on whether sales are increasing. But considered alone, this fact may not be very helpful. The information that may be pertinent is i) Whether the sales have increased compared to the last year? ii) If so, by how much percentage has it increased?

This study of percentage changes in comparative statements is called horizontal analysis.



Example

The following is the information available of Longhorn Ltd for the years 20X6 and 20X7:

	20X6	20X5	Percentage of increase or decrease
	Tshs'000	Tshs'000	
Sales	240,000	200,000	20%
Cost of Goods Sold	147,900	108,000	37%
Selling Expenses	40,100	22,000	82%
Admin Expenses	24,000	28,000	(14)%
Interest Expenses	6,000	12,000	(50)%
Total Expenses	(218,000)	(170,000)	28%
Income before taxes	22,000	30,000	(27)%
Income taxes expense	(6,000)	(8,000)	(25)%
Net Income	16,000	22,000	(27)%

By performing a horizontal analysis it becomes relatively very easy to identify areas of wide divergence that require further attention. It can be observed that the sales have increased by 20%, in spite of which the net income has declined by 27% during the year 20X6. This should be a cause of concern to the company. The reason behind this is that in the year 20X6 the company incurred heavy selling expenses. Also it appears that there was an increase in the price of goods purchased without any corresponding increase in selling price. Thus a horizontal analysis helps to locate the problem areas.

2. Explain the limitation of using ratio analysis.

[Learning outcome e]

A lot of problems are encountered while using the tool of ratio analysis for assessing the performance of an entity. Some of these problems are as follows:

1. Ratio analysis is **not a very useful tool to determine the future prospects of an entity**. This is because ratio analysis is generally performed on historical data. Also the future prospects of the company depend on various assumptions made by an entity, relating to sales forecast, investments to be made, etc. Furthermore there is a time lag between the period of the financial statements and the time when the financial statements are published and available for analysis. This would make the ratio analysis outdated.
2. The **ratios can be distorted** due to inflation, use of different bases for valuing assets, or specific price changes. These shortcomings are basically **on account of the limitations of historical cost accounting**.
3. **Changes in the accounting policies** and practices of a company **and differences in accounting policies and practices between two entities** may lead to an incorrect comparison of ratios.



Example

If there is a change in method of depreciation from straight line to reducing balance, the ratios which are calculated using these figures would also be affected. Another example is the difference in the basis of valuation of inventory (LIFO, FIFO or weighted average).

4. Companies may have **different accounting periods**, due to which ratio analysis in which the performance of these companies are compared may not be realistic.

5. There are **differences of opinion regarding the various variables used** to compute ratios. For example, the capital gearing ratio can be calculated as a relation between the long-term debts and: the total long-term funds (equity + long-term debts) of a company, or the shareholders' funds of a company.
6. Entities sometimes apply **creative accounting** in order to show a good financial performance or position which can be misleading to the users of financial accounting. At such times, ratio analysis may not show the correct position.
7. Ratio analysis in which the performance of an entity is compared with the industry average may not be possible if the information relating **to industry average not available**.
8. Ratio analysis is also subject to inherent limitations of ratios. As discussed earlier, ratios are arrived at by dividing one financial item by another. If there is any extraordinary movement in any financial item, or if the amounts are not spread evenly throughout the period, then the ratios derived from using such an item will not reflect the true position of the entity, and decisions based on these ratios will be incorrect.



Example

Receivable Days are arrived at by using the formula:

Receivable Days = Receivables/Credit sales x 365 days.

This assumes that the sales are spread evenly throughout the year.

If the credit sales for the year ending December 20X7 are Tshs365 million and the receivables at that date are Tshs30 million, then the ratio is (Tshs30 million/Tshs365 million) x 365 = 30 days.

However, if it is a company dealing in greeting cards and of the annual sales of Tshs365 million the credit sales in December are Tshs120 million, then actually the ratio is (Tshs30 million/Tshs120 million) x 365 days = 90 days.



Test Yourself 11

The following ratios have been obtained from the financial statements of Lab Inc:

	20X5	20X6
Net Profit Margin	25.00%	20.00%
Return on Capital Employed	28.50%	22.00%
Capital Gearing ratio	85.00%	92.00%

Required:

- (a) Comment on the performance of the company.
- (b) Would your answer change if you were informed that a major fire broke out at the premises of Lab Inc in 20X6?
- (c) How does this example show the limitations of financial ratios in analysing corporate performance?

2. Analyse various methods for business valuation.

[Learning outcome f]

Net book value is simply the business valuation based upon the accounting books of the business. Assets less liabilities equal the owner's equity, which is the "book value" of the business. The book value method is one of the most commonly used methods of valuation. As the name suggests, it is the net value of all the assets of the company. If we divide net book value by the number of outstanding shares, we get the net book value per share.



Example

A company's share capital is Tshs1,000million (1m shares of 1,000 each) and its reserves and surplus is another Tshs1,000million. The net worth of the company would be Tshs2,000million (equity and reserves) and net book value would be Tshs2,000 per share (Tshs2,000million divided by 1 million outstanding shares).

The limitation of this valuation method is that the accounting records may not accurately reflect the true value of the assets in the business valuation. Assets and liabilities are shown at historical cost that sets the floor (minimum value) for stock prices under a worst-case scenario.

Book value is the amount at which an asset is recorded in an entity's books of accounts. The amount could be its original purchase price or possibly it's assessed value. It is not necessarily the price the asset would fetch if sold in the market, nor what it would cost to replace.



Example

Total Assets = Tshs10,000 million; Total Liabilities = Tshs4,000 million; Number of common stock shares outstanding = 3 million

$$BV \text{ per share} = \frac{\text{Tshs } 10,000\text{m} - \text{Tshs } 4,000\text{m}}{3 \text{ m}}$$

Tshs 2,000 per share

2. Net replacement cost basis

Replacement cost is the amount required to replace an asset at current prices. In other words, replacement cost means the cost to replace the asset on the same premises with another asset of comparable material and quality, used for the same purpose. For instance, it is the amount required to erect a building which replaces or serves the functions of a previous structure.

Note that replacement cost is likely to be different from fair market value or net realisable value.



Example

	Book Value	Estimated Replacement Value	
	Tshs'000	%	Tshs'000
Cash at bank	5,000	100	5,000
Debtors	70,000	100	70,000
Stock	200,000	115	230,000
Non-current assets	15,000	120	18,000
Total outside liability	(90,000)	100	(90,000)
	200,000		233,000
Valuation – Net replacement value			233,000

3. Price / earnings ratio method

The price to earnings ratio assumes that the corporation will be worth some multiple of its future earnings.

The P/E ratio of a stock (also called its "earnings multiple", or simply "multiple", "P/E", or "PE") is used to measure how cheap or expensive the stock's share price is. The lower the P/E, the less you have to pay for the stock, relative to what you can expect to earn from it.

$$\text{Earnings per Share (EPS)} = \frac{\text{Profits after tax}}{\text{Number of shares outstanding}}$$

$$\text{Price to Earnings ratio (PE)} = \frac{\text{Market Price}}{\text{Earnings per share}}$$

Value of company = Total earnings x P/E ratio



Example

A company earned Tshs100million last year, with one million shares outstanding, and had earnings per share of Tshs100 (Tshs100million /1million shares). The current market price is quoted at Tshs1,000. Therefore, the company's P/E multiple will be 10 (Tshs1,000/Tshs100). The company's earnings this year rose to Tshs120million and, accordingly, EPS rose to Tshs120. Assuming the same P/E multiple, i.e. investors are willing to pay Tshs10 for every Tshs1 of last year's earnings, the company's valuation using the P/E ratio method will be Tshs1200million (Tshs120 x 10).

By relating price and earnings per share for a company, one can analyse the market valuation of a company's shares relative to the wealth the company is actually creating.

This method has two drawbacks:

1. It is based on earnings and accounting profits, which are not good indicators of actual value creation for shareholders.
2. Selection of the multiplier is not consistent i.e. the company can choose whether to use the industry average or the adjusted industry average based on the company's expected growth, the rate of return on new capital and the costs of capital.

4. Earnings yield method

One way of calculating earnings yield is the reverse (or reciprocal) of the P/E which is the E/P. The earnings yield is quoted as a percentage, and is useful in comparing a share valuation or the market's valuation relative to bonds.

$$\text{Earnings yield (E/P)} = \frac{\text{Earnings per share}}{\text{Market Price}} \times 100$$

Earnings yield simply means the earnings per share for the most recent 12 months divided by market price per share. In this case, value is derived by capitalising the company's annual maintainable expected earnings by an appropriate required earnings yield or return on investment. Annual maintainable expected earnings can be calculated using past earnings adjusted for future increase and synergy or economies of scale.

$$\text{Capitalized earnings value} = \frac{\text{Annual maintainable expected earnings}}{\text{Required earnings yield}}$$

The capitalisation rate should be appropriate for the company's size and industry prospects.



Example

A company earned Tshs100 million last year, with one million shares outstanding and had earnings per share of Tshs100 (Tshs100 million /1m). The current market price is quoted at Tshs1,000. The P/E ratio would therefore be 10 (Tshs1,000/Tshs100).

Hence, required earnings yield = EPS/Share price x 100 = 100/1,000 x 100 = 10%

If we assume the company will maintain the same level of earnings, annual maintainable expected earnings are Tshs100 million.

Capitalised value = Tshs100 million /10% = Tshs1,000million

The advantage of the earnings yield method is that it is a forward-looking measure as it uses expected earnings and encourages forecasting of future performance. The limitation of this method is that it uses the earnings figure from the financial statements, which is largely subjective.



Test Yourself 12

PQR Plc, which is unquoted, earns profit of Tshs90 million before tax. It has issued 10 million shares. The rate of corporation tax is 30%. A similar listed firm sells at a P/E ratio of 15:1.

What value would you place on PQR's business?

5. Discounted cash flow (DCF) method or NPV method

The DCF approach calculates the value of a business by discounting its future cash flows at a rate which reflects the risk inherent to the business.

According to the DCF approach, the market value of any company is simply the discounted value of all anticipated future free cash flows generated by the firm. DCF recognises the time value of money by discounting future cash inflows and outflows to the present, using an appropriate discount rate which reflects the risk profile associated with these cash flows.

Stock can be valued in many ways. The soundest method of valuation is the discounted cash flow method (DCF) or income valuation. This involves a final value of disposition and a discounting of the profits (cash flows, earnings and dividends) that the stock will deliver to the stockholder in the near future. A risk premium, which is normally included in the discount rate, is normally based on the capital asset pricing model.

The DCF valuation method requires the valuer to:

- forecast the future cash flows of the company for at least 4 to 5 years in the light of the current market situation, industry prospects, synergy if any, including an assessment of the terminal value and the likely cash benefits and costs arising from business transactions.
- assess an appropriate discount rate, which is usually the subject company's weighted average cost of capital (WACC).



Definition

Weighted average cost of capital (WACC)

In finance, a firm's cost of capital is measured using the weighted average cost of capital (WACC). Two main sources of money are available to corporations: equity and debt. Taking into consideration the relative weights of each component of the capital structure, the WACC calculates the expected cost of new capital for a firm.

WACC	$= R_d(1 - T_c) \frac{D}{V} + R_e \frac{E}{V}$
R_d	= Pre-tax cost of debt. Based on the current yield on traded company debt instruments or estimated, taking account of company gearing, size, industry risk etc.
T_c	= Corporate tax rate
D	= Market value of the business' debt
E	= Market value of equity
R_e	= Cost of equity
V	= $D + E$



Example

Details of MTC Ltd are as follows:

Equity	Tshs40m
Debt	Tshs60m
Corporate tax rate	30%
Expected return on equity	15%
Interest on debt	10%

Therefore, WACC = $0.10(1 - 0.30)\frac{60}{40+60} - 0.15\frac{40}{40+60} = 10.20\%$ thwart

Projected cash flow

Year	Cash inflow (Tshs in million)	PV factor @ 10.20%	PV Cash Flow (Tshs in million)
1	80	0.907	72.56
2	92	0.823	75.72
3	110	0.747	82.17
4	125	0.678	84.75
5	140	0.615	86.10
	Total		401.30

If outstanding equity shares are 10m, the value per share under the DCF method will be Tshs40.13 (i.e. Tshs401.30/10m shares).

Answers to Test Yourself

Answer to TY 1

(Amounts in Tshs'000)

$$\begin{aligned} \text{Return on assets} &= \frac{\text{Operating profit}}{\text{Total assets}} \\ &= \frac{\text{Tshs } 125,300}{\text{Tshs } 590,000} \times 100 = 21.23\% \end{aligned}$$

This means that assets worth Tshs100 generate operating profits of Tshs21.23.

Alternatively return of assets can also be calculated as follows:

$$\begin{aligned} \text{Return on assets} &= \frac{\text{Operating profit}}{\text{Sales revenue}} \times 100 \\ &= \frac{\text{Tshs } 125,300}{\text{Tshs } 350,000} \times 100 = 35.8\% \end{aligned}$$

This means that sales revenue of Tshs100 generates an operating profit of Tshs 35.80.

$$\begin{aligned} \text{Asset turnover} &= \frac{\text{Sales revenue}}{\text{Total assets}} \text{ (times p.a.)} \\ &= \frac{\text{Tshs } 350,000}{\text{Tshs } 590,000} = 0.59 \end{aligned}$$

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This means that assets worth Tshs100 generate sales revenue of Tshs59.

$$\begin{aligned}\text{Return on assets} &= \text{Operating profit margin} \times \text{Asset turnover} \\ &= 35.8\% \times 0.59 = 21.12\%\end{aligned}$$

Interpretation

The ROCE of 21.12% in the current year is lower than the ROCE for the previous year.

This could be on account of additions made to the assets. Some of the assets which have been freshly introduced may take a long time to generate optimal returns. Also another reason could be that the management has not been able to use the assets efficiently.

The **higher the ratio, the more efficiently the assets are managed**. This implies that the entity is generating optimum profits from the available resources. Hence the fall in the ratio during 20X8 as compared to 20X7 would be a cause of concern to the company since the investors may withdraw their investment from the company if they get a better return in the market.

Answer to TY 2

(Amounts in Tshs'000)

Working capital cycle = Inventory turnover + Receivable days - Payable days

(i) $\text{Inventory turnover period} = \frac{\text{Average inventory}}{\text{Cost of sales}} \times 365 \text{ days}$

$$\frac{\text{Tshs } 28,750}{\text{Tshs } 147,500} \times 365 \text{ days} = \frac{2,500 + 35,000}{2} \times 365 \text{ days}$$

= 71 days

$$\text{Receivable days} = \frac{\text{Average receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

$$\frac{\text{Tshs } 35,000}{\text{Tshs } 200,000} \times 365 \text{ days} = \frac{30,000 + 40,000}{2} \times 365 \text{ days}$$

= 64 days

(ii) $\text{Payable days} = \frac{\text{Average payables}}{\text{Credit purchases}} \times 365 \text{ days}$

$$\frac{\text{Tshs } 27,750}{\text{Tshs } 160,000} \times 365 \text{ days} = \frac{22,500 + 33,000}{2} \times 365 \text{ days}$$

= 63 days

(iii) Working capital cycle = Inventory turnover + Receivable days - Payable days

$$= 71 \text{ days} + 64 \text{ days} - 63 \text{ days} = \mathbf{72 \text{ days}}$$

Answer to TY 3

The 8% irredeemable preference share capital is to be classified as debt because, although the preference shares are non-redeemable, they carry a fixed interest charge. (The substance of the transaction is given more importance than its form).

In the absence of information, it is assumed that the bank overdraft is a short-term debt and is not to be included in the long-term debts.

	Tshs'000
Long-term debt	
8% non-redeemable preference share capital	100,000
Debentures	100,000
Long-term borrowings	400,000
Total long-term debt	600,000
Shareholders' funds	
Ordinary share capital	450,000
Reserves	125,000
Total shareholders' funds	575,000
Total long-term funds	
Total shareholders' funds	575,000
Total long-term debt	600,000
Total long-term funds	1,175,000

Shareholders' funds + Long-term debt

$$\text{Capital gearing ratio} = \frac{\text{Long-term Debt}}{\text{Long-term Debt} + \text{Equity}} \times 100$$

$$= \frac{\text{Tshs } 600,000}{\text{Tshs } 1,175,000} \times 100 = 51.06\%$$

Answer to TY 4

Working capital cycle = Inventory turnover + Receivable days – Payable days

Shine Inc sells all its finished goods to Plain Inc (its parent company). Hence it will be easier for Shine Inc to control its Inventory Turnover and Receivable Days and keep them at the lowest possible level.

It is assumed here that the parent company gives a preferential treatment to its subsidiary. However, this may not necessarily be the case. The management of Plain Inc may wish to test the management of Shine Inc and not give them any preferential treatment.

Payable Days are not controlled by Plain Inc and depend upon the efficiency of management.

In order to decide whether management is justified in claiming that excellent management techniques are responsible for the better Working Capital Cycle, one needs to assess which component of the Working Capital Cycle is managed more efficiently.

Management is justified in its claim if:

- **Inventory Turnover** and **Receivable Days** are **lower than average** and if Plain Inc does **not give any preferential treatment** to Shine Inc because of their related party relationship.
- **Payable Days** are **greater** than industry norms.

Management is not justified in its claim if:

- **Inventory Turnover** and **Receivable Days** are **lower than the norm** but that is because Plain Inc does **give preferential treatment** to Shine Inc because of their related party relationship.
- **Payable Days** are **lower** than the norm.

Answer to TY 5

A potential lender of funds will be primarily interested in knowing whether the company is in the **position of repaying its loan along with interest** – which will be reflected by the **Interest Cover**.

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However, taking **decisions** on the basis of **just one favourable ratio may prove to be dangerous**. One needs to consider the impact of all relevant ratios before arriving at any conclusive decision.

The other relevant ratios which Tom should consider are

- Capital Gearing:** if this is **too high**, then it will be **riskier for him to lend money**. In this case, Tom may **either not lend money or charge a higher rate of interest for the loan advanced**.
- Return on Capital Employed, which is an indicator of the performance of the company.** An underperformer will eventually not repay the loan capital or interest.
- Operating Profit Margin:** to decide which company is **more profitable**.

The required ratios are computed as follows:

	Love Inc	Warmth Inc
Interest Cover	$\frac{\text{Tshs}100,250}{\text{Tshs}24,000} = 4.1 \text{ times}$	$\frac{\text{Tshs}125,000}{\text{Tshs}48,000} = 2.6 \text{ times}$
Capital Gearing	$\frac{\text{Tshs } 300,000}{\text{Tshs } 425,000} \times 100 = 70.6\%$	$\frac{\text{Tshs } 400,000}{\text{Tshs } 575,000} \times 100 = 69.6\%$
ROCE	$\frac{\text{Tshs } 100,250}{\text{Tshs } 425,000} \times 100 = 23.6\%$	$\frac{\text{Tshs } 125,000}{\text{Tshs } 575,000} \times 100 = 21.7\%$
Operating Profit Margin	$\frac{\text{Tshs } 100,250}{\text{Tshs } 300,000} \times 100 = 33.4\%$	$\frac{\text{Tshs } 125,000}{\text{Tshs } 400,000} \times 100 = 31.3\%$

A scrutiny of the data and the ratios shows the following:

Advantages of Warmth Inc: it has higher sales and profits, marginally lower Capital gearing and a higher Current ratio.

Advantages of Love Inc: it has a higher Interest Cover and a marginally higher Return on capital employed and a better Operating profit margin.

The deciding factor in this case is the higher Interest Cover. The Current ratio does not affect Tom in any way. He is more interested in getting back his principal and interest. The Interest Cover of 4.1 times would ensure that. Also the fact that Love Inc has a better ROCE and a better operating profit margin would help him decide in favour of Love Inc.

In conclusion, Tom should lend money to Love Inc. He could take advantage of the high gearing ratio of Love Inc. and charge a higher rate of interest for the amount he would advance to Love Inc.

Answer to TY 6

The interest - turnover ratio of **Love Inc** is $\frac{\$24,000}{\$300,000} \times 100 = 8\%$

The interest - turnover ratio of **Warmth Inc** is $\frac{\$48,000}{\$400,000} \times 100 = 12\%$

The difference in ratios explains the higher Interest Cover of Love Inc. It suggests that Love Inc has negotiated and obtained a lower rate of interest on the amounts it has borrowed.

Answer to TY 7**Report on the credit period which should be offered to Cool Inc**

The latest financial statements have been used to determine the Payable Days of Cool Inc. This ratio shows that, on average, Cool Inc needs 45 days to clear its dues.

A credit period of 30 days (your requirement) may not be acceptable to Cool Inc. You need to recheck whether you are in a position to increase the credit period you can offer. It need not be 45 days as that is the average credit period. Skilful negotiations could help you obtain the contract at 40 days.

Appendix 1: Determination of payable days of Cool Inc.

	Tshs'000
Payables on 31 December 20X6	60,000
Payables on 31 December 20X7	70,000
Average payables	65,000
Total credit purchases	527,000

$$\begin{aligned} \text{Payable days} &= \frac{\text{Average payables}}{\text{Credit purchases}} \times 365 \text{ days} \\ &= \frac{\text{Tshs } 65,000}{527,000} \times 365 \text{ days} = 45 \text{ days} \end{aligned}$$

Since the payable days calculated above are more than 30 days, it would be difficult for Hot Inc to extend credit for 45 days. If it extend credit beyond 30 days, this might worsen the liquidity position further.

Answer to TY 8

Management will rely on the ratio of net cash from operating activities to capital expenditure in order to decide the amount of external borrowings to finance its planned capital expenditure of Tshs200 million over the next two years. This ratio is 39% (W1).

According to this ratio, the directors would have to borrow $(100\% - 39\%) \times \text{Tshs}200 \text{ million} = \text{Tshs}122 \text{ million}$ from external sources. However, they should remember that this ratio is to be used just as an indicator. They would also have to make allowances for the development period which would be required for the new capital expenditure to start generating operating surpluses.

W1 Ratio of net cash from operating activities to net capital expenditure (Amounts in Tshs'000)

$$\begin{aligned} &= \frac{\text{Net cash from operating activities}}{\text{Net capital expenditure}} \times 100 \\ &= \frac{\text{Tshs}50,250}{\text{Tshs}130,000} \times 100 = 38.6\% \end{aligned}$$

Answer to TY 9

A potential lender of funds will be primarily interested in knowing whether the company is in a **position to repay his loan along with interest**. For this purpose, he will be interested in **the Interest Cover**.

He will also be interested in the **Capital Gearing**: if this is **too high**, then it will be **riskier for him to lend money**. In this case, he may **either not lend money or charge a higher rate of interest for the loan advanced**.

He will also be interested in assessing **the company's performance**: if it is not performing well, it will not be able to sustain its liquidity. For this purpose, he will be interested in the **Return on Capital Employed**.

Answer to TY 10

A report on the performance of Wine Inc in the year 20X7

The sales turnover as well as the net profit of Wine Inc has shown an **improvement in absolute terms in 20X7**. This could be **attributed to the heavy investment Wine Inc has made in non-current assets**, which have helped **increase production and sales turnover**.

Now we shall assess with the help of accounting ratios whether this has resulted in an improvement in the performance of the company. The calculations of the ratios have been included in Appendix 1 of the report.

1. Profitability ratios

	Difference (% points)
The Gross Profit Margin has fallen from 64% to 41%	23
The Operating Profit Margin has fallen from 41% to 19%	22
The Net Profit Margin has fallen from 40% to 12%	28

(The unit % point is used when referring to differences in percentages).

Some explanations of these movements are as follows:

- The **increase in sales** may be the effect of a **decrease in selling prices**.
- There is a **need to control both direct and operating costs** as the reduction in Gross Profit Margin and Operating Profit Margin is almost the same (23% & 22%).
- There is a **substantial fall** in the ratio of **selling expenses to sales**, which reflects the fact that there is an **effective control** over these expenses.
- There is an **increase in administration expenses**: this need to be **looked into and controlled**.
- Net Profit Margin has reduced considerably because of the **increase in interest costs**. This increase is a result of increased borrowings to finance the purchase of non-current assets.

2. Return on Capital Employed (ROCE) and Asset Turnover

	Difference (% points)
ROCE has fallen from 36% to 20%	16
Return on Assets (ROA) has fallen from 36% to 19%	17

Asset Turnover ratio has shown a marginal increase.

This reflects the fact that the **investment in non-current assets has not yet started to give the required results**.

To decide **whether the investment has not been as productive as expected**, it would be advisable to **compare** the Asset Turnover ratio with industry averages or with the ratio of another entity having a similar business.

If this is not the reason for decrease, then the cause could be:

1. the **assets have not been used to their complete potential**; or
2. they have a **long development period**.

Thus the analyses of ratios show that the **performance of the company** has **not improved** in 20X7. A further analysis needs to be undertaken (along the lines suggested above) in order to identify the causes of the underperformance and to take corrective measures.

Appendix 1: Calculations of ratios used in the report (Amounts in Tshs'000)

Profitability ratios	20X7	20X6
Gross Profit Margin	$\frac{\text{Tshs } 173,000}{\text{Tshs } 425,000} \times 100 = 41\%$	$\frac{\text{Tshs } 51,200}{\text{Tshs } 80,000} \times 100 = 64\%$
Operating Profit Margin (W1)	$\frac{\text{Tshs } 80,300}{\text{Tshs } 425,000} \times 100 = 19\%$	$\frac{\text{Tshs } 33,120}{\text{Tshs } 80,000} \times 100 = 41\%$
Net Profit Margin	$\frac{\text{Tshs } 51,500}{\text{Tshs } 425,000} \times 100 = 12\%$	$\frac{\text{Tshs } 32,160}{\text{Tshs } 80,000} \times 100 = 40\%$
Selling Expenses : Sales	$\frac{\text{Tshs } 40,500}{\text{Tshs } 425,000} \times 100 = 10\%$	$\frac{\text{Tshs } 12,000}{\text{Tshs } 80,000} \times 100 = 15\%$
Administration Expenses : Sales	$\frac{\text{Tshs } 21,000}{\text{Tshs } 425,000} \times 100 = 5\%$	$\frac{\text{Tshs } 32,160}{\text{Tshs } 80,000} \times 100 = 2\%$
Activity ratios		
Asset Turnover	$\frac{\text{Tshs } 425,000}{\text{Tshs } 426,000} = 0.99 \text{ times}$	$\frac{\text{Tshs } 80,000}{\text{Tshs } 93,200} = 0.86 \text{ times}$
Return on Capital Employed ratios		
ROCE (W1)	$\frac{\text{Tshs } 80,300}{\text{Tshs } 399,020} \times 100 = 20\%$	$\frac{\text{Tshs } 33,120}{\text{Tshs } 90,320} \times 100 = 37\%$
Return on assets (W1)	$\frac{\text{Tshs } 80,300}{\text{Tshs } 426,920} \times 100 = 19\%$	$\frac{\text{Tshs } 33,120}{\text{Tshs } 93,200} \times 100 = 36\%$

Workings

W1 Operating profit (used for operating profit margin, ROCE, ROA)

	Tshs'000	Tshs'000
Gross profit	173,000	51,200
Selling expenses	(40,500)	(12,000)
Administration expenses	(21,000)	(1,440)
Depreciation	(31,200)	(4,640)
Operating profit	80,300	33,120

Answer to TY 11

- (a) The decline in Net Profit Margin can be attributed to a reduction in sales revenue or an increase in costs. The financial position of the company has suffered a setback, and this could lead to the eventual downfall of the company if this trend is not reversed. The decreased profitability has led to a decrease in the Return on Capital Employed. An increase in the Capital Gearing ratio suggests that there has been an increased dependence on long-term borrowings. An increase in interest costs on the increased borrowings could also be the cause of the decrease in profitability.
- (b) Yes, the answer would change. The fire is an extraordinary event which has led to losses that will not be repeated in the next year. The increase in the Capital Gearing ratio suggests that there has been an increase in dependence on long-term borrowings. This could be perhaps in order to rebuild / repurchase assets. Of course, the impact of a major fire can be felt for more than one year but the performance and financial position of the company could revive once again. The true assessment of how the company has fared in 20X6 can be made only if the loss – both actual and opportunity cost – can be quantified and adjustments are made for this.

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- (c) The differences between answers (a) and (b) show the inherent weaknesses of financial ratios in analysing the performance of a company.

The fire in the premises of the company in 20X6 is not a regular occurrence – hence the loss on account of fire is an extraordinary item. Allowances and adjustments for this extraordinary item are essential for a reliable measurement of the performance of the company.

Ratio analysis on its own is not able to pinpoint the effects of such extraordinary items. Hence a blind trust in financial ratios will lead to incorrect analysis, interpretations and decisions. It is absolutely essential to obtain all possible information and make requisite changes to the ratios which are to be analysed.

Answer to TY 12

PQR Plc Profit after tax = (1 - 0.30) x Tshs90 m = Tshs63 m

$$\text{Earnings per share (EPS)} = \frac{\text{Profit after tax}}{\text{Number of shares outstanding}} = \frac{\text{Tshs 63 million}}{10 \text{ million}} = \text{Tshs 6.3}$$

Share Value = EPS x P/E ratio = Tshs6.3 x 15 = Tshs94.5

Value of business = 100 million shares x Tshs94.5 = Tshs9,450 million.

Quick Quiz

Delete the wrong answer.

As a rule of thumb, it can be said that:

1. The lower the Gross Profit Margin, the **more / less** efficient is the performance of the company.
2. The higher the Dividend Cover, the **more / less** likely it is that a company will maintain its Dividend Yield.
3. The lower the Net Profit Margin, the **more / less** efficient is the performance of the company.
4. The lower the Current Ratio, the **more / less** liquid the business.
5. The higher the Operating Profit Margin the **more / less** efficient is the performance of the company.
6. The longer the Working Capital Cycle, the **more / less** liquid the business.
7. The higher the Inventory Turnover, the **more / less** quickly is inventory being sold.
8. The higher the Return on Capital Employed, the **more / less** efficiently the business is being managed in generating profits from the resources available.
9. The higher the Interest Cover, the better position the company **is / is not** in to pay the fixed charge of interest.
10. The higher the Return on Assets, the **more / less** efficiently the total assets are being managed in generating profits from the resources available.
11. The higher the Asset Turnover, the **more / less** efficiently are the assets being used to generate revenues.
12. The lower the Capital Gearing, the **more / less** geared is the company.
13. The lower the Price / Earnings ratio, the **more / less** confidence the shareholders will have in the ability of a company to increase the EPS, and the less risky the investment.
14. The lower the Dividend Yield, the **higher / lower** the return a shareholder expects from the shares he holds.

Answers to Quick Quiz

1. The lower the Gross Profit Margin, the ~~more~~/ **less** efficient is the performance of the company.
2. The higher the Dividend Cover, the **more** / ~~less~~ likely it is that a company will maintain its Dividend Yield.
3. The lower the Net Profit Margin, the ~~more~~/ **less** efficient is the performance of the company.
4. The lower the Current Ratio, the ~~more~~/ **less** liquid the business.
5. The higher the Operating Profit Margin, the **more** / ~~less~~ efficient is the performance of the company.
6. The longer the Working Capital Cycle, the ~~more~~/ **less** liquid the business.
7. The higher the Inventory Turnover, the **more** / ~~less~~ quickly is inventory being sold.
8. The higher the Return on Capital Employed, the **more** / ~~less~~ efficiently the business is being managed in generating profits from the resources available.
9. The higher the Interest Cover, the better position the company **is** / ~~is not~~ in to pay the fixed charge of interest.
10. The higher the Return on Assets, the **more** / ~~less~~ efficiently the total assets are being managed in generating profits from the resources available.
11. The higher the Asset Turnover, the **more** / ~~less~~ efficiently are the assets being used to generate revenues.
12. The lower the Capital Gearing, the ~~more~~/ **less** geared is the company.
13. The lower the Price / Earnings ratio, the ~~more~~/ **less** confidence the shareholders will have in the ability of a company to increase the EPS, and the less risky the investment.
14. The lower the Dividend Yield, the **higher**/ ~~lower~~ the return a shareholder expects from the shares he holds.

Self-Examination Questions

Question 1

Calculate all the accounting ratios discussed in this Study Guide for Shell Inc, using the figures below:

Statement of profit or loss of Shell Inc for the year ended 31 December 20X6

	Tshs'000	Tshs'000
Sales turnover		250,000
Cost of sales		(130,000)
Gross profit		120,000
Administrative expenses	20,000	
Selling and distribution expenses	25,000	
Net interest payable	8,000	(53,000)
Profit before tax		67,000
Tax		(20,100)
Profit after tax		46,900

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Statement of financial position at 31 December 20X6

	Tshs'000	Tshs'000
Non-current assets		
Tangible assets	411,750	411,750
Current assets		
Inventory	45,500	
Receivables	52,500	
Cash	5,250	103,250
Total assets		515,000
Equity and liabilities		
Ordinary share capital (200,000 shares of Tshs1000)	200,000	
10% non-redeemable preference shares	100,000	
Accumulated profits	55,000	355,000
Non-current liabilities		
Loans from banks	125,000	125,000
Current liabilities		
Payables	15,000	
Bank overdraft	20,000	35,000
Total equity and liabilities		515,000

The following additional information is available:

1. Earnings Per Share is Tshs46,900,000/200,000 shares = Tshs234.5
2. The market price of the shares is Tshs4,000
3. Credit sales equal 75% of total sales
4. Credit purchases equal 60% of total purchases
5. No dividend was declared during the year
6. Opening inventory is Tshs30,000,000

Question 2

Two companies Pineapple Co and Pear Co have approached Blue Chip Finance Co for loans.

Statement of profit or loss

	Pineapple Co		Pear Co	
	Year end 31/12/20X7	Year end 31/12/20X6	Year end 31/12/20X7	Year end 31/12/20X6
	Tshs million	Tshs million	Tshs million	Tshs million
Revenue	1,833	2,000	1,867	2,067
Cost of sales	(933)	(1,000)	(1,057)	(1,087)
Gross profit	900	1,000	810	980
Administration / selling expenses	(350)	(400)	(284)	(300)
PBIT	550	600	526	680
Interest	(60)	(67)	(73)	(73)
Income tax expense	(165)	(180)	(158)	(204)
Net profit	325	353	295	403
Dividends	(100)	(100)	(100)	(100)
Net profit	225	253	195	303

Statement of financial position

	Pineapple Co		Pear Co	
	As at 31/12/20X7	As at 31/12/20X6	As at 31/12/20X7	As at 31/12/20X6
	Tshs million	Tshs million	Tshs million	Tshs million
Non-current assets	2,050	2,000	1,586	1,517
Inventories	225	200	167	183
Trade receivables	248	267	267	300
Cash	20	33	50	50
	2,543	2,500	2,070	2,050
Issued share capital	500	500	367	367
Reserves	1,273	1,200	703	617
	1,773	1,700	1,070	984
Long-term borrowings	500	600	800	800
Current liabilities	270	200	200	266
	2,543	2,500	2,070	2,050

Required:

- (a) Blue Chip Co has asked you to go through the two sets of financial statements and advise as to which company is more creditworthy.
- (b) ‘Different categories of users consider and analyse only those ratios relevant to themselves’. Comment.

Question 3

Comment upon the working capital management of Penguin Inc on the basis of the ratios given below:

	Apple Inc	Industry average
Inventory Turnover	26 days	35 days
Receivable Days	35 days	30 days
Payable Days	25 days	28 days

Question 4

Star Ltd has an issued and subscribed capital of 600,000 equity shares of Tshs12,000 each, fully paid up. The company’s after tax profits for the year amount to Tshs79,800,000. The average present stock exchange price of the company’s share is Tshs2,000. The P/E ratios of the four listed companies to be used for calculation, whose businesses are of a similar type to Star Ltd are:

Company	20X7	20X8	20X9
P Ltd	6.8	7.6	8.4
Q Ltd	7.8	7.1	8.1
R Ltd	7.4	6.8	7.0
S Ltd	5.0	5.9	6.1

Required:

Calculate the valuation of the business and the valuation per share based on the average P/E ratio of the industry.

Answers to Self-Examination Questions
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Answer to SEQ 2**(a) Report on the relative creditworthiness of Pineapple Co and Pear Co**

An analysis of the financial statements leads to the following conclusions:

Pineapple Co

In spite of a marginal increase in the profitability ratios, there is a decline in Return on Capital Employed and Return on Assets. This, together with the fall in Asset Turnover, suggests that the capital and assets are not being used at their optimal level.

It has a low Capital Gearing ratio which has fallen further in 20X7. This low level of borrowings has led to a high Interest Cover a positive feature.

Pear Co

The reason for the increase in direct costs which has led to a considerable fall in the profitability ratios needs to be investigated. This fall in profitability has led to a fall in all the relevant ratios.

Capital gearing is less than 50%. Interest cover is adequate.

Comparison between the two companies

In spite of the fall in the profitability and its cascading effects on the accounts of Pear Co, it still has a better Return on capital employed and Return on assets than Pineapple Co.

Both companies have low capital gearing and high interest cover.

Conclusion:

If the cause of the fall in profitability of Pear Co can be identified and it can be ascertained that it has been controlled and will not lead to a further loss in the coming years, then Pear Co is more creditworthy than Pineapple Co.

If the 'cause' identified as the reason for fall in profitability cannot be controlled, then it would mean that the company's profitability might decline in the future as well. The profitability of Pineapple Co has remained stable and so, in the situation mentioned above, Pineapple Co would be more creditworthy than Pear Co.

Appendix 1: Calculation of ratios (ratios calculated in Tshs million)

	Pineapple Co		Pear Co	
	20X7	20X6	20X7	20X6
Return on capital employed ratios:				
Return on capital Employed	$\frac{550}{x 2,273}$ 100	$\frac{600}{2,300}$ x 100	$\frac{526}{x 1,870}$ 100	$\frac{680}{x 1,784}$ 100
	24.20%	26.09%	28.13%	38.12%
Return on assets	$x \frac{550}{100}$ 2,543	$\frac{600}{2,500}$ x 100	$x \frac{526}{2,070}$ 100	$x \frac{680}{2,050}$ 100
	21.63%	24.00%	25.41%	33.17%
Profitability ratios:				

Gross profit margin	$\frac{900}{2,067} \times 100$	$\frac{1,000}{2,000} \times 100$	$\frac{810}{1,867} \times 100$	$\frac{980}{2,067} \times 100$
	49.10%	50.00%	43.39%	47.41%
Operating profit Margin	$\frac{550}{2,067} \times 100$	$\frac{600}{2,000} \times 100$	$\frac{526}{1,867} \times 100$	$\frac{680}{2,067} \times 100$
	30.01%	30.00%	28.17%	32.90%
Net profit margin	$\frac{325}{2,067} \times 100$	$\frac{353}{2,000} \times 100$	$\frac{295}{1,867} \times 100$	$\frac{403}{2,067} \times 100$
	17.73%	17.65%	15.80%	19.50%
Activity ratios:				
Asset turnover	$\frac{1,833}{2,543}$	$\frac{2,000}{2,500}$	$\frac{1,867}{2,070}$	$\frac{2,067}{2,050}$
	0.72 times	0.80 times	0.91 times	1.01 times
Gearing ratios:				
Capital gearing	$\frac{500}{2,273} \times 100$	$\frac{600}{2,300} \times 100$	$\frac{800}{1,870} \times 100$	$\frac{800}{1,784} \times 100$
	22.00%	26.09%	42.78%	44.84%
Interest cover	$\frac{550}{60}$	$\frac{600}{67}$	$\frac{526}{73}$	$\frac{680}{73}$
	9.17 times	8.96 times	7.2 times	9.32 times

(b) ‘Different categories of users consider and analyse only those ratios relevant to themselves’.

A wide range of users depend upon the information contained in financial statements to make economic decisions. As the financial statements by themselves only present data, they have to be analysed. The tools used for these analyses are accounting ratios. The different categories of users have different reasons for which they require information. For instance, a prospective lender of funds would be concerned with the creditworthiness of the company; a prospective supplier will be bothered with its liquidity position.

A supplier would not be bothered about the interest cover that the company has to offer and the lender of funds would not be bothered about the Working Capital Cycle of the company. This is the reason why different categories of users consider and analyse only those ratios which are relevant to them.

Answer to SEQ 3

The Working Capital Cycle of Penguin Inc is 26 days + 35 days – 25 days = 36 days

The average Working Capital Cycle of the industry is 35 days + 30 days – 28 days = 37 days

This shows that Penguin Inc has a Working Capital Cycle which is of a slightly smaller duration than the industry average. This signifies that management is doing a good job of managing the working capital on a total basis. The Inventory Turnover and Payable Days are lesser than the industry average. Receivable Days are, however, higher than the industry norms. Management should try to get this down to the industry norms.

They also need to consider whether there have been any forced sales as Inventory Turnover is much lower than the industry average and Receivable Days are higher than the industry average.

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Answer to SEQ 4

Calculation of average P/E ratio of four listed companies

Company	20X7	20X8	20X9	Company Average
P Ltd	6.8	7.6	8.4	7.60
Q Ltd	7.8	7.1	8.1	7.67
R Ltd	7.4	6.8	7.0	7.07
S Ltd	5.0	5.9	6.1	5.67
Total				28.01

$$\text{Average P/E ratio} = \frac{28.01}{4} = 7$$

$$\text{Earnings per share} = \frac{\text{Profit after tax}}{\text{Number of equity shares}} = \frac{79,800,000}{600,000} = \text{Tshs } 133$$

$$\text{P/E ratio of Star Ltd} = \frac{\text{Market price per share}}{\text{Earnings per share}} = \frac{2,000}{133} = 5.03$$

$$\text{Value of share} = \text{Earnings per Share} \times \text{Average P/E ratio} = \text{Tshs}133 \times 7 = \text{Tshs}931$$

$$\text{Value of business} = \text{Total Earnings} \times \text{Average P/E ratio} = \text{Tshs}79.8 \text{ million} \times 7 = \text{Tshs}558.6 \text{ million}$$

