

Conceptual Framework

The need for a framework

What is meant by a conceptual framework of accounting

Accounting standards need to be built on a reliable set of concepts

It's an attempt to define the nature and purpose of accounting

It's a coherent and consistent foundation that will underpin the development of accounting standards

It's a statement of generally accepted accounting principles (GAAP) for evaluating existing practices and developing new ones

It's a theoretical basis for determining how transactions should be measured (historical value or current value) and reported

It's a basis for economic decision making

In summary it's...

a framework for setting accounting standards

a basis for resolving accounting disputes

fundamental principles which then do not have to be repeated in accounting standards

Who else is the framework useful to?

1. Auditors
2. Users of accounts
3. Anyone interested in how IFRS's are formulated

The Framework is NOT an accounting standard, and if there's a conflict between the two then the IFRS wins

Is there an alternative system?

Simply, Yes. A rules-based system

WITHOUT a principles based conceptual framework

The following happens..

1. Inconsistent standards
2. Standards produced on a "fire fighting" basis
(Being reactive rather than proactive)
3. Standard setting bodies were biased in their membership
4. Same theoretical issues repeated each time a problem comes up

Having no framework led to 'rules- based' accounting systems

Such a system is very prescriptive and inflexible, though also the accounts are then more comparable and consistent.

The fundamental concepts


What is meant by relevance and faithful representation?

The Framework differentiates between fundamental and enhancing information characteristics

woah! What?!

Fundamental qualitative characteristics


For information to be useful, it must be both relevant and faithfully represented



Relevance

Faithful representation

Enhancing qualitative characteristics



Comparability (including consistency)

Timeliness

Verifiability

Understandability

Faithful Representation

Accounts must represent faithfully the phenomena it purports to represent

Faithful Representation means..

Substance over form

Faithful representation means capturing the real substance of the matter

Represents the economic phenomena

Faithful means an agreement between the accounting treatment and the economic phenomena they represent

The accounts are verifiable and neutral

Completeness, Neutrality & Verifiability

Examples

Sell and buy back = Loan

An entity may sell some inventory to a finance house and later buy it back at a price based on the original selling price plus a pre-determined percentage. Such a transaction is really a secured loan plus interest. To show it as a sale would not be a faithful representation of the transaction.



Convertible Loans

Another example is that an entity may issue convertible loan notes. Management may argue that, as they expect the loan note to be converted into equity, the loan should be treated as equity. They would try to argue this as their gearing ratio would then improve. However, it is recorded as a loan as primarily this is what it is.

As noted previously, simply following rules in accounting standards can provide for treatment which is essentially form over substance. Whereas, users of accounts want the substance over form.

The concept behind faithful representation should enable creators of financial statements to faithfully represent everything through measures and descriptions above and beyond that in the accounting standard if necessary.

Limitations to Faithful Representation

1. Inherent uncertainties
2. Estimates
3. Assumptions

Relevance

Relevant information influences the economic decisions of the user

Has Predictive value and/or Confirmatory value

So users can assess the entity ability to..

1. Take advantage of opportunities
2. React to adverse situations
3. eg. Discontinued operations separated from continuing on the income statement

Materiality

This is not a matter to be considered by standard-setters but by preparers of accounts and their auditors

A 'true and fair' override

If compliance with an IFRS would be misleading, then compliance not

needed

This is called the "true & fair" override - by not following standards the accounts are true and fair

This would only happen in **extremely rare** circumstances

The entity should disclose:

IFRSs complied with except where it has departed in order to achieve a fair presentation

The IFRS departed from

An explanation and financial effect

Enhancing Qualitative Characteristics

Comparability

Comparability is fundamental to assessing the performance of an entity

Analysing trends needs the accounts to have been prepared on a comparable (consistent) basis

Comparability is improved by:

Consistent accounting policies

Different policies may be necessary though to be more relevant and reliable

Verifiability, Timeliness & Understandability

These should be maximised both individually and in combination

Let's look in more detail..

Verifiable

This allows independent observers to agree that a transaction is faithfully represented

Timely

Timeliness means that information is available to decision-makers in time to be capable of influencing their decisions

Understandable

Understandability is enhanced when the information is:

1. classified
2. characterised
3. presented clearly and concisely

Complex info is not left out just because it is hard to understand

If it is relevant..it's relevant!

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information with diligence

Changes in accounting policies and accounting estimates

Comparatives are changed for accounting POLICY changes only

Changes in accounting estimates have no effect on the comparative

Changes in accounting policy means we must change the comparative too to ensure we keep the accounts comparable for trend analysis

Accounting Policy

Definition

"the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting the financial statements"

An entity should follow accounting standards when deciding its accounting policies

If there is no guidance in the standards, management should use the most relevant and reliable policy

Changes to Accounting Policy

These are only made if:

It is required by a Standard or Interpretation; or

It would give more relevant and reliable information

1. **Adjust the comparative amounts** for the affected item

(as if the policy had always been applied)

2. **Adjust Opening retained earnings**

(Show this in statement of changes in Equity too)

Accounting Estimates

Definition

"an adjustment of the carrying amount of an asset or liability, or related expense, resulting from reassessing the expected future benefits and obligations associated with that asset or liability"

Examples

Allowances for doubtful debts;
Inventory obsolescence;
Charge the useful economic life of property, plant and equipment

Changes in Accounting Estimate

1. **Simply change the current year**
2. **No change to comparatives**

Prior Period Errors

These are accounted for in the same way as changes in accounting policy

Accounting treatment

1. **Adjust the comparative amounts** for the affected item
2. **Adjust Opening retained earnings**

2. Adjust Opening retained earnings

(Show this in statement of changes in Equity too)

Recognition and measurement

Criteria for recognition

"Recognised" means brought into the accounts

When can something be recognised in the accounts?

All 3 tests must be passed

Meet the definition of an asset/liability or income/expense or equity

It is probable that any future economic benefit will flow to or from the entity

The item has a cost or value that can be **reliably measured**

Recognising an Asset

Definition

A resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the entity

to the entity

Assets can be recognised when:

1. It is controlled (definition)
2. Probable benefits
3. Reliable measure of cost & benefits

Recognising a Liability

Definition

A present obligation of the enterprise arising from past events, expected to result in an outflow of resources

Liabilities can be recognised when:

1. There's a present obligation (definition)
2. It's probable
3. There's a reliable measure

Recognising Income

Definition

Increases in assets (or decreases of liabilities)

(that result in increases in equity, other than contributions from equity participants)

Income from normal activities

Recognised in the Statement of Profit or Loss and other Comprehensive Income

Some items recognised directly in Equity

Eg. revaluation gains on assets

In these circumstances the income (gain) is then also reported in the OCI. (Other Comprehensive Income section of the Statement of Profit or Loss and other Comprehensive Income)

Recognising Expenses

Definition

Decreases in assets or (incurrences of liabilities)

(that result in decreases in equity, other than distributions to equity participants)

Normally recognised in the Income statement

Most expenses are recognised in the Statement of Profit or Loss section of the Statement of Profit or Loss and Comprehensive Income

Some expenses are reported directly in Equity and OCI

Eg. an impairment loss, on a previously revalued asset, that does not exceed the balance of its Revaluation Reserve

Revenue Recognition - When

Right, the first thing you need to worry about when given a question about revenue is WHEN do we actually show this revenue in the accounts?

Is it when we invoice? When we deliver? When we receive the cash?

Well, firstly (and this comes from the 'recognition' chapter of the conceptual framework) you need to ensure that:

2 tests need to be passed as normal

1. It is **probable** that future economic benefits will flow to the entity and
2. These benefits can be **measured reliably**

Sale of Goods

In addition to 1 and 2 above, revenue from sale of goods can only be recognised when the majority of the risks and rewards have been transferred and you have no more managerial control

Notice how you only need control not ownership to be transferred - this is an example of substance over form

You need to pass 4 tests to recognise revenue from the sale of goods:

1. Probable Future Benefits

2. The goods have been transferred

2. These can be reliably measured

3. (Majority of) Risks and rewards transferred

4. No managerial control

Breaking Down a transaction

These recognition criteria in this Standard are usually applied separately to each transaction.

However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed.

Aggregating separate transactions

Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Sale of Services

These are recognised as the service completes and again only when the revenue is probable and reliably measurable:

So the revenue from a service is recognised when:

1. Percentage Complete

2. Probable Economic Benefits

3. Reliable Measure of Economic Benefits

The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered.

The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period.

When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable

Interest, Royalties, and Dividends

For interest, royalties and dividends, provided that it is probable that the economic benefits will flow to the enterprise and the amount of revenue can be measured reliably, revenue should be recognised as follows:

Interest

Use the effective interest method as set out in IAS 39

Royalties

On an accruals basis in accordance with the substance of the relevant agreement

Dividends

When the shareholder's right to receive payment is established

Revenue recognition - how much

We should recognise revenue at its FAIR VALUE

This is normally the **amount received**, and this is generally the case

Fair value

is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms length transaction

General Rule

1. Selling Price less
2. Trade discounts less
3. Volume discounts

Commission

If you're an agent then just show the commission you receive not the full selling price

Deferred Consideration

Here the Fair value is the Present Value

The basic idea here is that you discount the future cash down to today's present value and this is the amount that goes to sales (step 1)

Step 2: This receivable is a discounted figure. All discounted figures need to be unwound. We do this through interest always (paid or received)

1. Dr Receivable (PV of future cash to be received)
Cr Sales (PV of future cash)
2. Dr Receivables
Cr Interest Receivable (I/S)

Cr Interest Receivable (I/S)

Each year

Interest Free Credit

The revenue receivable has two separate elements:

- The fair value of the goods on the date of sale
- Financing income

1. Dr Receivable (Selling price of item)
Cr Sales

2. Dr Receivables
Cr Interest Receivable (I/S)

Each year with the imputed interest rate

Illustration

A farmer shamefully sells cows, oh the pain... He asks for a 20% deposit at the start and the full balance is due after two years. The price of the cow is calculated using a 10% per annum finance charge.

A cow is sold to a customer for £10,000. (So very cheap for the king of all animals)

How should the revenue should be recognised?

Sale of Cow (£2,000 + £6,611 (W))

Financing income (£6,611 (W) × 10%)

Carrying amount of receivable (£6,611 (W) × 1.10)

WORKING

The deposit is £2,000 (£10,000 × 20%), so the amount receivable in two years is £8,000. This is discounted at 10% for two years to £6,611 (£8,000 × $1/1.10^2$).

Goods and services provided in one contract

For example you could buy a car with free servicing thrown in for a couple of years

Here - you need to split the value of the selling price into the 2 components - then treat them like they are being sold separately:

Illustration

A car dealer sells a new car, together with one year's servicing, for £20,000. The fair values of these components are: car £18,000, Servicing 4,000

So here it seems that a 10% discount has been offered so the car sale becomes - 16,400 and the servicing 3,600

The car sale is then recognised immediately and the servicing as the year progresses

Other Measures

Historic Cost

The amount paid or fair value of the consideration given

Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Current Cost

The amount that would have to be paid if the same or an equivalent asset was acquired currently

Net realisable value

The amount that could currently be obtained by selling the asset, net of the estimated selling and completion costs

Present value of future cash flows

The present discounted value of the future net cash inflows that the item is expected to generate

Please make sure you try the quiz on this bad boy - it will make a lot more sense afterwards ... :)

Fair Value

Fair value considers the characteristics of the asset

For example

The condition and location of an asset

Any restrictions on the sale or use of an asset

This means that when revaluing its property, plant and equipment, an entity should consider:

the **highest and best use** of the assets

Fair value assumes the sales takes place in:

The Principal market

the market with greatest volume and level of activity for the asset or liability

The most advantageous market

The market that maximises the amount that would be received paid for the asset

Valuation Techniques

Market approach

Prices from similar market transactions

e.g. quoted prices of listed equity, debt securities or futures, or market interest rates

Income approach

This converts future cash flows to a single discounted amount; e.g. discounted cash flow models and option pricing models

Cost approach

This reflects the amount required currently to replace the service capacity of an asset, i.e. the current replacement cost

When measuring fair value, an entity is required to maximise the use of relevant observable inputs and minimise the use of unobservable inputs

	Level 1	Level 2	Level 3
Definition	Quoted prices in active markets for identical assets or liabilities	Observable inputs	Unobservable inputs
Example	Share prices on a stock exchange	Current market rents for similar properties and market interest rates for the FV of an investment property	Projected cash flows used to value a none public business

How does all this work in practice?

E.g. An entity owns 10,000 ordinary shares in M & S

Since there is an active market for these shares through the London stock exchange, the entity must use a market approach (level 1 input).

However, the measurement of the fair value of an unlisted debt security may require the use of an income approach, e.g. a discounted cash flow model using market interest rate for similar debt securities (level 2 input) and market credit spreads adjusted for entity-specific credit risk (level 2 or 3 inputs).

The legal versus the commercial view of accounting

Faithful and Reliable accounts

Accounts should show a faithful and reliable representation

To do this sometimes you need to show the substance of a transaction rather than its legal form

For example, if you 'sell' an asset but still enjoy its benefits, then this probably isn't a true sale in reality (in all probability this is a loan - see later).

How do you know if substance is not the same as form?

Well it usually is - but look for..

Where control differs from ownership of an asset

Where items are sold at NOT fair value

Where there's an extra "option" in the agreement

Where this is any "extra" attachment to an agreement

This is called a linked transaction

Consignment Stock

Also known as goods on sale or return basis

The issue here is who CONTROLS the stock in substance - you need to know whose stock it is

Find out who takes the majority of the following risks..

If the stock becomes obsolete

If stock is slow to sell

Illustration

You sell goods to me.

If I don't sell the goods I return them to you for a refund

Solution

The stock is yours because you take the risks:

1) Obsolescence - If they don't sell I send them back to you for a refund

Factoring of Receivables

Here we sell our debtors to a factor in return for cash

But again we need to look to see whose debtors they really are (have i really sold them in substance) by looking at who keeps the majority of the risks...

Receivables Risks

Risk of bad debt

Risk of slow paying debtors

Illustration

You sell me your debtors but we have the following agreement:

- 1) If the debts go bad - I return them to you for a refund
- 2) You pay me 2% interest a month on all debtors who don't pay me immediately

Solution

You have not sold the debtors because you keep both the bad debt risk and slow paying risk (you pay me interest on o/S debtors)

Therefore you do not have a sale you have a payable loan to me

This loan gets repaid as the debtors pay me

Sale and Buy back

For a sale of goods you need to have transferred the majority of the risks and rewards

here look at the rewards.. who gets the majority of the benefits of the asset

If you make this sale and then buy it back - then you have probably kept the majority of the rewards and so not sold the asset

instead, again, it is a loan

Alternative models and practices

Advantages and disadvantages of historical cost accounting

Advantages of Historical Cost Accounting

Advantages

1. Cost is known and can be checked to an invoice
2. Enhances comparability
3. Leads to stable, non-volatile pricing

Disadvantages of Historical Cost Accounting

Disadvantage

1. Non-current asset values become quickly out of date
2. Depreciation charge is unrealistically low
3. Lower costs lead to higher profits - which may lead to too high dividends in real terms
4. Comparisons over time are impossible
5. Users are often interested in current values not past e.g. security on loan

Current Cost accounting

Provides more realistic book values by valuing assets at current replacement cost

It is usually calculated by adjusting the historical cost for inflation.

The current operating profit is considered to be more relevant to many decisions such as dividend distribution, employee wage claims and even as a basis for taxation

The problems that current cost accounting (and other approaches to accounting for inflation) attempt to solve are obviously linked to inflation.

In practical terms, it can be very difficult to determine the current value of assets. It is often subjective and complex.

Financial and Physical capital maintenance

These 2 look at maintaining financial or operating balances

Financial capital maintenance

Profit is when..

1. Money net assets at end > Money net assets at start
2. Can be measured using purchasing power
3. Takes into account inflation

Physical capital maintenance

Profit is when..

1. Physical operating capability at end > Physical operating capability at start

Regulatory Framework

Why have a regulatory framework?

Why regulation is needed

A regulatory framework is needed to ensure relevant and reliable information is given to users

A regulatory framework regulates the behaviour of companies towards their investors

They increase users' understanding of, and their confidence, in financial statements

Benefits of adopting IFRS

They are high-quality and transparent global standards that are intended to achieve consistency and comparability

Companies that use IFRS and have their financial statements audited in accordance with International Standards on Auditing (ISA) will have an enhanced status and reputation

The International Organisation of Securities Commissions (IOSCO) recognise IFRS for listing purposes

Thus companies that use IFRS need produce only one set of financial statements for any securities listing for countries that are members of IOSCO.

Companies that own foreign subsidiaries will find the process of consolidation simplified if all their subsidiaries use IFRS

Companies that use IFRS will find their results are more easily compared with those of other companies that use IFRS

This would help the company to better assess and rank prospective investments in its foreign trading partners

What are the challenges of adopting IFRS to national standards?

1. Laws and regulations

2. IFRS training to finance staff and regulators
3. Greater complexity in the financial reporting process

Not for profit entities

Not-for-profit organisations are distinguished from profit maximising organisations by three characteristics

These are:

They don't have shareholders giving them money

Finance is mainly limited to donations and government subsidies

Any profits are kept in the business (not given away as a dividend)

Their aims have a greater social, cultural, philanthropic, welfare or environmental dimension

Accounting standards are required to measure the financial position and performance of organisations

Not-for-profit and public sector entities do not have to produce financial statements for the public but they will have to account for their income and costs.

Particular attention is paid to:

1. Effectiveness

Are the objectives reached?

2. Economy

Optimal use of resources

(keeping the cost of input resources as low as possible, but to a given standard)

3. **Efficiency**

the 'output' per unit of resource consumed

Some standards will be relevant such as those relating to non-current assets, inventories, leasing, etc. but others, e.g. earnings per share, are not so relevant

Standard Setting

IFRS, IASB etc

The IFRS Foundation

The IFRS Foundation, formerly known as IASC Foundation, is an independent, not-for profit private sector organisation working in the public interest

Its principal objectives are:

to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs) through its standard-setting body, the IASB;

to promote the use and rigorous application of those standards;

to take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs); and

to bring about convergence of national accounting standards and IFRSs to high quality solutions

The International Accounting Standards Board (IASB)

Objectives

It sets the accounting standards

It is made up of 15 full-time members of different nationalities and backgrounds (auditors, users of accounts and academics)

It is responsible for the development and publication of IFRSs, including the IFRS for SMEs and for approving Interpretations of IFRSs as developed by the IFRS Interpretations Committee

The IFRS Advisory Council (IFRS AC)

The IFRS AC, which was previously called the Standards Advisory Council, is the formal advisory body to the IASB and the Trustees of the IFRS Foundation

Objectives

to advise the IASB on range of issues, including the IASB's agenda and work programme

to provide advice on single projects with a particular emphasis on practical application and implementation issues

Structure

comprised of a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups that are affected by and interested in the IASB's work

these members are appointed by the Trustees

these members are appointed by the Trustees

The IFRS Interpretations Committee (IFRS IC)

The IFRS IC, previously known as the International Financial Reporting Interpretations Committee, is the interpretative body of the IASB

Objectives

to review on a timely basis widespread accounting issues that have arisen within the context of current IFRSs

to review on a timely basis widespread accounting issues that have arisen within the context of current IFRSs

Structure

comprises 14 voting members drawn from a variety of countries and professional backgrounds

are appointed by the Trustees and are selected for their ability to maintain an awareness of current issues as they arise and the technical ability to resolve them

Standard Setting Process

International Financial Reporting Standards (IFRSs) are developed through an international consultation process, the "due process".

The due process comprises six stages:

1. **Setting the agenda**

The IASB identifies a subject (mainly by reference to the needs of the investors)

2. **Planning the project**

After considering the nature of the issues and the level of interest among constituents, the IASB may establish a working group at this stage

3. **Developing and publishing the discussion paper**

4. **Developing and publishing the exposure draft**

for public comment, which is a draft version of the intended standard

5. **Developing and publishing the standard**

6. After the standard is issued, the staff and the IASB members **hold regular meetings with interested parties**, to help understand unanticipated issues related to the practical implementation and potential impact of its proposals

National standard setters and the IASB

The IASB works in partnership with the major national standard-setting bodies:-

They do this by:

Co-ordinating each others work plans

Review each others standards

National standard setters can issue IASB discussion papers and exposure draft for comments in their own countries

National standard setters may include more guidance in their exposure drafts on relevant issues to them

Financial Statements

Tangible non-current assets

Initial Cost of PPE

When should we bring PPE into the accounts?

When the following 3 tests are passed:

1. When we control the asset
2. When it's probable that we will get future economic benefits
3. When the asset's cost can be measured reliably

What gets included in 'Cost'

1. **Directly attributable costs** to get it to work and where it needs to be

eg. site preparation, delivery and handling, installation

2. **Estimated cost of obligatory dismantling the asset at the end**

This is:

Dr PPE

Cr Liability

All at present value

3. **Borrowing costs**

If it is an asset that takes a while to construct

Let's look at the last 2 in further detail..

Future obligated costs

Dr PPE
Cr Liability

at present value

The present value is calculated by discounting down at the rate given in the exam

eg. 100 in 2 years time at 10% = $100/1.10/1.10 = 82.6$

So the double entry would be:

Dr PPE 82.6
Cr Liability 82.6

However the LIABILITY needs unwinding..

Unwinding of discount

Dr Interest
Cr Liability

Use the original discount rate (so here 10%)

$10\% \times 82.6 = 8.26$

Dr Interest 8.26
Cr Liability 8.26

Borrowing costs

Must be a qualifying asset - that means the asset takes a "substantial period to build"

Interestingly if the loan and asset is big enough this may only be a few months

So instead of taking interest to the I/S as an expense you add it to the cost of the qualifying asset

There are 2 scenarios here to worry about:

- 1) You **use current borrowings** to pay for the asset
- 2) You **get a specific loan** for the asset

Lets look at these 2 now..

Use current borrowings

Here you need then to get the weighted average of those borrowings and use this as the interest rate

(I know you're thinking - how the cowing'eck do I work out the weighted average of borrowings... aaarrgghh!)

Well relax my little monkey armpit - here's how you do it..

1. Calculate the total amount of borrowings
2. Calculate the interest payable on these in total
3. Divide the interest by the borrowing - et voila!

Illustration

5% Overdraft 1,000

8% Loan 3,000

10% Loan 2,000

We buy an asset with a cost of 5,000 and it takes one year to build - **how much interest goes to the cost of the asset?**

Calculate the WA cost of the borrowings:

1) Total Borrowing = $(1,000 + 3,000 + 2,000) = 6,000$

2) Interest payable = $(50 + 240 + 200) = 490$

3) $490 / 6,000 = 8.17\%$

So the total interest to be added to the asset is $8.17\% \times 5,000 = 408$

Get a specific loan

Use the specific interest rate - but be careful of any interest received too

We must only add to the cost the net interest

Calculate the interest paid on the specific loan

Calculate any interest received on loans proceeds not used

Add the net of these 2 to 'cost of the asset'

Illustration

Buy asset for 2,000 - takes 2 years to build. Get a 2,000 10% loan. We reinvest any money not used in an 8% deposit account. In year 1 we spend 1,200. How much interest is added to the cost of the asset?

Interest Paid = $2,000 \times 10\% = 200$

Interest received = $((2,000 - 1,200) \times 8\%) = 64$

Dr

PPE Cost (200-64) = 136

Cr

Interest Accrual

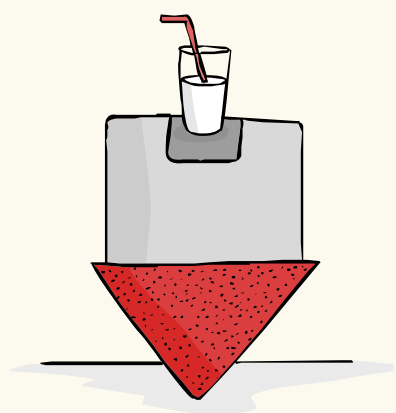
Borrowing costs can only start to be added to the cost **after** the following 3 conditions are met:

Borrowing costs actually incurred

Activities started (e.g. planning permission etc)

Expenses on asset started

The interest must stop being added to the asset when there is a substantial delay in work and also when the asset is substantially complete



The special case of an asset with a component included with a totally different UEL

This could be something like Land and buildings - basically you should take the land value away from the total cost and then depreciate the remainder over the UEL of the building

Illustration

Buy House for 100,000. The land has a value of 40,000. UEL of building is 10 years

Depreciation would be:

Land 40,000 - zero depreciation

Building 60,000 - 6,000 depreciation

PPE - After Initial recognition

After the initial recognition there are 2 choices..

Cost model

Cost less accumulated depreciation and impairment

Depreciation should begin when ready for use not wait until actually used

Revaluation model

Fair value at the date of revaluation less depreciation

Revaluations should be carried out regularly

For volatile items this will be annually

For others between 3-5 years or less if deemed necessary.

If an item is revalued, its entire class of assets should be revalued

Market value normally is fair value.

Specialised properties will be revalued to their depreciated replacement cost

Accounting treatment of a Revaluation

An Increase (above depreciated historic cost)

Dr Asset

1. Credit equity - "revaluation surplus"
2. Also show in the OCI

A decrease down to Historic cost

Credit asset

1. Debit equity - "revaluation surplus"
2. Also show in the OCI

A decrease below historic cost

Credit asset

1. Debit Income statement

Disposal of a Revalued Asset

The revaluation surplus in equity - IS NOT transferred to the income statement - it just drops into RE

It will, therefore, only show up in the statement of changes in equity

Lets make no mistake about this - the revaluation adjustments can be very tricky. This is because, when you revalue upwards, the asset will increase and hence the depreciation will increase. This means smaller profits and smaller retained earnings just because of the revaluation!

Shareholders will not be impressed by this as retained earnings is where they are legally allowed to get their dividends from. Because of this, a transfer is made out of the revaluation reserve and into retained earnings every year with the extra depreciation caused by the previous revaluation

This, though, then causes more problems if the asset is subsequently impaired etc - but worry not - the COW has the answer!

This is what you do in a tricky looking revaluation question:

1) Calculate the Depreciated Historic Cost

This is basically what the asset would have been worth had nothing (revaluations/impairments) occurred in the past. We do this because anything above this figure is a genuine revaluation and so goes to the RR. Similarly anything below this is a genuine impairment and goes to the income statement

2) Calculate the NBV just before the Revaluation or Impairment in question

3) Now calculate the difference between step 2 and the new NBV (the amount to be revalued or impaired to).

This will be the debit or credit to the asset. The other side of the entry will depend on the depreciated historic cost calculated in step 1

I know all that sounds tricky - so let's look at an illustration

Illustration

An asset is bought for 1,000 (10yr UEL). 2 years later it is revalued to 1,000. One year after that it is impaired to 400.

What is the double entry for this impairment?

Step 1: DHC would be 1,000 less 3 years of depreciation = 700

Step 2: NBV at date of impairment = 1000 NBV one year earlier. So 1,000 less depreciation of $(1,000 / 8) = 125 = 875$

Step 3: Impair to 400.

So from 875 to 400 - credit Asset 475

Dr RR with any amount above the DHC of 700. So $875 - 700 = 175$

Dr I/S with any amount below DHC of 700. So $700 - 400 = 300$

Dr I/S 300

Dr RR 175

Cr PPE 475

Componentisation

Various components of an asset to be identified and depreciated separately if they have differing patterns of benefits

If a significant component is expected to wear out quicker than the overall asset, it is depreciated over a shorter period

Then any restoring or replacing is capitalised

This approach means different depreciation periods for different components

Examples are land, roof, walls, boilers and lifts.

So the depreciation reflects the effect of a future restoration or replacement

A challenging process

due to..

Difficulties valuing components

because it is unusual for the various component parts to be valued, so..

- Involve company personnel in the analysis

- Applying component accounting to all assets

- How far the asset should be broken down into components

- Any measure used to determine components is subjective

Asset registers may need to be rewritten

Breaking down assets needs 'materiality', setting a de minimis limit

When a component is replaced or restored

The old component is derecognised to avoid double-counting and the new component recognised

Where it is not possible to determine the carrying amount of the replaced part of an item of PPE

best estimates are required

A possibility is..

Use the replacement cost of the component, adjusted for any subsequent depreciation and impairment

A revaluation

apportion over the significant components

When a component is replaced

1. The carrying value of the component replaced should be charged to the income statement
2. The cost of the new component recognised in the statement of financial position

Transition to IFRS

Use the 'fair value as deemed cost' for the asset

The fair value is then allocated to the different significant parts of the asset

Componentisation adds to subjectivity

The additional depreciation charge can be significant.

Accountants and other professionals must use their professional judgment when establishing significance levels, assessing the useful lives of components and apportioning asset values over recognised components.

Discussions with external auditors will be key during this process.

Government Grants Part 1

Government grants are a form of government assistance

However, IAS 20 does not apply to the following situations:

Any **'tax breaks**
,

Government acting as **part-owner**
of the entity

Free technical or marketing **advice**

When can you recognise a government grant?

When there is reasonable assurance that:

The entity will comply with any conditions attached to the grant

The entity will comply with any conditions attached to the grant

A recognition based on a form of government grant

There are 2 approaches - depending on what the grant is given for:

Capital Grant approach:

(For Assets)

Recognise the grant outside profit or loss initially

Income Grant approach:

(For expenses)

Recognise the grant in profit or loss

Capital Grant approach

There are 2 methods for this approach..

Dr Cash

Cr Asset Cost or...

Cr Deferred Income

Then take this deferred income to the income statement as the asset depreciates and in the same proportion (Dr Deferred Income Cr Income statement)

That's all I'll say here as it is best seen visually and practically in the video :)

Income Grant approach

Dr Cash

Cr Other income or

Cr the expense to which it relates

Investment property Part 1

A building (or land) owned but not used – just an investment

The building is not used it just makes cash by:

- 1) its FV going up (capital appreciation) or
- 2) from rental income

Accounting treatment for the Rental Income

1. Add it to the income statement
2. Easy! (Even for a gonk like you!) :p

Accounting treatment for the FV increase

The difference in FV each year goes to the I/S

Double easy - double gonky

No depreciation is needed because it's not used :)

Give me examples of what can be Investment Properties

Ok you asked for it..

Land held for **long-term capital appreciation** rather than short-term sale

Land held for a currently **undetermined future use**

This basically means they haven't yet decided what to do with the land

A building owned but leased to a third party under an operating lease

A building which is vacant but is held to be leased out under an operating lease

Property being constructed or developed for future use as an investment property

Ok smarty pants - what ISN'T an Investment property?

Property intended for sale in the **ordinary** course of business

(It's stock!)

Owner-occupied property

Property leased to another entity under a finance lease

Can a property be part IAS 40 Investment property and part normal IAS 16 property?

Mais oui, monsieur/madame - For example, head office on one floor and rent out the rest. If the rest *can be sold separately* then they can be treated as an investment property.

Can it still be an IAS 40 Investment property if we are involved in the building still by giving services to it?

Involved in the building still by giving services to it.

Si Claro hombre/mujer - It's still an IAS 40 Investment property if the **supply is small and insignificant**. If it's a significant part of the deal with the tenant then the property becomes an IAS 16 property

What if my subsidiary uses it but I don't?

Right ok - now your questions are getting on my nerves... but still - it's an IAS 40 Investment property in your own individual accounts - because you personally are not using it.

However, in the group accounts its an IAS 16 property because someone in the group is using it..

..now enough of the questions already.. get back to [facebook](#) ..

IAS 36 Impairments

An asset is impaired when book value is higher than recoverable amount

What is Recoverable Amount?

Well you have to choices with an asset - you can either:

Sell or Use..

So, you'll choose the higher of the following

FV-CTS

(Fair value less costs to sell)

VIU

(Value in use)

Here's some boring definitions for you..

Fair value

The amount obtainable from the sale of an asset in a bargained transaction between knowledgeable, willing parties.

Value in use

The discounted present value of estimated future cash flows expected to arise from:

the continuing use of an asset, and from

its disposal at the end of its useful life

Identifying an Asset That May Be Impaired

If there is an indication that an asset may be impaired, then you must calculate the asset's recoverable amount... to see if it is below carrying value

if it is - then you must impair it

Illustration

Asset has carrying value of 100

It has a FV-CTS of 90

It has a VIU of 95

It's recoverable amount is therefore the higher of the 2 = 95 and this is below the carrying value in the books and so needs impairment of 5

What are the indicators of impairment?

Losses / worse economic performance

Market value declines

Obsolescence or physical damage

Changes in technology, markets, economy, or laws

Increases in market interest rates

Loss of key employees

Restructuring / re-organisation

Just to confuse you a little bit more, we do not JUST check for impairment when there has been an indicator (listed above). We also check the following ANNUALLY regardless of whether there has been an impairment indicator or not...

an intangible asset with an indefinite useful life.

an intangible asset not yet available for use.

goodwill acquired in a business combination

Let's look at VIU in more detail..

The future cash flows..

Must be based on supportable assumptions

Should normally not go beyond five years

Relate to the asset in its **current** condition

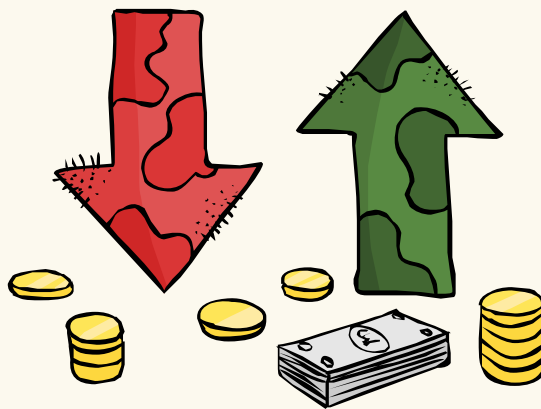
Should not include cash from financing activities, or income tax

The discount rate used should be the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset

For impairment of an individual asset

The discount rate is the rate the company would pay in a current market transaction to borrow money to buy that specific asset or portfolio.

If a market-determined asset-specific rate is not available, a surrogate must be used that reflects the time value of money over the asset's life as well as country risk, currency risk, price risk, and cash flow risk.



Reversal of Impairments

These are allowable up to the depreciated historic cost

However, IAS 36 requires an assessment at each balance sheet date whether there is an indication that an impairment loss may have decreased. This does not apply to goodwill or to the unwinding of the discount.

Cash Generating Units

CGU is the smallest identifiable group of assets that generates cash inflows

Take the example of a restaurant, the assets on their own do not generate cash, but all together they do. We call the restaurant as a whole a CGU

Where an asset forms part of a CGU, any impairment review must be made on the GROUP of assets as a whole

How should this impairment loss be allocated? This will be described in the following section.. so be patient you

How should an impairment loss be allocated?

The impairment loss is allocated to reduce the carrying amount of the assets of the unit in the following order:

- Reduce the carrying amount of goodwill (allocated to the CGU)
- Reduce the carrying amounts of the other assets of the unit pro rata

Illustration

The following carrying amounts were recorded in the books of a restaurant immediately prior to the impairment: -

Goodwill	100
Property, plant and equipment	100
Furniture and fixtures	100

The fair value less costs to sell of these assets is \$260m whereas the value in use is \$270m

Required:- Show the impact of the impairment

Solution

Recoverable amount is 270 - so the CV of the CGU needs to be reduced from 300 to 270 = 30

This 30 reduces goodwill down to 70

Intangible non current assets

What is an intangible asset

What is an Intangible asset?

Well, according to IAS 38, it's an **identifiable** non-monetary asset without physical substance, such as a licence, patent or trademark.

Whooah there partner, whats identifiable mean??

Well it just means the asset is one of 2 things:

1. It is SEPARABLE, meaning it can be sold or rented to another party on its own (rather than as part of a business) or
2. It arises from contractual or other legal rights.

It is the lack of identifiability which prevents internally generated goodwill being recognised . It is not separable and does not arise from contractual or other legal rights.

Examples

Employees can never be recognised as an asset; they are not under the control of the employer, are not separable and do not arise from legal rights

A taxi licence can be an intangible asset as they are controlled, can be sold/exchanged/transferred and arise from a legal right

right

(The intangible doesn't have to be separable AND arise from a legal right, just one or the other is enough)

When can you recognise an IA and for how much?

Well it's the old reliably measurable and probable again!

In posher terms...

1. When it is probable that future economic benefits attributable to the asset will flow to the entity
2. The cost of the asset can be measured reliably

Worthwhile pointing out here that the probability criteria mentioned above is ALWAYS satisfied for a separately acquired intangible, because the cost will reflect that probability the more probable the benefits, the higher the cost

So at how much should we show the asset at initially?

Well thick pants - it's obviously brought in at cost!! Aaarh but what is cost I hear you whisper in my big floppy cow-like ears.. well it's

Purchase price plus directly attributable costs

Remember that the directly attributable costs are the costs that are directly attributable to the asset at the time of acquisition

Remember that directly attributable means costs which otherwise would not have been paid, so often start costs are excluded

If the intangible came with a subsidiary we bought

Well this time, the intangible asset (other than goodwill) should initially be recognised at its fair value

If the FV cannot be ascertained then it is not reliably measurable and so cannot be shown in the accounts.

In this case by not showing it, this means that goodwill becomes higher

Research and development

Research is expensed, Development is often an asset

Research

Research is investigation to get new knowledge and understanding

All goes to I/S

Development

Under IAS 38, an intangible asset must demonstrate all of the following criteria:

(use pirate as a memory jogger)

1. **P**robable future economic benefits
2. **I**ntention to complete and use or sell the asset
3. **R**esources (technical, financial and other resources) are adequate and available to complete and use the asset
4. **A**bility to use or sell the asset

4. **A**bility to use or sell the asset

5. **T**echnical feasibility of completing the intangible asset (so that it will be available for use or sale)

6. **E**xpenditure can be measured reliably

Once capitalised they should be amortised

Amortisation begins when commercial production has commenced

It must be reviewed at the year-end to check it still is an asset and not an expense

If the criteria are no longer met, then the previously capitalised costs must be written off to the statement of profit or loss immediately.

Goodwill v Other intangibles

Goodwill is calculated as follows:

FV of Consideration	X
NCI	X
FV of Net Assets Acquired	(X)
Goodwill	X

Goodwill may be due to:

Reputation for quality or service

Technical expertise

Possession of favourable contracts

Good management and staff

Negative goodwill

If the difference above is negative, the resulting gain is recognised as a bargain purchase in the statement of profit or loss

Goodwill v Other intangibles

Main differences

It cannot be valued on its own

Goodwill cannot be disposed of as a separate asset

The factors contributing to the value of goodwill cannot be valued

The value of goodwill is volatile

Impairment of Goodwill

Goodwill is reviewed for impairment not amortised

An impairment occurs when the subs recoverable amount is less than the subs carrying value + goodwill

How this works in practice depends on how NCI is measured.. Proportionate or Fair Value method

Proportionate NCI

Here, NCI only receives % of S's net assets

NCI DOES NOT have any share of the goodwill

1. Compare the recoverable amount of S (100%) to..
2. NET ASSETS of S (100%) +
Goodwill (100%)
3. The problem is that goodwill on the SFP is for the parent only - so this needs grossing up first
4. Then find the difference - this is the impairment - but only show the parent % of the impairment

Example

H owns 80% of S. Proportionate NCI

Goodwill is 80 and NA are 200

Recoverable amount is 240

How much is the impairment?

Solution

$$RA = 240$$

$$NA = 200 + G/W (80 \times 100/80) = 100 = 300$$

Impairment is therefore 60

The impairment shown in the accounts though is $80\% \times 60 = 48$.

This is because the goodwill in the proportionate method is parent goodwill only. Therefore only parent impairment is shown

Fair Value NCI

Here, NCI receives % of S's net assets AND goodwill

NCI DOES now own some goodwill

1. Compare the recoverable amount of S (100%) to..
2. NET ASSETS of S (100%) +
Goodwill (100%)
3. As, here, goodwill on the SFP is 100% (parent & NCI) - so NO grossing up needed
4. Then find the difference - this is the impairment - this is split between the parent and NCI share

Example

H owns 80% of S. Fair Value NCI

Goodwill is 80 and NA are 200

Recoverable amount is 240

How much is the impairment?

Solution

RA = 240

NA = 200 + G/W 80 = 280

Impairment is therefore 40

The impairment shown in P's RE as $80\% \times 40 = 32$

The impairment shown in NCI is $20\% \times 40 = 8$

Impairment adjustment on the Income Statement

1. **Proportionate NCI**

Add it to P's expenses

2. **Fair Value NCI**

Add it to S's expenses

(This reduces S's PAT so reduces NCI when it takes its share of S's PAT)

Inventory

Basic Inventory

Inventories should be measured at the lower of cost and net realisable value

What goes into 'cost'?

1. Purchase price
2. Conversion costs
3. Costs to bring into current location & condition

What does NOT go into 'cost'

Abnormal amounts

Storage costs

Administration overheads

Illustration

Item A has the following costs:

Direct Labour	100
Raw Materials	200
Depreciation on production machines	10
Factory Manager wage	10
Other production Overheads	8
Admin Overheads	5

What is the 'cost'

Solution

328

Include everything except admin costs

Net Realisable Value

The net realisable value of an item is essentially its net selling proceeds after all costs have been deducted

It is calculated as follows..

Estimated selling price	X
Less: estimated costs of completion	(X)
Less: estimated selling and distribution costs	(X)
	X

Construction Contracts - % complete

IAS 11 defines a construction contract as:

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 for their ultimate purpose or use

Accounting treatment

Basically uses the accruals concept

Sales - % complete

Costs - % complete

How do you calculate % complete?

There are 2 ways - and you will be told which to use :)

Agreed value of work method

Work done so far / Contract price total

Cost Method

Costs to date / Total costs

Illustration of % complete

Contract Price	1,000
Estimated total costs	800
Costs to date	600
Agreed value of work done	700
Progress billings invoiced	600

Calculate the stage of completion using:- a. the agreed value of work method b. the cost method

Solution - agreed value of work done

$$700 / 1,000 = 70\%$$

So sales would be 700

Costs would be (70% x 800) = 560

Solution - Costs method

$$600 / 800 = 75\%$$

So sales would be $(75\% \times 1000) = 750$

Costs would be 600

Construction contracts - accounting

Remember the I/S shows the work done not the amounts invoiced

Let's look at that example again

Contract Price	1,000
Estimated total costs	800
Costs to date	600
Agreed value of work done	700
Progress billings invoiced & received	600

The Income statement pro forma for a profit making contract

Sales on I/S	% Complete
COS on I/S	% Complete

SO using agreed value of work done method the Income statement would like this..

Sales	700
COS	(70% x 800) 560

Proforma for SFP

Sales on I/S - Amounts invoiced	If + goes to receivables; if - goes to payables
COS on I/S - Costs to date	if + goes to payables; if - goes to receivables
Amounts invoiced - Amounts received	goes to trade receivables

$700 - 600 = 100$	Show in Receivables
$560 - 600 = 40$	Show in Receivables

Construction contracts - Loss making

Be prudent, and show the whole loss immediately

I/S proforma for a loss-making contract

Sales	% Complete
COS	Balancing figure
Loss	Total Loss

Illustration

Contract Price	1,000
Estimated total costs at the start	800
Costs to date	600
Agreed value of work done	700
Progress billings invoiced & received	600
Estimated total costs now	1,100

Use agreed value of work done method to calculate percentage complete

Required:- Calculate the effect of the above contract on the financial statements

Solution

Solution

So using agreed value of work done method the Income statement would like this..

Sales	700
COS	(Balancing figure) 800
Loss	100

Proforma for SFP

Sales on I/S - Amounts invoiced	If + goes to receivables; if - goes to payables
COS on I/S - Costs to date	if + goes to payables; if - goes to receivables
Amounts invoiced - Amounts received	goes to trade receivables

$700 - 600 = 100$	Show in Receivables
$800 - 600 = 200$	Show in Payables

Construction Contracts - Unreliable outcome

Zero profit is shown here

Revenue made to equal the recoverable contract costs

Illustration

An evil leather making company negotiated a two-year project that commenced in the latter half of the year

The project manager (devil) has been reviewing the contract and, at the year end, is unsure whether the contract will make a profit or a loss as there are uncertainties surrounding the project's completion (Good!)

The project manager's records show that costs during the year amount to \$700,000 and no cash had yet been received

What should the accounting entries be regarding the contract at the year end?

Solution

Sales	700
COS	700

What costs are in contract costs?

Include items such as:

Any directly attributable costs initially

Any costs which can be specifically charged to the customer under the terms of the contract

Rectification costs

Rectification costs must be charged to the period in which they were incurred, and not spread over the remainder of the contract life.

Therefore, such costs should not be added in when calculating the profit or loss to be shown on a contract

Construction Contracts - already begun..

This affects the I/S not SFP workings

Where a contract is already part way through, i.e. in its second year, some revenue and costs have previously been recognised

Therefore, it is important to take this into account in the calculations to make sure they show the current year revenue and costs

Approach to take:

1. Do contract for year 2 as normal
2. Take away Year 1's Sales and COS figures (and then you're left with year 2 - perfect!

Financial Assets and Liabilities

Financial Instruments - Introduction

Ok, ok, relax at the back - this is not as bad as it seems... trust me

Definition

Assets and liabilities are financial instruments. Financial assets are instruments that give rise to cash flows or the right to receive cash flows.

Any contract that gives rise to a financial asset in one entity and a financial liability or equity instrument of another.

Examples

Cash, trade receivables, investments, trade payables and loans....

And the trickier stuff.....

It also applies to derivatives financial such as call and put options, forwards, futures, and swaps

And the just plain weird....

It also applies to some contracts that do not meet the definition of a financial instrument, but have characteristics similar to derivative financial instruments, such as precious metals at a future date when the following applies:

The contract is subject to possible settlement in cash rather than by delivering the precious metal

The purchase of the precious metal was not normal for the entity

The following are NOT financial instruments:

Anything without a contract

eg. Prepayments

Anything not involving the transfer of a financial asset

eg. Deferred income and Warranties

Recognition

The important thing to understand here is that you bring a FI into the accounts when you enter into the contract NOT when the contract is settled. Therefore derivatives are recognised initially even if nothing is paid for it initially

Substance over form

Form (legally) means a preference share is a share and so part of equity. HOWEVER, a substance over form model is applied to debt/equity classification. Any item with an obligation, such as redeemable preference shares, will be shown as liabilities

Derecognition

This basically means when to get rid of it / take it out of the accounts

So you should do this when:

so you should do this when:

The contractual rights you used to have have expired/gone

For Example

You sell an asset and its benefits now go to someone else (no conditions attached)

You DONT derecognise when..

You sell an asset but agree to buy it back later (this means you still have an interest in the risk and rewards later)

Financial Assets - Initial Measurement

There are 3 categories to remember

Category	Initial Measurement	Year-end Measurement	Difference goes where?
FVTPL	FV	FV	Profit and Loss
FVTOCI	FV	FV	OCI
Amortised Cost	FV	Amortised Cost	-

What sort of things go into the amortised cost category?

IFRS 9 basically says that it must be a receivable loan in the normal sense of the term that goes into amortised cost.

So, a normal receivable loan has ONLY capital and interest to be received, and we don't normally sell it before the loan

ends.

So there are actually 2 tests to help us decide if an item should go to amortised cost:

The 2 Tests are

1. Business model test - do we normally keep our receivable loans until the end rather than sell them on?
2. Cashflows test - are the ONLY cashflows coming in capital and interest?

play audio

pause audio

clipAttachment

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RCAtweets

So what sort of things go into the FVTPL category?

If one of the tests above are not passed then they are deemed to fall into the FVTPL category

This will include anything held for trading and derivatives

INITIAL measurement

Good news! Initially both are measured at FV.

Easy peasy to remember

The FV is calculated, as usual, as all cash inflows discounted down at the market rate

Financial assets that are Equity Instruments

eg. Shares in another company

These again are easy - Just 2 categories

FVTPL or

FVTOCI (if the shares are held for longer term)

FVTPL = Fair Value through Profit & Loss

FVTOCI = Fair Value through Other Comprehensive Income

NB. The choice of these 2 is made at the beginning and cannot be changed afterwards

Is a receivable convertible loan - FVTPL or Amortised Cost?

Well let's look at the 2 test

1. **Business model** - presumably we do hold until the end and not sell it - so yes that test is passed
2. **Cashflow test** - are the ONLY inflows those from the capital and interest received? Well actually - no

There is the potential issue of shares that we may ask for instead of the capital back.

Therefore a receivable convertible loan is not an amortised cost item - it falls under the **FVTPL** category

Financial assets - Accounting Treatment

So we have these 3 categories..

Category	Initial Measurement	Year-end Measurement	Difference goes where?
FVTPL	FV	FV	Profit and Loss
FVTOCI	FV	FV	OCI
Amortised Cost	FV	Amortised Cost	-

Initially both are measured at FV

Now let's look at what happens at the year-end..

FVTPL accounting treatment

1. Revalue to FV
2. Difference to I/S

FVTOCI accounting treatment

1. Revalue to FV
2. Difference to OCI

Amortised cost accounting treatment

1. Re-calculate using the amortised cost table

(see below)

Amortised Cost Table

8% 100 receivable loan (effective rate 10% due to a premium on redemption)

Opening Balance	Interest (effective rate)	(CashReceived)	Closing balance
100	10	(8)	102

Financial liabilities - Categories

There's only 2 categories, FVTPL and Amortised cost.. Yay!

Right-y-o, we've looked at recognising (bring into the accounts for those of you who are a sandwich short of a picnic*) - now we want to look at HOW MUCH to bring the liabilities in at.

We already dealt with this on a tricky convertible loan.

Trust me this section is much easier. Basically there are 2 categories of Financial Liability...

2 Categories

1. Fair Value Through Profit and Loss

This includes financial liabilities incurred for trading purposes and also derivatives

2. Amortised Cost

If financial liabilities are not measured at FVTPL (see below), they are measured at amortised cost

The good news is that whatever the category the financial liability falls into - we always recognise it at Fair Value INITIALLY.

It is how we treat them afterwards where the category matters (and remember here we are just dealing with the initial measurement)

Accounting Treatment of Financial Liabilities (Overview)

	Initially	At Year-End	Any gain/loss
FVTPL	Fair Value	Fair Value	Income Statement
Amortised Cost	Fair Value	Amortised Cost	

So - the question is - how do you measure the FV of a loan??

Well again the answer is simple - and you've done it already with compound instruments. All you do is those 2 steps:

STEP 1:	Take all your actual future cash payments
STEP 2:	Discount them down at the market rate

If the market rate is the same as the rate you actually pay then this is no problem and you don't really have to follow those 2 steps as you will just come back to the capital amount...let me explain

10% 1,000 Payable Loan 3 years

Capital	1,000	x	0.751	751
Interest	100	x	2.486	249
Total				1,000

So the conclusion is - WHERE THE EFFECTIVE RATE YOU PAY IS THE SAME AS THE MARKET RATE THEN THE FV IS THE PRINCIPAL - so no need to do the 2 steps.

Always presume the market rate is the same as the effective rate you're paying unless told otherwise by El Examinero.

Possible Naughty Bits

Premium on redemption

This is just another way of paying interest. Except you pay it at the end (on redemption)

eg 4% 1,000 payable loan - with a 10% premium on redemption.

This means that the EFFECTIVE interest rate is more than 4% - because we haven't yet taken into account the extra 100 (10% x 1,000) payable at the end. So the examiner will tell you what the effective rate actually is - let's say 8% (not enough info in the question to calculate this)

The crucial point here is that you presume the effective rate is the same as the market rate so the initial FV is still 1,000

Discount on Issue

Exactly the same as above - it is just another way of paying interest - except this time you pay it at the start

eg 4% 1,000 payable loan with a 5% discount on issue

So again the interest rate is not 4%, because it ignores the extra interest you pay at the beginning of 50 (5% x 1,000). So the effective rate is let's say 7% (again we cannot calculate this and will just be given in the exam)

The crucial point here is that the discount is paid immediately. So, although you presume that the effective rate is the same as the market rate (7% say), the INITIAL FV of the loan was 1,000 but is immediately reduced by the 50 discount - so is actually 950

NB You still pay interest of 4% x 1,000 not 4% x 950

*A quaint old English saying - meaning you're an idiot :p

Financial Liabilities - Amortised Cost

So, we've just looked at initial measurement (at FV) Now let's look at how we measure it from then onwards....

This is where the categories of financial liabilities are important - so let's remind ourselves what they are:

	Initially	At Year-End	Any gain/loss
FVTPL	Fair Value	Fair Value	Income Statement
Amortised Cost	Fair Value	Amortised Cost	-

So you only have 2 rules to remember - cool...

FVTPL - simple just keep the item at its FV (remember this is those 2 steps) and put the difference to the income statement

Amortised Cost - Amortised Cost is the measurement once the initial measurement at FV is done

Amortised Cost

This is simply spreading ALL interest over the length of the loan by charging the **effective** interest rate to the income statement each year.

If there's nothing strange (premiums etc) then this is simple. For example

10% 1,000 Payable Loan

Opening	Interest to I/S	Interest actually Paid	Closing Loan on SFP
1,000	100	(100)	1,000

Now let's make it trickier

10% 1,000 Loan with a 10% premium on redemption . Effective rate is 12%

Opening	Interest to I/S	Interest actually Paid	Closing Loan on SFP
1,000	120	(100)	1,020

So in year 1 the income statement would show an interest charge of 120 and the loan would be under liabilities on the SFP at 1,020. This SFP figure will keep on increasing until the end of the loan where it will equal the Loan + premium on redemption

And trickier still...

10% 1,000 loan with a 10% discount on issue. Effective rate is 12%

Opening	Interest to I/S	Interest actually Paid	Closing Loan on SFP
900	108	(100)	908

Financial Instruments - Transactions costs

For FVTPL - these go to the income statement

For everything else they get added/deducted to the opening balance

For everything else they get added/deducted to the opening balance

So if it is an asset - it will increase the opening balance

If it is a liability - it will decrease the opening balance

Illustration: Transaction costs

An entity acquires a financial asset for its offer price of £100 (bid price £98)

IFRS 9 treats the bid-offer spread as a transaction cost:

1. If the asset is **FVTPL**

The transaction cost of £2 is recognised as an expense in profit or loss and the financial asset initially recognised at the bid price of £98.

2. If the asset is classified as **amortised cost**

The transaction cost should be added to the fair value and the financial asset initially recognised at the offer price (the price actually paid) of £100.

Financial Liabilities - convertible loans

When we recognise a financial instruments we look at substance rather than form

Anything with an obligation is a liability (debt).

However we now have a problem when we consider convertible payable loans. The 'convertible' bit means that the company may not have to pay the bank back with cash, but perhaps shares.

So is this an obligation to pay cash (debt) or an equity instrument?

In fact it is both! It is therefore called a Compound Instrument

Convertible Payable Loans

These contain both a liability and an equity component so each has to be shown separately. This is best shown by example.
2% Convertible Payable Loan €1,000

This basically means the company has offered the bank the option to convert the loan at the end into shares instead of simply taking €1,000

The important thing to notice is that that the bank has the option to do this.

Should the share price not prove favourable then it will simply take the €1,000 as normal.

Features of a convertible payable loan

Better Interest rate

The bank likes to have the option. Therefore, in return, it will offer the company a favourable interest rate compared to normal loans

Higher Fair Value of loan

This lower interest rate has effectively increased the fair value of the loan to the company (we all like to pay less interest ;-))

We need to show all payable loans at their fair value at the beginning.

Lower loan figure in SFP

Important: If the fair value of a liability has increased the amount payable (liability) shown in the accounts will be lower.

After all, fair value increases are good news and we all prefer lower liabilities!

How to Calculate the Fair Value of a Loan

So how is this new fair value, that we need at the start of the loan, calculated?

Well it is basically the present value of its future cashflows...

Step 1: Take what is actually paid (The actual cashflow)

Step 1: Take what is actually paid (The actual cashflows):

Capital €1,000

Interest (2%) €20 pa.

Now let's suppose this is a 4 year loan and that normal (non-convertible) loans carry an interest rate of 5%.

Step 2: Discount the payments in step 1 at the market rate for normal loans (Get the cashflows PV)

Take what the company pays and discount them using the figures above as follows:

Capital €1,000 discounted @ 5% (4 years SINGLE discount figure) = $1,000 \times 0.823 = 823$

Interest €20 discounted @ 5% (4 years CUMULATIVE)= $20 \times 3.465 = 69$

Total = 892

This €892 represents the fair value of the loan and this is the figure we use in the balance sheet initially.

The remaining €108 (1,000-892) goes to equity.

Conclusion

When you see a convertible loan all you need to do is take the capital and interest PAYABLE.

Then discount these figures down at the rate used for other non convertible loans.

The resulting figure is the fair value of the convertible loan and the remainder sits in equity.

You do this at the START of each loan - that's all.

What happens after the start we will see later...

Convertible Payable Loan with transaction costs - eek!

Ok well remember our 2 step process for dealing with a normal convertible loan? No?? Well you're an idiot. However, luckily for you, I'm not so I will remind you :p

Step 1) Write down the capital and interest to be PAID

Step 2) Discount the capital and the interest to be paid at the market rate for normal convertible loans

Step 2) Discount these down at the Interest rate for a normal non-convertible loan

Then the total will be the FV of the loan and the remainder just goes to equity. Remember we do this at the start of the loan ONLY.

Right then let's now deal with transaction or issue costs. These are paid at the start.

Normally you simply just reduce the Loan amount with the full transaction costs. However, here we will have a loan and equity - so we split the transaction costs pro-rata

I know, I know - you want an example.... boy, you're slow - lucky you're gorgeous

eg 4% 1,000 3 yr Convertible Loan. Transaction costs of £100 also to be paid. Non convertible loan rate 10%

Step 1 and 2

Capital $1,000 \times 0.751 = 751$
Interest $40 \times 2.486 = 99$ (ish)
Total = 850

So FV of loan = 850, Equity = 150 (1,000-850)

Now the transaction costs (100) need to be deducted from these amounts pro-rata

So Loan = $(850-85) = 765$
Equity $(150-15) = 135$

And relax....

Debt and Equity

Loans go to debt (liabilities); ordinary shares go to equity. Why?

It is back to the conceptual framework again and also to the important concept of substance over form

The definition of liability includes the need for a present **obligation**.

As interest **MUST** be paid but dividends may not, only loans have this obligation and so go to liabilities.

Normal Payable loans

These have an obligation to pay interest and capital

Debt

Redeemable Preference shares

These have an obligation to pay dividends and capital

Debt

Irredeemable Preference shares

These do NOT have an obligation to pay dividends and capital

Equity

Our own shares

These do NOT have an obligation to pay dividends or capital

Equity

Convertible loans

These do have an obligation but are also potential shares

Debt and Equity

Leasing

Leases - Introduction

There are 2 types of lease - an Operating and a Finance lease

In simple terms, a finance lease is where the LESSEE takes the majority of the risks and rewards of the underlying asset

Therefore with a finance lease the lessee would show the asset on their SFP (and the related finance lease liability)

When classifying look for substance rather than the form

Finance Lease Indicators

The lessee gets ownership of the asset at the end of the lease term

The lessee can buy the asset at such a low price that it is reasonably certain that the option will be exercised;

The lease term is for the major part of the economic life

The PV of the lease payments is substantially the fair value of the leased asset; and

Only the lessee can use the asset as it is so specialised

Other possible finance lease indicators

If the lessee cancels the lease, he has to pay the lessor's losses

The lessee gets any residual value gains/losses and

The lessee can lease for a secondary period at a cheap rent

Land & Buildings

Normally separately classified

The minimum lease payments are allocated between the land and buildings elements in proportion to their relative fair values.

Land = Operating lease (unless title passes to the lessee at the end of the lease term)

Buildings = Operating or finance lease (by applying the classification criteria in IAS 17)

The classification of leases is a key issue in corporate reporting. From a lessees point of view, classifying as a finance lease will increase gearing and decrease ROCE (as there's more capital employed due to the finance lease liability). Interest cover will also decrease

As the SFP shows more liability, future borrowing will be harder to come by and current loan covenants may be breached. The level of perceived risk may increase, loan covenants may be compromised and an entity's future borrowing capacity may be restricted.

UK studies have revealed that average operating lease commitments are over ten times that of reported finance lease obligations.

Finance Lease accounting

This gives an asset on the SFP (and a related liability)

Therefore we also need to show the related depreciation and interest on the I/S

Income statement		SFP	
Depreciation	(10)	Asset	100
Interest	(8)	Liability	100

Accounting steps

1. Enter the Asset and Liability

(At the Fair value of the asset)

2. Calculate depreciation

This will depend on whether the asset goes back to the lessor at the year end or not

3. Calculate interest and Finance Lease liability at Y/E

This is done by the amortised cost table (below)

Amortised cost table for a Finance lease with payments in arrears

Opening FL liability	Interest to I/S	Lease rental Paid	Closing Liability on SFP
----------------------	-----------------	-------------------	--------------------------

1,000	120	(100)	1,020
-------	-----	-------	-------

Amortised cost table for a Finance lease with payments in advance

Opening FL liability	Lease rental paid	Balance	Interest to I/S	Closing Liability on SFP
1,000	(100)	900	90	990

Start of lease term

Dr Asset
 Cr Finance Lease liability
 @ lower of FV of the asset and Present value of the minimum lease payments
 + (any direct costs added to cost of asset)

As Payments are made

Finance lease payments should be apportioned between the finance charge and paying off the liability
 Dr Interest
 Dr Finance Lease liability
 Cr Cash

The interest is apportioned using the effective rate given in the question

Illustration – Finance Lease: Payment in Arrears

Asset Cost \$10,000
 Lease: 5 years x \$3,000 p.a. in arrears
 Effective/implicit interest rate is 8%

Opening FL liability	Interest to I/S	Lease rental Paid	Closing Liability on SFP
10,000	800	(3,000)	7,800

Payable within one year and after more than one year

The finance lease liability must be split between the amount that is to be paid within a year and the remainder which is payable in more than one year

Opening FL liability	Interest to I/S	Lease rental Paid	Closing Liability on SFP
Yr. 1 10,000	800	(3,000)	7,800
Yr. 2 7,800	624	(3,000)	5,424

Therefore, the amount payable in less than a year (year 2) is $(7,800 - 5,424) = \$2,376$ The remaining \$5,424 is payable in more than one year

Illustration – Finance Lease: Payment in Advance

The only difference is how the table looks and the split between payable within 1yr and after more than 1yr.

Consider the previous example again. This time the payment comes before the interest as it is paid in advance:

Opening FL liability	Lease rental paid	Balance	Interest to I/S	Closing Liability on SFP
Yr 1 10,000	(3,000)	7,000	560	7,560
Yr 2 7,560	(3,000)	4,560		

The amount payable < 1yr is $(7,560 - 4,560) = 3,000$

This \$3,000 should ideally be further split down between:

Interest \$560

Capital \$2,440

Operating Lease accounting

So here the lessee does not take the risks and rewards of the asset, so no asset is shown on the SFP

All that happens is the lease payments are recognised as an expense in the income statement over the lease term on a straight-line basis

An operating lease simply shows the rental payments in the Income statement. Remember to do this on an accruals basis and not a payment basis

Illustration

A company pays an initial premium of 1,000 + 4 quarterly instalments of 1,500. The lease was acquired half way through the year.

What is the income statement charge in the period?

Answer: $1,000 + (4 \times 1,500) = 7,000$ in total for the year

Only half a year to be charged regardless of payments - so $7,000 / 2 = \mathbf{3,500}$

Operating Lease Incentives

The lessee normally recognises the total incentives as a reduction of rental expense over the lease term, on a straight-line basis

Leases - Substance over form

Finance Leases are a good example of substance over form

Substance over Form

Companies do not like to have many liabilities on their SFP

It is therefore in their interests to record a lease as an operating lease instead of a finance lease

However..

1. The substance of the lease must be followed not the legal form
2. Therefore if its a finance lease - an asset should be recorded even though not legally owned

Asset Definition

In most finance leases, the asset itself is never owned by the company

but..

1. Conceptual framework defines an asset by "control" not ownership
2. Showing the asset is an example of substance over form

Off balance sheet financing

This is treating a finance lease as an operating lease

Remember with a finance lease you show the asset AND the liability

1. Companies like to keep liabilities off their SFP

1. Companies like to keep liabilities off their balance sheet

2. But this is not the true picture
3. Will distort ratios such as ROCE

Also, in the statement of profit or loss, the operating lease would show just the lease payments, whereas the finance lease would show interest (from the liability) and depreciation (from the asset)

Unless these two are calculated on a straight line basis, it would probably be the case that interest + depreciation would be higher than lease payments in the early years and lower as time moves on

Provisions and Contingencies

Provisions

A provision is a liability of uncertain timing or amount

All this means is that it is not a creditor, as you know exactly how much that is and when it is to be paid

However it is still a potential liability

To create a provision though

Dr Expense

Cr Provision

the potential liability must be *probable*

In fact 3 tests need to be passed..

1. Is there a present **obligation** (legal or constructive) as a result of a past event
2. Is it **probable** that an outflow of resources embodying economic benefits will be required to settle the obligation
3. Can a **reliable estimate** can be made of the amount of the obligation

Measurement of a Provision

The amount recognised as a provision should be the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period.

Provisions for one-off events

Eg. restructuring, environmental clean-up, settlement of a lawsuit

Measured at the **most likely** amount

Large populations of events

Eg. warranties, customer refunds

Measured at a **probability-weighted expected value**

A company sells goods with a warranty for the cost of repairs required in the first 2 months after purchase.

Past experience suggests:

88% of the goods sold will have no defects

7% will have minor defects

5% will have major defects

If minor defects were detected in all products sold, the cost of repairs will be \$24,000;

If major defects were detected in all products sold, the cost would be \$200,000.

What amount of provision should be made?

$$(88\% \times 0) + (7\% \times 24,000) + (5\% \times 200,000) = \$11,680$$

Contingent Assets

Here, it is not a potential liability, but a potential asset

The principle of PRUDENCE is important here, it must be harder to show a potential asset in your accounts than it is a potential liability

This is achieved by changing the probability test

For a potential (contingent) asset - it needs to be virtually certain (rather than just probable)

Probability test for Contingent Liabilities

Remote chance of paying out - Do nothing

Possible chance of paying out - Disclosure

Probable chance of paying out - Create a provision

Probability test for Contingent Assets

Remote chance of receiving - Do nothing

Possible chance of receiving - Do nothing

Probable chance of receiving - Disclosure

Virtually certain of receiving - create an asset in the accounts

Some typical examples

Circumstance	Provide?
Warranties/guarantees	Accrue a provision (past event was the sale of defective goods)
Customer refunds	Accrue if the established policy is to give refunds
Onerous (loss-making) contract	Accrue a provision
Land contamination	Accrue a provision if the company's policy is to clean up even if there is no legal requirement to do so
Future operating losses	No provision (no present obligation)
Firm offers staff training	No provision (there is no obligation to provide the training)
Major overhaul or repairs	No provision (no obligation)
Restructuring by sale of an operation/line of business	Accrue a provision only after a binding sale agreement
Restructuring by closure of business locations or reorganisation	Accrue a provision only after a detailed formal plan is adopted and announced publicly. A Board decision is not enough

Watch the video for more explanation of these :)

Accounting for Tax

Deferred Tax

This is basically the matching concept

Lets say we have credit sales of 100 (but not paid until next year)

There are no costs

The tax man taxes us on the cash basis (i.e. next year)

The Income statement would look like this:

Income Statement	
Sales	100
Tax (30%)	(0)
Profit	100

This is how it should look

The tax is brought in this year even though its not payable until next year, its just a temporary timing difference

Income Statement		SFP	
Sales	100		
Tax (30%)	(30)	Deferred tax payable	30
Profit	100		

Deferred tax on a revaluation

Deferred tax is caused by a temporary difference between accounts rules and tax rules

One of those is a revaluation:

Accounting rules bring it in now

Tax rules ignore the gain until it is sold

So the accounting rules will be showing more asset and more gain so we need to match with the temporarily missing tax

Illustration

A company revalues its assets upwards making a 100 gain as follows:

OCI		SFP	
		PPE	1,000 + 100
Revaluation Gain	100	Revaluation surplus	100

This is how it should look

The tax is brought in this year even though its not payable until sold, its just a temporary timing difference

Notice the tax matches where the gain has gone to

OCI		SFP	
		PPE	1,000 + 100
		Deferred tax payable (30%)	(30)
Revaluation Gain	100-30	Revaluation surplus	100-30

Current Tax

This is a simple tax payable

Dr Tax (I/S)
Cr Tax payable (SFP)

Let's say we did this - and the amount was 100

This is paid after the year end, however there were adjustments still to be made and we ended up paying 110

The problem is that the accounts have already been published

So the extra 10 has to go in the following year

This is an UNDER provision of tax

Under Provisions look like this on the trial balance in question 2

Trial Balance	Debit	Credit
Tax	10	

Over Provisions look like this on the trial balance in question 2

Trial Balance	Debit	Credit
Tax		10

How to deal with an under provision

in the trial balance

Add it to tax on I/S

How to deal with an over provision

in the trial balance

Take it away from tax on I/S

How do you deal with the tax payable for the year

Add it to tax on (I/S)

Reporting on Performance

Discontinued Operation

An analysis between continuing and discontinuing operations improves the usefulness of financial statements

When **forecasting** ONLY the results of continuing operations should be used

Because discontinued operations profits or losses will not be repeated

What is a discontinued operation?

1. A separate **major line of business** or geographical area

or..
2. is **part of a single co-ordinated plan to dispose** of a separate major line of business or geographical area

or..
3. is a **subsidiary acquired exclusively with a view to resale**

How is it shown on the Income Statement?

The PAT and any gain/loss on disposal

A single line in I/S

How is it shown on the SFP?

If not already disposed of yet?

Held for sale disposal group

How is it shown on the cash-flow statement?

Separately presented

in all 3 areas - operating; investing and financing

No Retroactive Classification

IFRS 5 prohibits the retroactive classification as a discontinued operation, when the discontinued criteria are met after the end of the reporting period

Assets Held for Sale

Key Issues

When is an asset held for sale?

Management is **committed to a plan** to sell

The asset is **available** for **immediate** sale

An **active programme** to locate a buyer is initiated

The sale is **highly probable, within 12 months** of classification as held for sale

The asset is being **actively marketed** for sale at a **sales price reasonable** in relation to its fair value

Abandoned Assets

The assets need to be disposed of through sale. Therefore, operations that are expected to be wound down or abandoned would not meet the definition. Therefore assets to be abandoned would still be depreciated.

Measurement

Immediately before the initial classification

The carrying amount of the asset will be measured in accordance with applicable IFRSs. Generally, bring depreciation up to date (if cost model followed) or revalue (if revaluation policy followed).

After classification as held for sale

Measured at the lower of carrying amount and fair value less costs to sell

An Impairment?

Any impairment loss must be recognised in profit or loss, even for assets previously carried at revalued amounts.

Revalued assets will need to deduct costs to sell from their fair value and this will result in an immediate charge to profit or loss.

Subsequent increase in Fair Value?

This basically happens at the year end if the asset still has not been sold

A gain is recognised in the p&l up to the amount of all previous impairment losses.

Non-depreciation

Non-current assets or disposal groups that are classified as held for sale shall not be depreciated

Balance sheet presentation

Presented separately on the face of the balance sheet in current assets

Subsidiaries Held for Disposal

IFRS 5 applies to accounting for an investment in a subsidiary held only with a view to its subsequent disposal in the near future.

Subsidiaries already consolidated now held for sale

The parent must continue to consolidate such a subsidiary until it is actually disposed of. It is not excluded from consolidation and is reported as an asset held for sale under IFRS 5.

So subsidiaries held for sale are accounted for initially and subsequently at FV-CTS of all the net assets not just the amount to be disposed of

Separate disclosure of material items

Exceptional items get disclosed separately

This is where disclosure is necessary in order to explain the performance of the entity better

The NORMAL accounting treatment is to:

Show in the standard line in the I/S

Disclose the nature and amount in notes

EXCEPTIONS such as these can have their own I/S line:

Write down of inventories to net realisable value (NRV)

Write down of property, plant and equipment to recoverable amount

Restructuring costs

Gains/losses on disposal of non-current assets

Discontinued operations profits / losses

Litigation settlements

Reversals of provisions

IAS 33 EPS Introduction

EPS is a much used PERFORMANCE appraisal measure

It is calculated as:

PAT - Preference dividends / Number of shares

It is not only an important measure in its own right but also as a component in the price earnings (P/E) ratio (see below)



Diluted EPS

This is saying that the basic EPS might get worse due to things that are ALREADY in issue such as:

Convertible Loan

This will mean more shares when converted

Share options

This will mean more shares when exercised

Who has to report an EPS?

PLCs

Group accounts where the parent has shares similarly traded/being issued

EPS to be presented in the income statement

IAS 33 EPS - earnings figure

This is basically Profit after Tax

less preference dividends

*Be careful of the type of preference share though...

Redeemable preference shares

These are actually liabilities and their finance charge isn't a dividend in the accounts but interest

Do not adjust for these dividends

Irredeemable preference shares

These are equity and the finance charge is dividends

Do adjust for these dividends

IAS 33 EPS - Number of shares

Calculating the weighted average number of ordinary shares

The number of shares given in the SFP at the year end - may not be the number of shares in issue ALL year

So we need to know how many we had in issue on AVERAGE instead of at the end

Well if there were no additional shares in the year then obviously the weighted average is the same as the year end - so no problem!

However, if additional shares have been issued we've got some work to do as follows (depending on how those shares were issued):

Full Market Price issue of shares

No problem here as the new shares came with the right amount of new resources so the company should be able to use those new resources to maintain the EPS

No adjustment needed (apart from time)

Bonus & Rights Issue of shares

More problematic, as the share were issued for cheaper (rights) than usual or for free (bonus)

In both cases the company has not been given enough new resource to expect the EPS to be maintained

This causes comparison to last year problems.

Adjust for these (Bonus fraction)

But not the same as in the ALL

Pretend they were in issue ALL year

Change comparative (Pretend they were in last year too)

So, how to calculate it is best explained by example:

1st January 100 shares in issue

1st May Full market price issue of 400 shares

1st July 1 for 5 bonus issue

Solution

Draw up a table like this:

DATE	TOTAL SHARES	TIME	BONUS FRACTION	WEIGHTED AVERAGE
------	--------------	------	----------------	------------------

Now fill in the first 2 columns:

DATE	TOTAL SHARES	TIME	BONUS FRACTION	WEIGHTED AVERAGE
1st Jan	100			
1st May	500			
1st July	600			

Notice how this shows the TOTAL shares. Now fill in the timing of how long these TOTALS lasted for in the year

DATE	TOTAL SHARES	TIME	BONUS FRACTION	WEIGHTED AVERAGE
1st Jan	100	4/12		
1st May	500	2/12		
1st July	600	6/12		

Finally look for any bonus issues and pretend that they happened at the start of the year. We do this by applying the bonus fraction to all entries BEFORE the actual bonus or rights issue

In this case the bonus fraction would be 6/5 - so apply this to everything before the actual bonus issue:

In this case the bonus fraction would be 6/5 so apply this to everything before the actual bonus issue.

DATE	TOTAL SHARES	TIME	BONUS FRACTION	WEIGHTED AVERAGE
1st Jan	100	4/12	6/5	
1st May	500	2/12	6/5	
1st July	600	6/12		

Finally, multiply through and calculate the weighted average:

DATE	TOTAL SHARES	TIME	BONUS FRACTION	WEIGHTED AVERAGE
1st Jan	100	4/12	6/5	40
1st May	500	2/12	6/5	100
1st July	600	6/12		300
				440

IAS 33 Bonus issue

Bonus issue

Additional shares are issued to the ordinary equity holders in proportion to their current shareholding, for example 1 new share for every 2 shares already owned

No cash is received for these shares

Double Entry

Dr Reserves or Share premium
Cr Share Capital

IAS 33 pretends that the bonus issue has been in place all year - regardless of when it was actually made

We do this by multiplying the totals before the issue by a "bonus fraction".

Bonus Fraction Calculation - Bonus issue

1 for 2 bonus issue - means we've now got 3 where we used to have 2 = $\frac{3}{2}$

2 for 5 - now got 7 used to have 5 = $\frac{7}{5}$

3 for 4 - now got 7 used to have 4 = $\frac{7}{4}$

Example

1st Jan 100 shares in issue

1st July 1 for 2 bonus issue (ie. 50 more shares)

Weighted Average number of shares

$100 \times \frac{6}{12}$ (we had a total of 100 for 6 months) = $50 \times \frac{3}{2}$ (bonus fraction) = 75

$150 \times \frac{6}{12}$ (we had a total of 150 for 6 months) = 75

Total = 150

IAS 33 Rights Issue

Rights issue

A rights issue is:

An issue of shares for cash to the existing ordinary equity holders in proportion to their current shareholdings.

At a discount to the current market price. It is, in fact, a mixture of a full price and bonus issue

So again we do the same as in the bonus issue - we pretend it happened all year and to do this we multiply the previous totals by the bonus fraction

The problem is - calculating the bonus fraction for a rights issue is slightly different:

Example

2 for 5 offered at £4 when the market value is £10

So we are being offered 2 @ £4 = £8

For every 5 which cost us £10 each = £50

So we now have 7 at a cost of £58 = 8.29

This is what we call the TERP (theoretical ex-rights price).

The bonus fraction is the current MV / TERP = 10 / 8.29

IAS 33 Basic EPS putting it all together

IAS 33 Basic EPS putting it all together

1. Step 1: Calculate the EARNINGS (PAT - irredeemable pref shares)
2. Step 2: Calculate Weighted average NUMBER OF SHARES
3. Divide one by the other!

IAS 33 Diluted EPS

This is the basic EPS adjusted for the potential effects of a convertible loan (currently in the SFP) being converted and options (currently in issue) being exercised

This is because these things will possibly increase the number of shares in the future and thus dilute EPS.

This is how these items affect the Basic Earnings and Shares

Earnings

The convertible loan will (once converted) increase earnings as interest will no longer have to be paid.

So increase the basic earnings with a tax adjusted interest savings

Shares

Simply add the shares which will result from the convertible loan

Also add the "free" shares from a share option

Convertible loan

Add the interest saved (after tax) to the EARNINGS from basic EPS

Add the extra shares convertible to the SHARES from basic EPS

Options

Step 1 : Calculate the money the options will bring in

Step 2 : Calculate how many shares this would normally buy

Step 3 : Look at the number of shares given away in the option, compare it to those in step 2 and these are the “free shares”

We add the free shares to the SHARES figure from basic EPS

Illustration

5% 800 convertible loan - each 100 can be converted into 20 shares (tax 30%)

100 share options @ \$2 (MV \$5)

How to calculate Interest Saved

$5\% \times 800 = 40 \times 70\% \text{ (tax adjusted)} = 28$

How to calculate the extra convertible shares

$800/100 \times 20 = 160$

How to calculate the free shares in share options

Cash in from option \$200, this would normally mean the company issuing $(200/5)$ 40 shares instead of the 100, so there has effectively been 60 shares issued for ‘free’. We use this figure in the diluted eps calculation

An alternative calculation is:

$100 \times (5-2) / 5 = 60$

Solution

Basic EPS	Convertible Loan	Share options
E 100	+ 28	
S 50	+ 160	+ 60

Diluted EPS = $128 / 270 = 0.47$

EPS as a performance measure

EPS is better than PAT as an earnings performance indicator

Profit after tax gives an absolute figure

An increase in PAT does not show the whole picture about a company's profitability

Some profit growth may come from acquiring other companies

If the acquisition was funded by new shares then profit will grow but not necessarily EPS

So EPS trends show a better picture of profitability than PAT

Simply looking at PAT growth ignores any increases in the resources used to earn them

The diluted EPS is useful as it alerts existing shareholders to the fact that future EPS may be reduced as a result of share capital changes

Where the finance cost per potential new share is less than the basic EPS, there will be a dilution

IAS 10 Events After The Reporting Period

Events can be adjusting or non-adjusting

If the event gives us more information about the condition at the year end then we adjust

If not then we don't

When is the "After the Reporting date" period?

It is anytime between period end and the date the accounts are authorised for issue

Ok and why is it important?

Well it's important because if the firm is in the market to raise capital then the period

Even if it may well be that many of the figures in the accounts are estimates at the period end

However, what if we get more information about these estimates etc afterwards, but before the accounts are authorised and published.. should we change the accounts or not?

The most important thing to remember is that the accounts are prepared to the SFP date. Not afterwards.

So we are trying to show what was the situation at the SFP date. However, it may be that more information ABOUT the conditions at the SFP date have come about afterwards and so we should adjust the accounts.

Sometimes we do not adjust though...

Adjusting Events

The event (which occurred after the SFP date) provides evidence of conditions that existed at the period end

Examples are..

1. **Debtor goes bad 5 days after SFP date**

(This is evidence that debtor was bad at SFP date also)

2. **Stock is sold at a loss 2 weeks after SFP date**

3. **Property gets impaired 3 weeks after SFP date**

(This implies that the property was impaired at the SFP date also)

Non-Adjusting Events - these are disclosed only

These are events (after the SFP date) that occurred which do not give evidence of conditions at the year end, rather they are indicative of conditions AFTER the SFP date

1. **Stock is sold at a loss because they were damaged post year end**

(This is evidence that they were fine at the year end - so no adjustment)

2. **Property impaired due to a fall in market values generally post year end**

(This is evidence that the property value was fine at the year end - so no adjustment required)

Non-adjusting event which affects Going Concern

Adjust the accounts to a break up basis regardless if the event was a non-adjusting event

Question 2's to June 14

Question 2 (to June 14)

Business combinations F7

The concept of a group

A single economic unit

Parent and Sub are deemed to be parts of the SAME company from a group perspective

However LEGALLY each member is a separate legal entity and therefore the group itself IS NOT a separate legal entity

This focuses on a criticism of group accounts where the assets and liabilities of P and S are added together

This can give the impression that all of the group's assets would be available to discharge all of the group's liabilities

This is not the case

Definition of a subsidiary

Here's some key definitions

Consolidated financial statements:

The financial statements of a group presented as those of a single economic entity

the financial statements of a group presented as those of a single economic entity

Subsidiary: an entity that is controlled by another entity (known as the parent)

Parent: an entity that has one or more subsidiaries

Control: the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities

Identification of subsidiaries

Control is presumed when the parent has 50% + voting rights of the entity

Even when less than 50%, control may be evidenced by power..

Getting the 50%+ by an arrangement with other investors

Governing the financial and operating policies

Appointing the majority of the board of directors

Casting the majority of votes

When is a group required to prepare consolidated accounts?

Always produce group accounts...unless

Exceptions

1. The parent is itself a 100% subsidiary
2. The parent isn't a 100% sub but the other owners don't mind the parent not preparing group accounts
3. The parent's loans or shares are not traded in a public market
4. The parent didn't file its accounts with a stock exchange (in order to issue shares)

5. The ultimate parent already produces group accounts

Why directors may not wish to consolidate a subsidiary

Co-terminous Year-ends and Accounting policies

Ideally P and S should have the same year end and accounting policies

The accounts of the parent and its subsidiaries (used for the group accounts) should all have the **same reporting date**, unless it is impracticable to do so

If it is impracticable, adjustments must be made for the effects of significant transactions or events that occur between the dates of the subsidiary's and the parent's year end.

The difference must never be more than three months

Consolidated financial statements must be prepared using **uniform accounting policies** for like transactions and other events in similar circumstances

The concept of group accounts

Group accounts principles

Some more definitions

Consolidated financial statements

Where assets, liabilities, equity, income, expenses and cash flows of the parent and its subs are presented as those of a single economic entity

Control of an investee

An investor controls an investee when the investor is exposed, or has rights, to the variable returns of the investee

Also it has the ability to affect those returns through its power

Parent

An entity that controls one or more entities

Power

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

Protective rights

Rights designed to protect rather than control

Relevant activities

Activities of the investee that significantly affect the investee's returns

What i CONTROL exactly?

Firstly as an investor you need to decide if you are a PARENT or not..

This means do you control the investment or not

An investor controls when it is exposed, or has rights, to variable returns from its involvement with the investee (investment) and has the ability to affect those returns through its power eg....

Existing rights give the ability to direct the relevant activities

Exposure, or rights, to variable returns from its involvement with the investee

Ability to use power over the investee to affect the amount of the it's returns

Rights to variable returns

Through straightforward voting rights

Can't be just protective rights

Rights to make decisions over the investment (not on behalf of someone else though)

Intra-group transactions

Intragroup balances, transactions should be eliminated in full

Intragroup balances, transactions, income, and expenses should be eliminated in full

Intragroup losses may indicate that an impairment loss on the related asset should be recognised

Related parties and groups

P and S are related in their OWN accounts..

Where a company is part of a group, the financial statements (of a subsidiary) may be influenced by related party transactions

Potential problems

1. Lots of post acquisition trading between P and S
2. This trading not necessarily at arms length
(not commercial rates)

3. This will distort S's profits (either in a good or bad way)

4. S may gain other advantages

eg. Technology/research, cheap finance, etc.

Therefore P can 'flatter' S's accounts (especially if it's going to sell S)

The potential buyer would not necessarily be able to determine that this had happened from either the consolidated or S's own financial statements

General Rules

In Own Accounts

P and S are related

Transactions, balances etc all stay in the accounts

They are, though, disclosed as being related party transactions

Even if at arms length

In Group accounts

All intragroup transactions and balances are eliminated

Why use Fair values when calculating goodwill?

This is to ensure goodwill is calculated correctly

If a company has net assets of 100 in its accounts - these aren't necessarily at FV

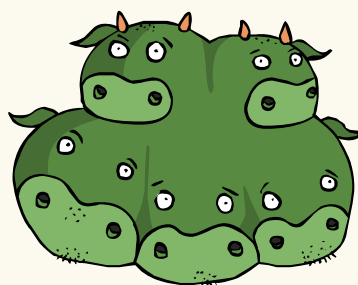
Lets say the FV is actually 120

Now someone buys this company for 150 - how much is goodwill?

If FV of assets is used then it is 30 (this is the correct figure)

Preparing group SFP

Business Combinations - Basics



Business combinations - the basics

So first of all - what is a business combination?

Well my little calf, it's an event where the acquirer obtains control of another business. The **acquisition** ethos of accounting is therefore used.

Let me explain, let's say we are the Parent acquiring the subsidiary. We must prepare our own accounts AND those of us and the sub put together. This is to show our shareholders what we CONTROL

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Basic principles

Consolidation

When a business combination takes place, not only does the acquirer have to prepare its own accounts but also some called “consolidated accounts”

The purpose of consolidated accounts is to show the group as a single economic entity. This is the substance of the combination. Showing what the results are for the acquirer (parent) and acquiree (subsidiary) are combined together

The accounts show all that is **controlled** by the parent, this means:

All assets and liabilities of a subsidiary are included

All income and expenses of the subsidiary are included

Non controlling Interest (NCI)

However the parent does not always **own** all of the above. The parent controls the sub. So the % that is not owned by the parent is called the “non controlling interest”.

A line is included in equity called non controlling interests. This accounts for their share of the assets and liabilities on the SFP

A line is also included on the income statement which accounts for the NCI’s share of the income and expenses

One Thing you must understand before we go on

Forgive me if this is basic, but hey, sometimes it’s good to be sure

	H	S
Non Current Asset	500	600
Investment in S	200	

Current Assets	100	200
Share Capital	100	100
Reserves	300	400
Current Liabilities	100	50
Non Current Liabilities	300	250

Notice if you add the assets together and take away the liabilities for H - it comes to 400 (500+200+100-100-300)

This is what we call the net assets figure. It is the net worth of the company according to accounts (book) values.

There are 2 things to understand about this figure:

It is NOT the true/fair value of the company

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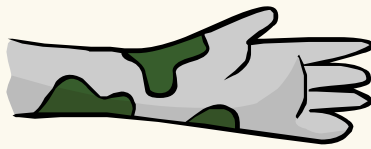
It is equal to the equity section of the SFP

Equity

This shows you how the net assets figure has come about. The share capital is the capital introduced from the owners (as is share premium). The reserves is all the accumulated profits/losses/gains less dividends since the business started. Here the figure is 400 for H.

Notice it is equal to the net assets





Acquisition costs

Where there's an acquisition there's probably some of the costs eg legal fees etc

Costs **directly attributable** to the acquisition are expensed to the income statement.

Be careful though, any costs which are just for the parent (acquirer) issuing its own debt or shares are deducted from the debt or equity itself (often share premium)

Business combinations - the basics

So first of all - what is a business combination?

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Simple Goodwill



Goodwill

When a company buys another - it is not often that it does so at the **fair value of the net assets** only

This is because most businesses are more than just the sum total of their 'net assets' on the SFP. Customer base, reputation, workforce etc are all part of the value of the company that is not reflected in the accounts. This is called "goodwill"

Goodwill only occurs on a business combination. Individual companies cannot show their individual goodwill on their SFPs. This is because they cannot get a reliable measure, This is because nobody has purchased the company to value the goodwill appropriately.

On a business combination the acquirer (Parent) purchases the subsidiary - normally at an amount higher than the FV of the net assets on the SFP, they buy it at a figure that effectively includes goodwill. Therefore the goodwill can now be measured and so does show in the group accounts.



How is goodwill calculated?

On a basic level - I hope you can see - that it is the amount paid by the parent less the FV of the subs assets on their SFP.

Let me explain..

	S
Non Current Assets	1,000
Current Assets	400
Share Capital	100
Share Premium	100
Reserves	700
Current Liabilities	100
Non Current Liabilities	400

In this example S's Net assets are 900 (same as their equity remember). This is just the 'book value' of the net assets.

The Fair Value of the net assets may be, say, 1,000.

However a company may buy the company for 1,200. So, Goodwill would be 200.

The goodwill represents the reputation etc of a company and can only be reliably measured when the company is bought out. Here it was bought for 1,200. Therefore, as the FV of the net assets of S was only 1,000 - the extra 200 is deemed to be for goodwill

The increase from book value 900 to FV 1,000 is what we call a Fair Value adjustment

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NCI in the Goodwill calculation





So far we have presumed that the company has been 100% purchased when calculating goodwill

Our calculation has been this:

Consideration	x
FV of Net Assets Acquired	(x)
Goodwill	x

Non controlling Interests

Let's now take into account what happens when we do not buy all of S. (eg. 80%)

This means we now have some non controlling interests (NCI) at 20%

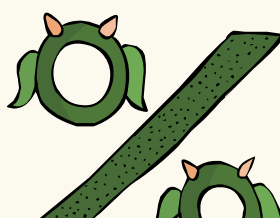
The formula changes to this:

Consideration	x
NCI	x
FV of Net Assets Acquired	(x)
Goodwill	x

This NCI can be calculated in 2 ways:

Proportion of FV of S's Net Assets

FV of NCI itself





Proportion of FV of S's Net Assets method

"Proportionate Method"

This is very straight forward. All we do is give the NCI their share of FV of S's Net Assets..Consider this:

P buys 80% S for 1,000. The FV of S's Net assets were 1,100.

How much is goodwill?

Consideration	1,000
NCI	220
FV of Net Assets Acquired	(1,100)
Goodwill	120

The NCI is calculated as 20% of FV of S's NA of 1,100 = 220

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"Fair Value Method" of Calculating NCI in Goodwill

So in the previous example NCI was just given their share of S's Net assets. They were not given any of their reputation etc. In other words, NCI were not given any goodwill.

I repeat, under the proportionate method, NCI is NOT given any goodwill.

Under the FV method, they are given some goodwill. This is because NCI is not just given their share of S's NA but actually the FV of their 20% as a whole (ie NA + Goodwill). This FV figure is either given in the exam or can be calculated by looking at the share price (see quiz 2)

P buys 80% S for 1,000. The FV of S's Net assets were 1,100. The FV of NCI at this date was 250.

buys 80% S for 1,000. The FV of S's Net assets were 1,100. The FV of NCI at this date was 250

How much is goodwill?

Consideration	1,000
NCI	250
FV of Net Assets Acquired	(1,100)
Goodwill	150

Notice how goodwill is now 30 more than in the proportionate example. This is the goodwill attributable to NCI

NCI goodwill = FV of NCI - their share of FV of S's NA



Remember

Under the proportionate method NCI does not get any of S's Goodwill (only their share of S's NA)

Under the FV method, NCI gets given their share of S's NA **AND** their share of S's goodwill

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Goodwill	x

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Equity Table

S's Equity Table

Share Equity Table

As you will see when we get on to doing bigger questions, this is always our first working. This is because it helps all the other workings.

Remember that Equity = Net assets

Equity is made up of:

- 1) Share Capital
- 2) Share Premium
- 3) Retained Earnings
- 4) Revaluation Reserve
- 5) Any other 'reserve'!

If any of the above are mentioned in the question for S, then they must go into this equity table working

What does the table look like?

	At SFP date	At Acquisition	Post Acquisition
Share Capital	x	x	x
Share Premium	x	x	x
Retained Earnings	x	x	x
Total	x	x	x

Remember that any other reserve would also go in here

So how do we fill in this table?

- 1) Enter the "**Year end**" figures straight from the SFP
- 2) Enter the "**At acquisition**" figures from looking at the information given normally in note 1 of the question. Please note you can presume the share capital and share premium is the same as the year end figures, so you're only looking for the at acquisition reserves figures
- 3) Enter "**Post Acquisition**" figures simply by taking away the "At acquisition" figures away from the "Year end" figures (ie. Y/E - Acquisition = Post acquisition)

So let's try a simple example.. (although this is given in a different format to the actual exam let's do it this way to start with)

A company has share capital of 200. share premium of 100 and total reserves at acquisition of 100 at acquisition and have made

profits since of 400. There have been no issues of shares since acquisition and no dividends paid out.

Show the Equity table to calculate the net assets now at the year end, at acquisition and post acquisition

Solution

	Now	At Acquisition	Post Acquisition
Share Capital	200	200	0
Share Premium	100	100	0
Retained Earnings	500	100	400
Total	800	400	400

Fair Value Adjustments

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Ok the next step is to also place into the Equity table any Fair Value adjustments

When a subsidiary is purchased - it is purchased at FAIR VALUE at acquisition.

Using the figures above, if I were to tell you that the FV of the sub at acquisition was 480. Hopefully you can see we would need to make an adjustment of 80 (let’s say that this was because Land had a FV 80 higher than in the books:

	Now	At Acquisition	Post Acquisition
Share Capital	200	200	0
Share Premium	100	100	0
Retained Earnings	500	100	400
Land	x	80	x
Total	800	480	x

Now as land doesn’t depreciate - it would still now be at 80 - so the table changes to this:

	Now	At Acquisition	Post Acquisition
Share Capital	200	200	0
Share Premium	100	100	0
Retained Earnings	500	100	400
Land	80	80	0
Total	880	480	400

If instead the FV adjustment was due to PPE with a 10 year useful economic life left - and lets say acquisition was 2 years ago, the table would look like this:

	Now	At Acquisition	Post Acquisition
Share Capital	200	200	0
Share Premium	100	100	0
Retained Earnings	500	100	400
PPE	64	80	-16
Total	864	480	384

The -16 in the post acquisition column is the depreciation on the FV adjustment. (80 / 10 years x 2 years).

This makes the now column 64 (80 at acquisition - 16 depreciation post acquisition)

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This makes the now column 64 (80 at acquisition - 16 depreciation post acquisition)

NCI on the SFP

Non Controlling Interests

So far we have looked at goodwill and the effect of NCI on this..now let's look at NCI in a bit more detail

(Don't worry we will pull all this together into a bigger question later)

If you remember there are 2 methods of measuring NCI at acquisition:

1) Proportionate method

This is the NCI % of FV of S's Net assets at acquisition

2) FV Method

This is the FV of the NCI shares at acquisition (given mostly in the question)

This choice is made at the beginning

Obviously, S will make profits/losses after acquisition and the NCI deserve their share of these. Therefore the formula to calculate NCI on the SFP is as follows:

NCI @ Acquisition	x	(this is the same figure as used in goodwill*)
NCI % of S's post acquisition profits/losses	x	
NCI on the SFP	x	

* This figure depends on the option chosen at acquisition (Proportionate or FV method)

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Impairment

S may become impaired over time. If it does, it is S's goodwill which will be reduced in value first. If this happens it only affects NCI if you are using the FV method.

This is because the proportionate method only gives NCI their share of S's Net assets and none of the goodwill. Whereas, when using the FV method, NCI at acquisition is given a share of S's NA and a share of the goodwill

NCI on the SFP Formula revised

NCI @ Acquisition	x	(this is the same figure as used in goodwill*)
NCI % of S's post acquisition profits/losses	x	
Impairment	(x)	(ONLY if using FV method)
NCI on the SFP	x	

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Basic groups - Simple Question 1



Have a look at this question and solution below and see if you can work out where all the figures in the solution have come from. Make sure to check out the videos too as these explain numbers questions such as these far better than words can..

	P	S
Non Current Asset	500	600
Investment in S	200	
Current Assets	100	200
Share Capital	100	100
Reserves	300	400
Current Liabilities	100	50
Non Current Liabilities	300	250

P acquired 80% S when S’s reserves were 80

Prepare the Consolidated SFP, assuming P uses the proportionate method for measuring NCI at acquisition

Goodwill

Consideration	200
NCI	36
FV of Net Assets Acquired	(180)
Goodwill	56

NCI

NCI @ Acquisition	36	(from goodwill working above)

NCI % of S's post acquisition profits	64	(20% x (400-80))
Impairment	(0)	(20% x 0)
NCI on the SFP	100	

Reserves

P	300	
S	256	(80% x (400-80))
Impairment	(0)	(100% because proportionate method x 0)
	556	

	P	S	Group
Non Current Asset	500	600	1,100
Investment in S	200	Goodwill	56
Current Assets	100	200	300
Share Capital	100	100	100
Reserves	300	400	556
NCI			100
Current Liabilities	100	50	150
Non Current Liabilities	300	250	550





Notice:

- 1) Share Capital (and share premium) is always just the holding company
- 2) All P + S assets are just added together
- 3) "Investment in S"..becomes "Goodwill" in the consolidated SFP
- 4) NCI is an extra line in the equity section of consolidated SFP

Basic Groups - Simple Question 2



	P	S
Non Current Asset	500	600
Investment in S	120	
Current Assets	100	200
Share Capital	100	100
Reserves	220	400
Current Liabilities	100	50
Non Current Liabilities	300	250

acquired 80% S when S's Reserves were 40. At that date the FV of S's NA was 150. Difference due to Land. There have been no issues of shares since acquisition.

P uses the FV of NCI method at acquisition, and at acquisition the FV of NCI was 35. No impairment of goodwill.

Prepare the consolidated set of accounts

Step 1

Prepare S's Equity Table

	Now	At Acquisition	Post Acquisition
Share Capital	100	100	0
Retained Earnings	400	40	360
Land	10	10	0
Total	510	150	360

Now the extra 10 FV adjustment now must be added to the PPE when we come to do the SFP at the end

Step 2

Goodwill

Consideration	120
NCI	35 (Given)
FV of Net Assets Acquired	(150) from S's Equity table
Goodwill	5

Step 3

Step 3

Do any adjustments in the question

: NONE

Step 4

NCI

NCI @ Acquisition	35	(given)
NCI % of S's post acquisition profits	72	(20% x 360 (from S's Equity table))
Impairment	(0)	(20% x 0)
NCI on the SFP	107	

Step 5

Reserves

P	220	
S	288	(80% x 360 (from S's equity table))
Impairment	(0)	(80% x 0)
	508	

Step 6

Prepare the final SFP (with all adjustments included)

	P	S	Group
Non Current Asset	500	600	1,110 (including 10 from S's equity table)
Investment in S	120	Goodwill	5
Current Assets	100	200	300
Share Capital	100	100	100
Reserves	220	400	508
NCI			107
Current Liabilities	100	50	150
Non Current Liabilities	300	250	550

[Equity table explanation \(mp3\)](#)

Calculating Goodwill

Basic Goodwill Calculation

This is calculated on the date of acquisition of the sub

It represents the intangible reputation / customer base etc of the sub

It is calculated as follows:

FV of Consideration	X
NCI	X
FV of Net Assets Acquired	(X)
Goodwill	X

Make sure you use FV of Consideration

Consideration is simply what the Parent pays for the sub

It is the first line in the goodwill working as follows:

FV of Consideration	X
NCI	X
FV of Net Assets Acquired	(X)
Goodwill	X

Normal Consideration

This is straightforward. It is simply:

Dr Investment in S
Cr Cash

Future Consideration

This is a little more tricky but not much. Here, the payment is not made immediately but in the future. So the credit is not to cash but is a liability.

Dr Investment in S
Cr Liability

The only difficulty is with the amount

As the payment is in the future we need to discount it down to **the present value** at the date of acquisition

Illustration

P agrees to pay S 1,000 in 3 years time (discount rate 10%)

Dr Investment in S 751
Cr Liability 751 ($1,000 / 1.10^3$)

As this is a discounted liability, we must unwind this discount over the 3 years to get it back to 1,000. We do this as follows:

Year	1	2	3
------	---	---	---

Dr Interest Cr Liability	75	84	91

Contingent Consideration

This is when P MAY OR MAY NOT have to pay an amount in the future (depending on, say, S's subsequent profits etc). We deal with this as follows:

Dr Investment in S
Cr Liability

All at fair value

You will notice that this is exactly the same double entry as the future consideration (not surprising as this is a possible future payment!)

The only difference is with the amount

Instead of only discounting, we also take into account the probability of the payment actually being made

Doing this is easy in the exam - all you do is value it **at the FV**

(This will be given in the exam you'll be pleased to know)

Illustration

1/1/x7 H acquired 100% S when it's NA had a FV of £25m. H paid 4m of its own shares (mv at acquisition £6) and cash of £6m on 1/1/x9 if profits hit a certain target.

At 1/1/x7 the probability of the target being hit was such that the FV of the consideration was now only £2m. Discount rate of 8% was used

At 31/12/x7 the probability was the same as at acquisition.

At 31/12/x8 it was clear that S would beat the target

Show the double entry

Contingent consideration should always be brought in at FV. Any subsequent changes to this FV post acquisition should go through the income statement

Any discounting should always require an winding of the discount through interest on the income statement

Double entry - Parent Company

1/1/x7

Dr Investment in S (4m x £6) + £2 = 26

Cr Share Capital 4

Cr Share premium 20

Cr Liability 2

31/12/x7

Dr interest 0.16

Cr Liability 0.16

31/12/x8

Dr Income statement 4 (6-2)

Dr Liability 2

Cr Cash 6

Use either proportionate or FV NCI

NCI can be valued using the PROPORTIONATE method or the FAIR VALUE method

Proportionate method

Here NCI gets its % of S's NA

1. % of S's NA (at fair value)
2. No goodwill in S is given to NCI

Let's say the parent acquires 80% of a subsidiary with net assets of 100.

NCI would receive 20 at acquisition

The goodwill calculation would look like this...

FV of Consideration	X
NCI	20
FV of Net Assets Acquired	(100)
Goodwill	X

Fair Value

Here NCI get their % of NA AND goodwill

1. % of S's NA (at fair value)
2. % of S's Goodwill

Let's say the parent acquires 80% of a subsidiary with net assets of 100.

NCI would receive the FV of its holding at acquisition

This would be given in the exam or calculated as NCI shares x share price

Let's say this is 28

The goodwill calculation would look like this...

FV of Consideration	X
NCI	28
FV of Net Assets Acquired	(100)
Goodwill	X

Make sure you use FV of Net Assets Acquired

A subsidiary is brought into group accounts at FAIR value at acquisition

Here's a subsidiary at **Book Value**

Property, plant and equipment	47,400
Financial asset: equity investments	7,500
Inventory	20,400
Trade Receivables	14,800
Bank	2,100
Equity shares of \$1 each	40,000
Retained earnings	26,600
10% loan notes	8,000

Trade Payables	17,600
NET ASSETS at book value	66,600

The FAIR Values of the above net assets were the same as their book value with the exception of PPE which had a FV \$3000 in excess of the book value

Here's the subsidiary at **FAIR Value**

Property, plant and equipment	47,400 + 3,000
Financial asset: equity investments	7,500
Inventory	20,400
Trade Receivables	14,800
Bank	2,100
Equity shares of \$1 each	40,000
Retained earnings	26,600
Revaluation Reserve	3,000
10% loan notes	8,000
Trade Payables	17,600
NET ASSETS at fair value	69,600

Once the FV of the NA has been calculated, the total goes into the goodwill calculation as follows:

FV of Consideration	X
NCI	X
FV of Net Assets Acquired	(X)
Goodwill	X

Adjustments

Unrealised Profit

The key to understanding this - is the fact that when we make group accounts - we are pretending P & S are the same entity.

Therefore you cannot make a profit by selling to yourself!

So any profits made between two group companies (and still in group inventory) need removing - this is what we call 'unrealised profit'

Unrealised profit - more detail

Profit is only 'unrealised' if it remains within the group. If the stock leaves the group it has become realised.

So 'Unrealised profit' is profit made between group companies and REMAINS IN STOCK

Example

P buys goods for 100 and sells them to S for 150. S has sold 2/5 of this stock

The Unrealised Profit is: Profit between group companies $50 \times \frac{3}{5}$ (what remains in stock) = 30

How do we then deal with Unrealised Profit

If P buys goods for 100 and sells them to S for 150. Thereby making a profit of 50 by selling to another group company. S sells 4/5 of them to 3rd parties

Unrealised profit is $50 \times \frac{1}{5} = 10$

The idea of what we need to do	How we do it on the SFP
Reduce Profit of Seller	Reduce SELLERS Retained Earnings
Reduce Inventory	Reduce BUYERS Inventory

[Unrealised profit \(mp3\)](#)

So why do we reduce inventory as well as profit?

Well let's say that S buys goods for 100 and sells them to P for 150 and P still has them in stock

How much did the stock actually cost the group? The answer is 100, as they are still in the group. However P will now have them in their stock at 150. So we need to reduce stock/inventory also with any unrealised profit

Intra-Group Balances & In-transit Items



Inter group company Balances

As with Unrealised Profit - this occurs because group companies are considered to be the same entity in the group accounts

Therefore you cannot owe or be owed by yourself

So if P owes S - it means P has a payable with S, and S has a receivable from P in their INDIVIDUAL accounts

In the group accounts, you cannot owe/be owed by yourself - so simply cancel these out:

Dr Payable (in P)

Cr Receivable (in S)

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[clipAttachment](#)

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The only time this wouldn't work is if the amounts didn't balance, and the only way this could happen is because something was still in transit at the year end. This could be stock or cash.

You always alter the receiving company. What I mean is - if the item is in transit, then the receiving company has not received it yet - so simply make the RECEIVING company receive it as follows:

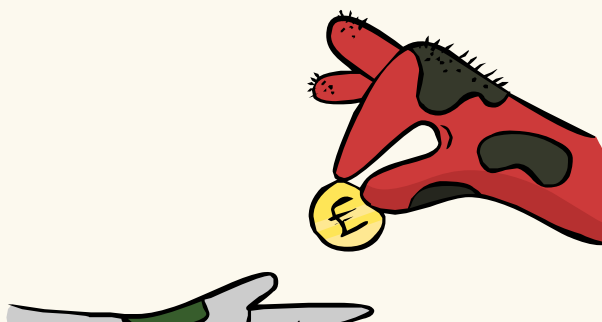


Stock in transit

In the RECEIVING company's books:

Dr Inventory

Cr Payable





Cash in transit

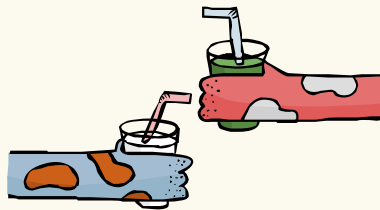
In the RECEIVING company's books:

Dr Cash
Cr Receivable

Having dealt with the amounts in transit - the inter group balances (receivables/payables) will balance so again you simply:

Dr Payable
Cr Receivable

Share for Share Exchanges



Share for share exchanges

These can form part, or all, of the cost of investment which is used in the goodwill calculation.

Under normal circumstances, P acquires S's shares by giving them cash, so the double entry is

Dr Cost of Investment
Cr Cash

However this time, P does not give cash, but instead gives some of its own shares

If this exchange has yet to be accounted for, the double entry is always: -

Dr Cost of Investment
Cr Share capital (with the nominal value of P shares given out)
Cr Share premium (with the premium)





Illustration

P acquired 80% of S shares via a 2 for 1 share exchange. At the date of acquisition, the following balances were in the books of P and S:

	P	S
Share Capital	\$400	(\$0.50) \$400
Share Premium	\$100	\$50

The share price of H was \$2 at the date of acquisition. This has not been accounted for.

Show the accounting treatment required to account for the share exchange.

P acquired 80% of S's shares. The shares had a value of \$400 but a nominal value of \$0.50. This means S has 800 shares in total. P acquired 80% x 800 = 640 shares

The share for share deal was 2 for 1. So P gives 1,280 of its shares in return for 640 of S's shares. P's shares have a MV of \$2 at this date so the "cost of investment is 1,280 x 2 = 2,560

Double entry

Dr Cost of Investment 2,560
Cr Share Capital (P) 1,280
Cr Share Premium (P) 1,280

[Nominal values in share for share exchanges \(mp3\)](#)

Preparing group Income statement

Group Income Statement

Group Income statement

Rule 1

Add Across 100%

Like with the SFP, P and S are both added together. All the items from revenue down to Profit after tax; except for:

- 1) Dividends from Subsidiaries
- 2) Dividends from Associates

Rule 2

NCI

This is an extra line added into the consolidated income statement at the end. It is calculated as $\text{NCI\%} \times \text{S's PAT}$

The reason for this is because we add across all of S (see rule 1) even if we only own 80% of S. We therefore owe NCI 20% of this which we show at the bottom of the income statement

Rule 3

Associates

Simply show one line (so never add across an associate). The line is called "Share in Associates' Profit after tax"

[Income statement - PAT \(mp3\)](#)

Rule 4

Depreciation from the Equity table working

Remember this working from when we looked at group SFP's?

	Now	At Acquisition	Post Acquisition
Share Capital	100	100	0

Share Premium	50	50	0
Retained Earnings	430	250	180
PPE	40	50	-10
Total	620	450	170

The -10 from the FV adjustment is a group adjustment. So needs to be altered on the group income statement. It represents depreciation, so simply put it to admin expenses (or wherever the examiner tells you), be careful though to only out in THE CURRENT YEAR depreciation charge



Rule 5

Time apportioning

This isn't difficult but can be awkward/tricky. Basically all you need to remember is the group only shows POST -ACQUISITION profits. ie. Profits made SINCE we bought the sub or associate

If the sub or associate was bought many years ago this is not a problem in this year's income statement as it has been a sub or assoc all year.

The problem arises when we acquire the sub or the associate mid year. Just remember to only add across profits made after acquisition. The same applies to NCI (as afterall this just a share of S's PAT). For example if our year end is 31/12 and we buy the sub or assoc on 31/3. We only add across 9/12 of the subs figures and NCI is $\% \times S's \text{ PAT} \times 9/12$

One final point to remember here is adjustments such as unrealised profits / depreciation on FV adjustments are entirely post - acquisition and so are NEVER time apportioned

Rule 6

Unrealised profit

If you haven't already looked at this when we were doing the group SEP do so now [here](#)

you haven't already looked at this when we were doing the group SFP do so now [here](#)

You will remember this table I hope

The idea of what we need to do	How we do it on the SFP
Reduce Profit of Seller	Reduce SELLERS Retained Earnings
Reduce Inventory	Reduce BUYERS Inventory

Well the idea stays the same - it's just how we alter the accounts that changes, because this is an income statement after all and not an SFP. So the table you need to remember becomes:

The idea of what we need to do	How we do it on the SFP
Reduce Profit of Seller	Increase SELLERS Cost of Sales
Reduce Inventory	No adjustment required

Notice how we do not need to make an adjustment to reduce the value of inventory. This is because we have increased cost of sales (to reduce profits), but we do this by actually reducing the value of the closing stock.

Other group issues

Associates



Associates

An associate is an entity over which the group has significant influence, but not control

Significant Influence

Significant Influence

Significant influence is normally said to occur when you own between 20-50% of the shares in a company but is usually evidenced in one or more of the following ways:

representation on the board of directors

participation in the policy-making process

material transactions between the investor and the investee

interchange of managerial personnel; or

provision of essential technical information

[Associate indicators \(mp3\)](#)

Accounting treatment

An associate is **not** a group company and so is not consolidated. Instead it is accounted for using the **equity method** .
Intercompany balances are not cancelled.

Statement of Financial Position

There is just one line only "investment in Associate" that goes into the consolidated SFP (under the Non current Assets section)

It is calculated as follows:

Cost	400
Share of A's post acquisition reserves	200
Less impairment	(100)
	500

Consolidated income statement

Again just one line in the consolidated income statement:

--	--

Include share of PAT less any impairment for that year in associate

Do not include dividend received from A

What's important to notice is that you do NOT add across the associate's Assets and Liabilities or Income and expenses into the group totals of the consolidated accounts. Just simply place one line in the SFP and one line in the Income Statement

Unrealised profits for an associate

1) Only account for the parent's share (eg 40%). This is because we only ever place in the consolidated accounts P's share of A's profits so any adjustment also has to be only P's share

2) Adjust earnings of the seller

Adjustments Required on Income statement

If A is the seller - reduce the line "share of A's PAT"

If P is the seller - increase P's COS

Adjustments Required on SFP

If A is the seller - reduce A's Retained earnings and P's Inventory

If P is the seller - reduce P's Retained Earnings and the "Investment in Associate" line



Illustration

P sells goods to A (a 30% associate) for 1,000; making a 400 profit. 3/4 of the goods have been sold to 3rd parties by A.

What entries are required in the group accounts?

Profit = 400; Unrealised (still in stock) 1/4 - so unrealised profit = $400 \times 1/4 = 100$. As this is an associate we take the parents share of this (30%). So an adjustment of $100 \times 30\% = 30$ is needed

Adjustment required on the Income statement

P is the seller - so increase their COS by 30

Adjustment required on the group SFP

P is the seller - so reduce their retained earnings and the line "Investment in Associate" by 30

Illustration

	H	S	A
PPE	300,000	100,000	160,000
18,000 shares in S	75,000		
24,000 shares in A	30,000		
Receivables	345,000	160,000	80,000
Share capital £1	250,000	30,000	60,000
Retained earnings	400,000	180,000	100,000
Trade payables	100,000	50,000	80,000

The retained earnings of S and A were £70,000 and £30,000 respectively when they were acquired 8 years ago. There have been no issues of shares since then, and no FV adjustments required. The group use the proportionate method for valuing NCI at acquisition

Prepare the consolidated SFP

Solution

Step 1: Equity Table

	Now	At Acquisition	Post Acquisition
Share Capital	30,000	30,000	0
Retained Earnings	180,000	70,000	110,000
Total	210,000	100,000	110,000

Step 2: Goodwill

Consideration	75,000
NCI	40,000 (40% x 100,000)
FV of Net Assets Acquired	(100,000) from equity table
Goodwill	15,000

S owns 18,000 of A's share capital of 30,000 so 60%

Step 3: NCI

NCI @ Acquisition	40,000	(from goodwill working)
40 % of S's post acquisition profits	44,000	(40% x 110,000) (From equity table)
Impairment	(0)	
NCI on the SFP	84,000	

Step 4: Retained Earnings

P	400,000	
S	66,000	(60% x 110,000 (From Equity table)
A	28,000	(40% x 70,000 (100-30)
Impairment	(0)	(100% because proportionate method x 0)
	494,000	

Step 5: Investment In Associate

Cost	30,000
------	--------

Share of A's post acquisition reserves	28,000 (from RE working)
Less impairment	(0)
	58,000

Final Answer

Goodwill

	H	S	A	Group
PPE	300,000	100,000	160,000	400,000
18,000 shares in S	75,000			15,000
18,000 shares in A	30,000		Investment in Associate	58,000
Receivables	345,000	160,000	80,000	505,000
Share capital £1	250,000	30,000	60,000	250,000
Retained earnings	400,000	180,000	100,000	494,000
NCI				84,000
Trade payables	100,000	50,000	80,000	150,000

Impairment of Goodwill

Goodwill is reviewed for impairment not amortised

An impairment occurs when the subs recoverable amount is less than the subs carrying value + goodwill

How this works in practice depends on how NCI is measured.. Proportionate or Fair Value method

Proportionate NCI

Here, NCI only receives % of S's net assets

NCI DOES NOT have any share of the goodwill

1. Compare the recoverable amount of S (100%) to..
2. NET ASSETS of S (100%) +
Goodwill (100%)
3. The problem is that goodwill on the SFP is for the parent only - so this needs grossing up first
4. Then find the difference - this is the impairment - but only show the parent % of the impairment

Example

H owns 80% of S. Proportionate NCI

Goodwill is 80 and NA are 200

Recoverable amount is 240

How much is the impairment?

Solution

RA = 240

NA = 200 + G/W (80 x 100/80) = 100 = 300

Impairment is therefore 60

The impairment shown in the accounts though is 80% x 60 = 48.

This is because the goodwill in the proportionate method is parent goodwill only. Therefore only parent impairment is shown

Fair Value NCI

Here, NCI receives % of S's net assets AND goodwill

NCI DOES now own some goodwill

1. Compare the recoverable amount of S (100%) to..
2. NET ASSETS of S (100%) +
Goodwill (100%)
3. As, here, goodwill on the SFP is 100% (parent & NCI) - so NO grossing up needed
4. Then find the difference - this is the impairment - this is split between the parent and NCI share

Example

H owns 80% of S. Fair Value NCI

Goodwill is 80 and NA are 200

Recoverable amount is 240

How much is the impairment?

Solution

RA = 240

NA = 200 + G/W 80 = 280

Impairment is therefore 40

The impairment shown in P's RE as $80\% \times 40 = 32$

The impairment shown in NCI is $20\% \times 40 = 8$

Impairment adjustment on the Income Statement

1. Proportionate NCI

Add it to P's expenses

2. Fair Value NCI

Add it to S's expenses

(This reduces S's PAT so reduces NCI when it takes its share of S's PAT)

Question 1's to June 14

Question 1 (to June 14)

Analysing and Interpreting Financial Statements

Limitations of financial statements

Interpreting Ratios

Profitability

Return on Capital Employed

ROCE

This is a measure of management's overall efficiency in using the finance/assets

is affected by the carrying amount of PPE

So old plant will give a higher than usual ROCE

Revaluations upwards will give a lower than usual ROCE

ROCE can be broken down (explained by) 2 more ratios:

Operating Margin

Asset Turnover

So if operating margin goes up and ROCE goes down - you know that ROCE is going down due to a poor Net asset turnover.

The assets aren't producing the amount of sales they used to

the assets aren't producing the amount of sales they used to

Margin X Asset Turnover

Gross Margin

Gross Profit

Sales

This is affected by..

An increase in gross profit doesn't necessarily mean an increase in the margin

This is because Gross profit is also affected by the volume of sales (not just the margin made on each one)

Opening and closing inventory measured at different costs

Inventory write downs due to damage/obsolescence

A change in the sales mix

eg. from higher to lower margin sales

New (different margin) products

New suppliers with different costs

Selling prices change

eg. discounts offered

More or less Import duties

Exchange rate fluctuations

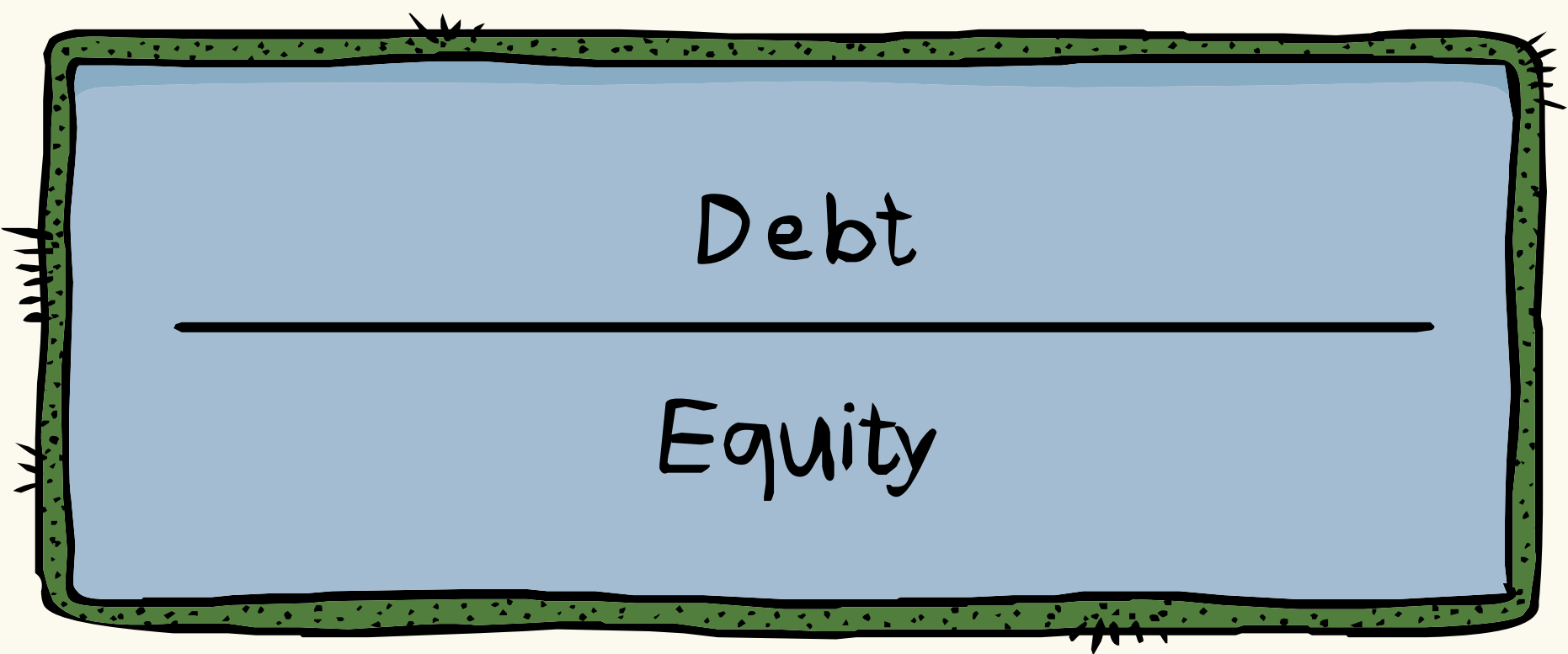
Change in cost classification:

eg. Some costs included as operating expenses now in cost of sales

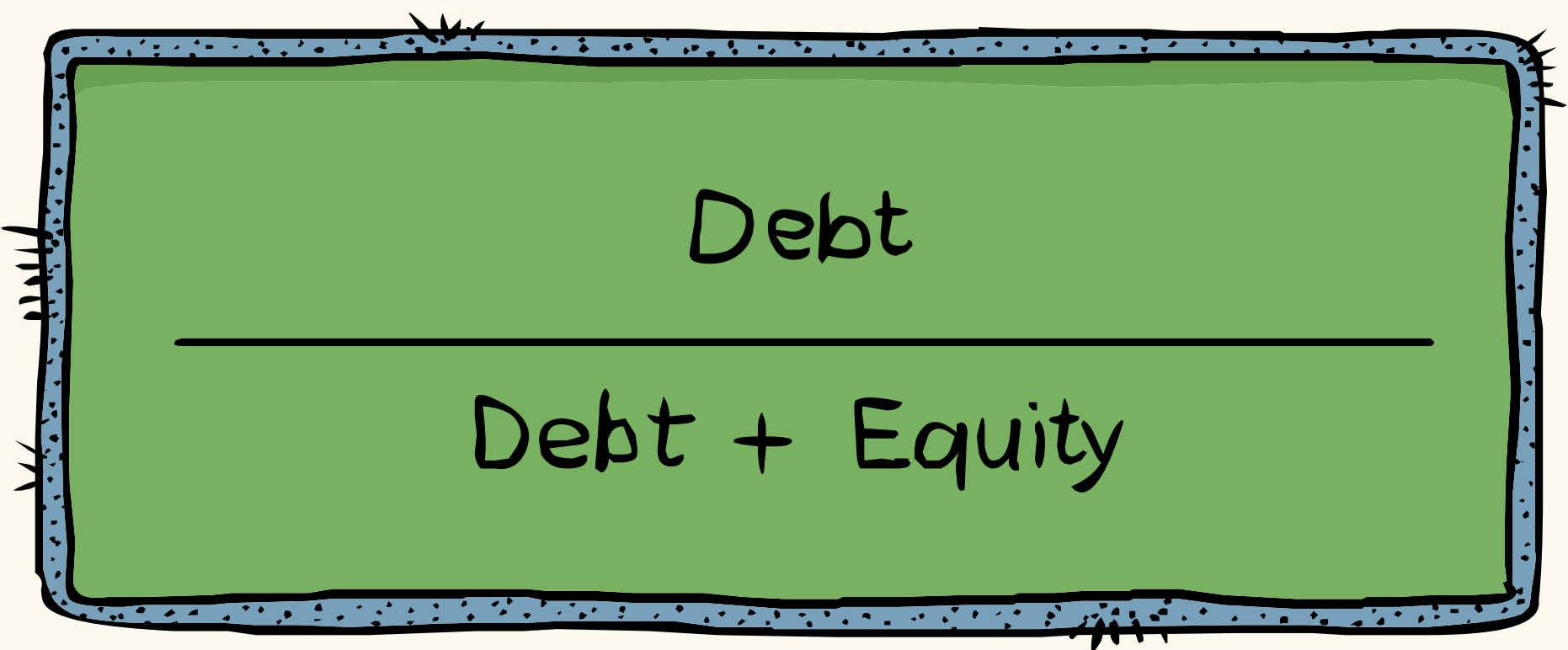
Operating Margin

Gearing

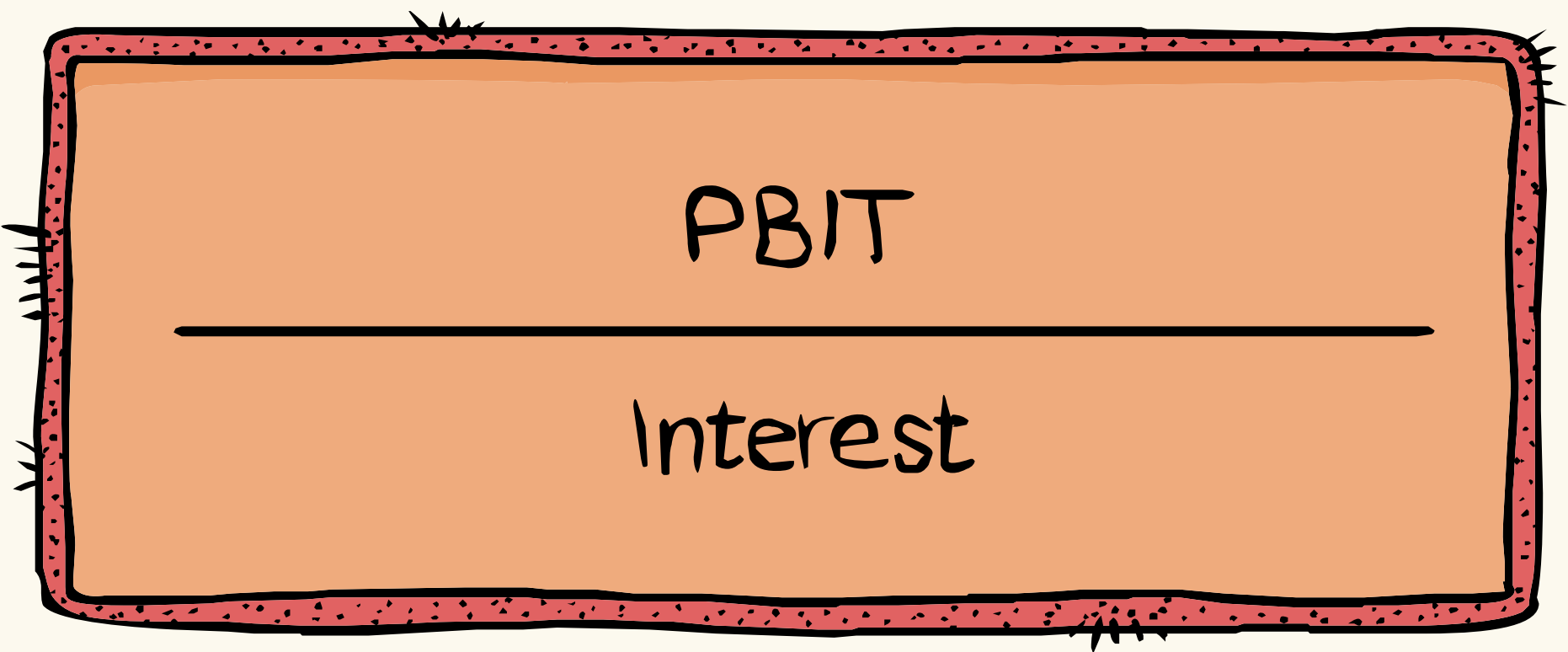
Financial Gearing



This could also be calculated as:



Interest Cover



Points to notice about LOW interest cover

low interest cover is a direct consequence of high gearing and . For example,

- It makes profits vulnerable to relatively small changes in operating activity

- So small reductions in sales / margins or small increases in expenses may mean interest can't be paid

Liquidity

Current ratio

Current Assets

Current Liabilities

Quick Ratio

Current Assets - Inventory

Current Liabilities

Bank Account / Overdraft

Don't forget the obvious and look at the movement on this

Look for why it has increased or decreased

If money is spent on assets that's normally a good thing

If money is spent on high dividends (with little cash) that's a bad thing

If a loan is paid off - that's normally a bad idea (as the company should be able to make a better return)

Working Capital Cycle

This is made up of

The difference between being paid needs to be funded (often by an overdraft)

1. Inventory Days + (ideally these are low)
2. Receivable days - (ideally these are low)
3. Payable days (ideally these are high)



Inventory

Cost of Sales x 365

Receivables

$\text{Credit Sales} \times 365$

Payables

$\text{Credit Purchases} \times 365$

Cash balances falling

New share / loan issues with no respective increase in assets

Sale and leaseback of assets

Payables days getting longer

Limitations of Interpretation Techniques

Ratio limitations

Ratios aren't always comparable

Factors affecting comparability

1. Different accounting policies

Eg One company may revalue its property; this will increase its capital employed and (probably) lower its ROCE

Others may carry their property at historical cost

2. Different accounting dates

Eg One company has a year ended 30 June, whereas another has 30 September

If the sector is exposed to seasonal trading, this could have a significant impact on many ratios, in particular working capital based ratios

3. Different ratio definitions

Eg This may be a particular problem with ratios like ROCE as there is no universally accepted definition

4. Comparing to averages

Sector averages are just that: averages

Many of the companies included in the sector may not be a good match to the type of business being compared

Some companies go for high mark-ups, but usually lower inventory turnover, whereas others go for selling more with lower margins

5. Possible deliberate manipulation (creative accounting)

6. **Different managerial policies**

e.g. different companies offer customers different payment terms

7. **Impact of price changes over time/distortion caused by inflation**

Compare ratios with

1. Industry averages
2. Other businesses in the same business
3. With prior year information

We are unable to compare if:

1. There is no prior year information or
2. no industrial averages

Other relevant information

When buying a company

Audited financial statements

Forward looking information

Eg. Profit and financial position forecasts
Capital expenditure budgets and
Cash budgets and
Order levels

Current **(fair) values** of assets being acquired

Level of business risk

Highly profitable companies may also be highly risky, whereas a less profitable company may have more stable 'quality' earnings

Expected price to acquire a company

It may be that a poorer performing business may be a more attractive purchase because it has higher potential for growth

Specialised, not-for-profit and public sector entities

Not for Profit sector

Getting a Loan

Similar criteria as would be used for profit-orientated entities

How secure is the loan?

Here use the capital gearing ratio:

Long-term loans to net assets

Clearly if this ratio is high, further borrowing would be at an increased risk

Ability to repay the interest & capital

Interest cover should be calculated

$\text{PBIT} / \text{Interest}$

The higher this ratio the less risk of interest default

Look for trends indicating a deterioration in this ratio

Nature and trend of income

Are the sources of income increasing or decreasing

Does the reported income contain 'one-off' donations (which may not be recurring) etc?

Other matters

Market value of, and prior charges against, any assets used as loan security

Any (perhaps the trustees) personal guarantees for the loan

Question 3's to June 14

