Corporate Reporting

Study Text

The Institute of Chartered Accountants of Nigeria

ICAN

Corporate Reporting

The Institute of
Chartered Accountants
of Nigeria (ICAN)

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Professional level
Corporate Reporting

C

Contents

Professional level
Corporate Reporting

S

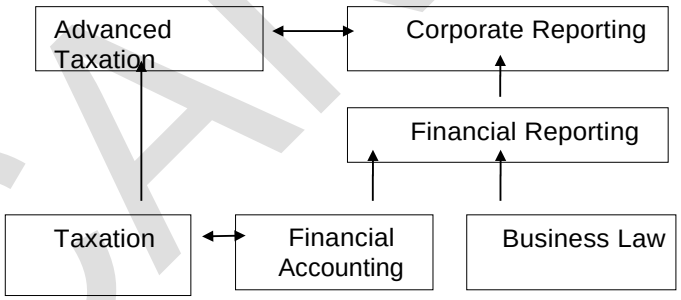
Syllabus

CORPORATE REPORTING

Aim
This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Linkage with other subjects

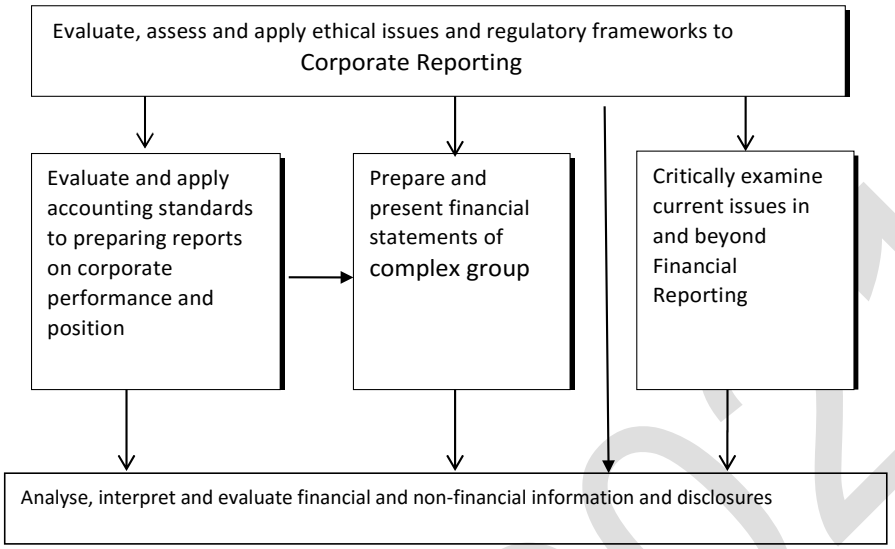
This diagram depicts the relationship between this subject and other subjects. Financial Accounting and Financial Reporting are pre-requisites to this subject.



Main competencies	
On successful completion of this paper, candidates should be able to:	
•	Prepare and report information in financial statements and notes on complex single-entity, group (subsidiaries and associates) and all forms of business combinations;
•	Select, assess and present suitable accounting policies;
•	Analyse, interpret and evaluate financial information and disclosures;
•	Prepare and analyse financial statements to show the position, performance, prospect and risks of business;
•	Understand current issues in the reporting framework and Corporate Reporting; and
•	Understand and assess creative accounting and aggressive earnings management.

Linkage of the main competencies

This diagram illustrates the linkage between the main competencies of this subject and is to assist candidates in studying for the examination.



Syllabus overview		
Grid		**Weighting**
A	Regulatory framework and ethical issues in Corporate Reporting	10
B	Reporting of entity's performance to stakeholders	20
C	Group financial statements	30
D	Current developments in and beyond Financial Reporting	20
E	Analysis of financial and other reports to appraise entity's financial performance and position	20
Total		**100**

Detailed syllabus				Chapter
A	**Regulatory framework and ethical issues in Corporate Reporting**			
	1	**Regulatory framework of Corporate Reporting**		
		a	Discuss the need for convergence in international regulatory frameworks of Financial Reporting standards.	1
		b	Evaluate the desirability, feasibility and implications of global Financial Reporting convergence using International Financial Reporting Standards (IFRS).	1
		c	Differentiate between rules-based and principles-based accounting standards;	1
		d	Assess the applicable regulations as sources of Nigerian GAAP;	1
		e	Discuss the merits and demerits of international convergence of Financial Reporting standards;	1
		f	Evaluate disclosures of corporate governance and chairman's report as they relate to a company's annual report; and	3
		g	Discuss the roles of Financial Reporting Council of Nigeria (FRCN) in Financial Reporting regulations and enforcement including IFRS compliance.	1
	2	**Ethical issues in Corporate Reporting**		
		a	Discuss the professional accountants' code of ethics as it relates to Corporate Reporting.	1
		b	Discuss and evaluate the ethical considerations that may arise in Corporate Reporting including ethical dilemmas.	1
		c	Assess, recommend and justify actions to be taken where ethical issues arise in given Corporate Reporting scenarios.	1
B	**Reporting of entity's performance to stakeholders**			
	1	**Performance reporting**		
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.	7
		b	Apply accounting standards relating to performance reporting such as IFRS 15, IFRS 8, IFRS 5, IAS 33 and IAS 34 to the preparation of financial statements.	3, 8, 28
		c	Formulate and evaluate entity's accounting policies (including group entities) in accordance with the provisions of IAS 8.	6
		d	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.	Sundry

Detailed syllabus				Chapter
B	**Reporting of entity's performance to stakeholders (continued)**			
	2	**Non- financial assets**		
		a	Assess the effects of different recognition and measurement methods and timing of recognition of non-financial assets on reported financial position.	7 and 9 to 12
		b	Discuss and appraise accounting treatments of non-current assets such as: property, plant and equipment - IAS 16; intangible assets - IAS 38; investment properties - IAS 40; leases - IFRS 16; non-current assets held for sale - IFRS 5; biological assets – IAS 41.	9 to 12 and 19
	3	**Non-financial liabilities**		
		a	Evaluate how different methods and timing of recognition and measurement of non-financial liabilities affect reported financial position.	7 and 12 to 15
		b	Appraise accounting treatments of non-financial liabilities such as employees' benefits – IAS 19; share based payment – IFRS 2; income tax – IAS 12; provisions and contingencies – IAS 37; and leases - IFRS 16.	12 to 15
		c	Appraise the effect of related parties' transactions and disclosures on reported performance in line with relevant accounting standards.	3
	4	**Financial assets and liabilities**		
		a	Determine and assess how different bases for recognition, measurement and classification of financial assets and financial liabilities impact on reported performance and position.	17 and 18
		b	Appraise the accounting treatment of financial instruments (IFRS 7 and IFRS 9) including impairment and hedge accounting under IFRS 9 for financial assets and liabilities.	17 and 18
	5	**Segment reporting**		
		a	Determine and assess the nature and extent of reportable segments (IFRS 8).	3
		b	Discuss the nature of segment information to be disclosed and its overall impact on reported performance of the reporting entity.	3

Detailed syllabus				Chapter
C	**Group financial statements**			
	1	**Introduction to consolidating complex group structure**		
		a	Identify and discuss complex group relationships including the criteria used to identify a subsidiary and an associate.	20, 22
		b	Identify and discuss the circumstances in which a group is required to prepare group financial statements and when an exemption can be granted.	20
		c	Identify and discuss the criteria used to determine how different types of investments are recognised and measured.	20, 22
		d	Discuss and apply the treatment given to a subsidiary acquired exclusively with a view to its subsequent disposal.	20
		e	Discuss why directors may not wish to consolidate a subsidiary and when this will be permitted.	20
		f	Outline and apply the key definitions and accounting methods relating to interests in associates and joint arrangements.	22

Detailed syllabus				Chapter
C	**Group financial statements (continued)**			
	2	**Preparation of group financial statement of a complex group**		
		a	Apply the provisions of relevant standards in determining the cost of acquisition in business combination under different scenarios.	20
		b	Determine and apply appropriate procedures to be used in preparing group financial statements.	20, 21 and 24
		c	Determine, apply and disclose from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of acquisitions achieved one time or in stages involving subsidiaries, associates and joint ventures.	20 to 23 and 25
		d	Calculate, determine and disclose, from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of full or partial disposals involving subsidiaries, associates and joint ventures.	24
		e	Discuss and appraise how foreign currency transactions of a single entity or group entities are measured and accounted for in the financial statements.	26
		f	Discuss and appraise how the financial statements of foreign entities are translated and consolidated.	26
		g	Calculate, determine and disclose, from financial information or other data in a given scenario, the amounts to be included in group financial statements relating to part of a group, the activities of which have been discontinued, or have been acquired or disposed of in the period.	24
		h	Prepare group financial statements where necessary in (c) to (g) above.	20 to 24
D	**Current developments in and beyond Financial Reporting**			
	1	**Global convergence of Financial Reporting and Nigerian Generally Accepted Accounting Principles (NGAAP)**		
		a	Determine, discuss and apply the accounting treatment of issues arising from the first-time transition to international accounting standards such as IFRS from NGAAP.	30
		b	Discuss accounting issues relating to applicable Nigerian accounting standards after IFRS adoption.	30

Detailed syllabus				Chapter
D	**Current developments in and beyond Financial Reporting (continued)**			
	2	**New international accounting standards and exposure drafts**		
		a	Discuss and apply newly issued international Financial Reporting standards that are effective 6 months from examination date.	Sundry
		b	Discuss newly issued exposure drafts.	Sundry
		c	Discuss any current issues in relation to the conceptual framework for Financial Reporting.	2
	3	**Social, environmental and ethical reporting**		
		a	Discuss the need for social, environmental and ethical reporting and why companies may engage in these types of reporting.	5
		b	Appraise the impact of social, environmental and ethical factors on corporate performance measurement.	5
	4	**Sustainability and integrated reporting**		
		a	Discuss the progress from social and environmental accounting to sustainability reporting.	5
		b	Discuss the principles and content elements of the Global Reporting Initiative (GRI) and United States (US) Sustainability Accounting Standards Board (SASB) frameworks for sustainability reporting.	5
		c	Evaluate the impact of sustainability reporting on corporate performance measures.	5
		d	Discuss the principles and content elements of the International Integrated Reporting Council (IIRC) Integrated Reporting (IR) framework.	5
		e	Discuss the need for and advantages of integrated reporting.	5
		f	Discuss the progress towards global adoption of integrated reporting.	5
	5	**Technology and soft skills in corporate reporting** **Discuss the following concepts in relation to corporate reporting:**		31
		a	Multiple capitals	31
		b	Integrated thinking	31
		c	Distributed ledger and related technologies	31
		d	Cloud computing	31
		e	Reporting in a virtual environment	31

Detailed syllabus				Chapter
E	**Analysis of financial and other reports to appraise entity's financial performance and position**			
	1	**Suitability of accounting policies and reported numbers**		
		a	Assess the suitability of an entity's accounting policies to meet their reporting requirements.	4
		b	Assess accounting treatments adopted in financial statements and assess their validity, suitability and acceptability.	6
		c	Appraise the nature and validity of information disclosed in annual reports, including integrated reporting and other voluntary disclosures.	5
		d	Appraise the nature and validity of items included in published financial statements.	4
	2	**Analyses, interpretation and appraisal of financial and other reports**		
		a	Evaluate relevant indicators of financial and non-financial performance.	29
		b	Analyse and evaluate the performance, including stock market performance, liquidity, efficiency and solvency of an entity using different techniques of analysis, such as: horizontal; vertical; ratios; trends; and common size.	29
		c	Adjust reported earnings of an entity to make it comparable over time, with similar entities and industry average.	29
		d	Assess the potential complex economic environment in which an entity operates, and its strategies based on financial and operational information contained within the annual report (such as Chairman and CEO/CFO business and performance reports, management commentary, corporate governance disclosures, financial summaries and highlights).	29
		e	Make inferences from the analyses of information taking into account the limitations of the information, the analytical methods used and the business environment in which the entity operates.	29
		f	Discuss and evaluate earnings management and creative accounting and assess their impact on the usefulness of ratios.	7, 29
	3	**Limitations of financial analyses**		
		a	Appraise the limitations of financial analyses.	29
		b	Appraise the significance of inconsistencies and omissions in reported information in evaluating performance.	29

You will have studied many of the necessary standards at an earlier level. However, this paper requires you to apply your knowledge in a more sophisticated way. Chapters on standards included in an earlier paper often include extra observations relevant to this paper so make sure that you do not miss these.

Also note that this paper requires a deeper knowledge of some areas covered in an earlier paper (for example, deferred taxation and financial instruments) and introduces further standards some of which are quite complex. These should be studied carefully.

Standard	Examinable in earlier paper	Examinable at this level?	Chapter
IAS 1: Presentation of Financial Statements	Yes	Yes	3
IAS 2: Inventories	Yes	No	na
IAS 7: Cash Flow Statements	Yes	Yes	30
IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors	Yes	Yes	6
IAS 10: Events occurring after the reporting period	Yes	No	3
IAS 12: Income Taxes	Yes (in part)	Yes	14
IAS 16: Property, Plant and Equipment	Yes	Yes	9
IAS 19: Employee Benefits	No	Yes	14
IAS 20: Accounting for Government Grants and Disclosure of Government Assistance	Yes	No	na
IAS 21: The Effects of Changes in Foreign Exchange Rates	No	Yes	26
IAS 23: Borrowing Costs	Yes	No	na
IAS 24: Related Party Disclosures	No	Yes	3
IAS 26: Accounting and Reporting by Retirement Benefit Plans	No	Yes	19
IAS 27: Separate Financial Statements	Yes	Yes	25
IAS 28: Accounting for Investments in Associates and Joint ventures	Yes	Yes	22
IAS 32: Financial Instruments: Presentation	Yes	Yes	18
IAS 33: Earnings Per Share	Yes	Yes	28
IAS 34: Interim Financial Reporting	No	Yes	3
IAS 36: Impairment of Assets	Yes	Yes	10
IAS 37: Provisions, Contingent Liabilities and Contingent Assets	Yes	Yes	9
IAS 38: Intangible Assets	Yes	Yes	9
IAS 40: Investment Property	Yes	Yes	9
IAS 41: Agriculture	Yes	Yes	19

Standard	Examinable in earlier paper	Examinable at this level?	Chapter
IFRS 1: First time adoption of IFRS	No	Yes	30
IFRS 2: Share-based payment	No	Yes	15
IFRS 3: Business combinations	Yes	Yes	20
IFRS 5: Non-current assets held for sale and discontinued operations	Yes	Yes	11
IFRS 6: Exploration for and evaluation of mineral resources	No	Yes	19
IFRS 7: Financial Instruments: Disclosures	Yes	Yes	18
IFRS 8: Operating segments	No	Yes	3
IFRS 9: Financial Instruments	No	Yes	17
IFRS 10: Consolidated financial statements	Yes	Yes	20-25
IFRS 11: Joint arrangements	No	Yes	22
IFRS 12: Disclosure of interests in other entities	No	Yes	25
IFRS 13: Fair value measurement	No	Yes	16
IFRS 14: Regulatory deferral accounts	No	Yes	19
IFRS 15: Revenue from contracts with customers	Yes	Yes	8
IFRS 16: Leases	No	Yes	12
IFRS 17: Insurance contracts	No	No	na
IFRS for SMEs	No	Yes	19
NGAAP-SAS 32- Statement for Not-for-profit	No	Yes	19

Foreword

The business environment has been undergoing rapid changes caused, by globalisation and advancement in Information Technology. The impact of these changes on the finance function and the skills set needed by professional accountants to perform their various tasks have been profound. These developments have made it inevitable for the Institute's syllabus and training curriculum to be reviewed to align its contents with current trends and future needs of users of accounting services.

The Institute of Chartered Accountants of Nigeria (ICAN) reviews its syllabus and training curriculum every three years, however, the syllabus is updated annually to take cognisance of new developments in the national environment and global accountancy profession. The Syllabus Review, Professional Examination and Students' Affairs Committees worked assiduously to produce a 3-level, 15-subject ICAN syllabus. As approved by the Council, examinations under the new syllabus will commence with the November 2021 diet.

It is instructive to note that the last four syllabus review exercises were accompanied with the publication of Study Texts. Indeed, when the first four editions of Study Texts were produced, the performances of professional examination candidates significantly improved. In an effort to consolidate on these gains and to further enhance the success rates of students in its qualifying examinations, the Council approved that a new set of learning materials (Study Texts) be developed for each of the subjects. Although, these learning materials may be regarded as the fifth edition, they have been updated to include IT and soft skills in relevant subjects, thereby improving the contents, innovation, and quality.

Ten of the new learning materials were originally contracted to Emile Woolf International (EWI), UK. However, these materials were reviewed and updated to take care of new developments and introduced IT and soft skills in relevant subjects. Also, renowned writers and reviewers which comprised eminent scholars and practitioners with tremendous experiences in their areas of specialisation, were sourced locally to develop learning materials for five of the subjects because of their local contents. The 15 subjects are as follows:

Foundation Level		
1.	Business, Management and Finance	EWI/ICAN
2.	Financial Accounting	EWI/ICAN
3.	Management Information	EWI/ICAN
4.	Business Law	ICAN

Skills Level		
5	Financial Reporting	EWI/ICAN
6	Audit and Assurance	EWI/ICAN
7.	Taxation	ICAN
8.	Corporate Strategic Management and Ethics	EWI/ICAN
9.	Performance Management	EWI/ICAN
10.	Public Sector Accounting and Finance	ICAN

Professional Level		
11.	Corporate Reporting	EWI/ICAN
12.	Advanced Audit and Assurance	EWI/ICAN
13.	Strategic Financial Management	EWI/ICAN
14.	Advanced Taxation	ICAN
15.	Case Study	ICAN

As part of the quality control measures, the output of the writers and reviewers were subjected to further comprehensive review by the Study Texts Review Committee.

Although the Study Texts were specially produced to assist candidates preparing for the Institute's Professional Examination, we are persuaded that students of other professional bodies and tertiary institutions will find them very useful in the course of their studies.

Haruna Nma Yahaya (Mallam), mni, BSc, MBA, MNIM, FCA
Chairman, Study Texts Review Committee

A

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The Institute is deeply indebted to the underlisted locally-sourced rewriters, reviewers and members of the editorial board for their scholarship and erudition which led to the successful production of these new study texts. They are:

Taxation		
1.	Enigbokan, Richard Olufemi	Reviewer
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Advanced Taxation		
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2.	Kareem, Kamilu	Writer

Case Study	
Adesina, Julius Babatunde	Writer/Reviewer

Information Technology Skills		
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1.	Ogunniyi, Olajumoke

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1.	Durukwaku, Sylvester

Corporate Strategic Management and **Ethics**	
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Advanced Audit and **Assurance**	
1.	Okere, Onyinye

Strategic Financial Management
1. Omolehinwa, Ademola

The Institute also appreciates the services of the following:

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Professional level
Corporate Reporting

CHAPTER 1

Regulatory framework

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

A	Ethical issues in and regulatory framework of Corporate Reporting		
	1	Ethical issues in Corporate Reporting	
		a	Discuss the professional accountants' code of ethics as it relates to Corporate Reporting.
		b	Discuss and evaluate the ethical considerations that may arise in Corporate Reporting including ethical dilemmas.
		c	Assess, recommend and justify actions to be taken where ethical issues arise in given Corporate Reporting scenarios.
	2	Regulatory framework of Corporate Reporting	
		a	Discuss the need for convergence in international regulatory frameworks of Financial Reporting standards.
		b	Evaluate the desirability, feasibility and implications of global Financial Reporting convergence using International Financial Reporting Standards (IFRS).
		c	Differentiate between rules-based and principles-based accounting standards;
		d	Assess the applicable regulations as sources of Nigerian GAAP;
		e	Discuss the merits and demerits of international convergence of Financial Reporting standards;
		g	Discuss the roles of Financial Reporting Council of Nigeria (FRCN) in Financial Reporting regulations and enforcement including IFRS compliance.

Exam context

This chapter gives an overview of the regulatory framework for Nigerian accounting rules including the role of the Financial Reporting Council of Nigeria and discusses the issues surrounding international convergence of accounting standards.

The chapter concludes with a section on ethics and in particular ICAN's code of conduct.

At the end of this chapter, you should be able to:

- Explain the role of the IASB in convergence of accounting standards;
- Explain the extent of convergence;
- Explain the sources of accounting regulation in Nigeria; and
- Identify ethical issues in relation to Financial Reporting.

1 CONVERGENCE WITH IFRS

Section overview

- International Financial Reporting Standards
- Convergence of accounting standards
- Advantages and disadvantages of harmonisation
- International adoption of IFRS
- FASB and the IASB
- Principles or rules

1.1 International Financial Reporting Standards

The *International Accounting Standards Committee* (IASC) was established in 1973 to develop international accounting standards with the aim of harmonising accounting procedures throughout the world.

The first *International Accounting Standards* (IASs) were issued in 1975. The work of the IASC was supported by another body called the *Standing Interpretation Committee*. This body issued interpretations of rules in standards when there was divergence in practice. These interpretations were called *Standing Interpretation Committee Pronouncements* or SICs.

In 2001, the constitution of the IASC was changed leading to the establishment of a body called the *IFRS Foundation* and the replacement of the IASC and the SIC by new bodies called the *International Accounting Standards Board* (IASB) and the *International Financial Reporting Interpretations Committee* (IFRIC). This body has since been named *the International Financial Reporting Standards Interpretations Committee* (IFRSIC).

The change in the constitution to establish the IASC foundation and to replace the IASC with the IASB was a vital step towards wider international acceptance of IFRS. The IASB is now better funded and has wider geographical and wider industry representation than the IASC.

The IASB adopted all IASs and SICs that were extant at the time but said that standards written from that time were to be called *International Financial Reporting Standards* (IFRS). Interpretations are known as IFRICs.

The term IFRS is also used to refer to the whole body of rules (i.e. IAS and IFRS in total) and thus comprises:

	Published by the IASC (up to 2001)	Published by the IASB (from 2001)
Accounting standards	IASs	IFRSs
Interpretations	SICs	IFRICs

Many IASs and SICs have been replaced or amended by the IASB since 2001.

International accounting standards cannot be applied in any country without the approval of the national regulators in that country. All jurisdictions have some kind of formal approval process which is followed before IFRS can be applied in that jurisdiction.

1.2 Convergence of accounting standards

Convergence of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally. This is also described as the international harmonisation of accounting standards.

Harmonisation of accounting would result in all companies anywhere in the world reporting financial position and financial performance in the same way with the belief being that this would lead to greater market efficiency through the quality of the information and should make raising finance cheaper and easier.

There are two candidate GAAPs to become the basis for an international GAAP. These are:

- US GAAP; and
- International Financial Reporting Standards (International Accounting Standards.

International Financial Reporting Standards have found widespread support.

1.3 Advantages and disadvantages of harmonisation

Advantages of harmonisation

- Investors and analysts of financial statements can make better comparisons between the financial position, financial performance and financial prospects of entities in different countries. This is very important, in view of the rapid growth in international investment by institutional investors.
- For international groups, harmonisation will simplify the preparation of group accounts. If all entities in the group share the same accounting framework, there should be no need to make adjustments for consolidation purposes.
- If all entities are using the same framework for Financial Reporting, management should find it easier to monitor performance within their group.
- Global harmonisation of accounting framework may encourage growth in cross-border trading, because entities will find it easier to assess the financial position of customers and suppliers in other countries.
- Access to international finance should be easier, because banks and investors in the international financial markets will find it easier to understand the financial information presented to them by entities wishing to raise finance.
- Harmonisation could also lead to a reduction in cost of capital as a result of the previous two points.

Disadvantages of harmonisation

- National legal requirements may conflict with the requirements of IFRSs. Some countries may have strict legal rules about preparing financial statements, as the statements are prepared mainly for tax purposes. Consequently, laws may need re-writing to permit the accounting policies required by IFRSs.

- Some countries may believe that their framework is satisfactory or even superior to IFRSs. This has been a problem with the US, although currently is not as much of an issue as in the past.
- Cultural differences across the world may mean that one set of accounting standards will not be flexible enough to meet the needs of all users.

1.4 International adoption of IFRS

Most jurisdictions already require IFRS for domestic reporting.

The IASB published a booklet called the *Pocket guide to IFRS standards: the global reporting language*.

The 2020 edition of the guide includes the following statistics:

- 94% (165/175) of jurisdictions have made a public commitment to IFRS as the single set of global accounting standards;
- 75% (132/175) jurisdictions already require the use of IFRS by all or most public companies, with most of the remaining jurisdictions permitting their use;
- The European Union remains the single biggest IFRS jurisdiction (GDP $19.6 trillion) but the combined GDP of IFRS jurisdictions outside of the European Union (US$27 trillion) is now greater than that of the European Union; and
- Since its publication, the IFRS for SMEs has been adopted by 60% (105/175) of jurisdictions while a further 19 jurisdictions are considering doing so.

Nigeria

Nigeria has adopted IFRS. This is explained in more detail later in this chapter.

USA

Foreign companies, whose securities are traded in the USA, can file financial statements prepared under IFRS without reconciling these to US GAAP.

It is hoped that the USA will adopt IFRS in the future though there is a great deal of resistance there.

European Union

Companies listed on any stock exchange in the EU have had to publish accounts that comply with international accounting standards since 2005.

The EU has an endorsement mechanism. Standards become compulsory in the EU once they are approved by the necessary regulatory authority.

The EU regulation applies only to the group accounts of listed entities. It was left to member states to decide on the accounting rules that should apply in other financial statements.

For example, in the UK other companies were given a choice of whether to apply IFRS or to continue with UK GAAP. Thereafter, UK GAAP itself, changed by incorporating standards identical to some IFRS.

1.5 FASB and the IASB

The stated mission of the US Securities and Exchange Commission (SEC) is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation in the United States of America".

The SEC recognises the importance of a single set of global Financial Reporting standards.

The Norwalk Agreement

The SEC has delegated the responsibility for the preparation of accounting standards to the Financial Accounting Standards Board (FASB).

In 2002, the IASB and FASB held a joint meeting in Norwalk, Connecticut, USA. At this meeting they each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border Financial Reporting.

After the meeting, they jointly produced a ***Memorandum of Understanding*** known as the ***Norwalk Agreement***. They agreed to use their best efforts to:

- make their existing Financial Reporting standards fully compatible as soon as is practicable; and
- to coordinate their future work programs to ensure that once achieved, compatibility is maintained.

To achieve compatibility, FASB and IASB agreed to:

- undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and IFRS; and
- enter into other joint projects on major areas (e.g. business combinations, financial instruments, leases, revenue recognition, insurance contracts).

Roadmap for adoption of IFRS in the US

The aim of the collaboration was to reach a stage where IFRS would be adopted in the US. To this end, the SEC announced a Roadmap to conversion with IFRS. At one time it was hoped that large companies would have adopted IFRS in the US by 2014 and other entities in stages thereafter. However, this hope has not been realised and it is long way from being so.

Condorsement

Until 2010, there were three schools of thought, or options, for moving to IFRS:

- Adoption / Conversion - a switch from local standards to IFRS, without converging them first.
- Convergence - migration of local standards to being closely aligned with IFRS.
- Endorsement - formal endorsement of new or amended IFRS before they become legally binding.

Condorsement is a term coined by a senior SEC official in a conference speech in America (in 2010), to describe a fourth approach to IFRS adoption. Under this plan, the U.S. transition to worldwide accounting standards would occur through a continuation of "convergence" projects, and then through gradual Financial Accounting Standards Board endorsement of IFRS in those areas where FASB and IASB still differ. U.S. GAAP would continue to exist under this scenario, and FASB would still retain its authority.

Conclusion

There is little hope that IFRS will be adopted for use in the US in the near future (if ever). It seems that US GAAP will continue in the US but IFRS will be used in most other parts of the world.

1.6 Principles or rules

Detailed Financial Reporting practice is developed by the accounting profession through accounting standards. Such standards may be principles based or rules based.

	Advantages	Disadvantages
Principles based standards	Allows use of judgement so is more flexible and able to deal with a wide variety of situations and transactions. It is more difficult to use creative accounting when the approach is based on fundamental principles.	Requires judgement. Correct approach may not always be obvious. Can give the illusion of being insufficiently rigorous.
Rules based standards	Brings certainty to the accounting process. Removes the possibility of similar situations being presented differently due to the exercise of different judgements.	Allows for manipulation as transactions can be constructed to achieve an artificial effect. Rules cannot anticipate all possible situations but in the attempt to do so accounting frameworks can become very large and complex. Can give the illusion of being rigorous.

IFRS are described as principles based standards and US GAAP as being rules based. This was never completely true as both IFRS and US GAAP are based on principles and both have rules. However, it is true to say that IFRS was much more principles based than US GAAP and US GAAP was much more rules based than IFRS.

This is no longer as true as it used to be because the IASB and FASB have been engaged in many joint projects.

Progress on joint projects

The projects have been successful insofar as they have led to convergence of standards in several key areas (though sometimes with small differences). Areas of significant convergence include business combinations, consolidation, share-based payment and revenue recognition. Also many rules of accounting for financial instruments are similar.

However, the two boards have arrived at different conclusions in other areas. These include accounting for leases and insurance contracts.

2 ACCOUNTING RULES IN NIGERIA

Section overview

- Sources of regulation
- Accounting standards in Nigeria (NASB)
- International Financial Reporting Standards – A list
- Companies and Allied Matters Act (CAMA) 2020

2.1 Sources of regulation

The main sources of regulation are:

- ❑ International Financial Reporting Standards (IFRS); and
- ❑ Companies and Allied Matters Act (CAMA) 2020).

2.2 Accounting standards in Nigeria

The Nigerian Accounting Standards Board (NASB) came into being in 1982 as an independent body with responsibility for developing and issuing Nigerian accounting standards. These were called ***Statements of Accounting Standards***.

The standards were given legal authority in Nigeria by section 335 of the Companies and Allied Matters Act 1990. This section required that *"financial statements ….shall comply…. with the accounting standards laid down in the Statements of Accounting Standards issued from time to time by the Nigerian Accounting Standards Board to be constituted by the Minister …."*

Financial Reporting Council of Nigeria (FRCN)

Financial Reporting Council of Nigeria Act, No. 6, 2011 resulted in the Nigerian Accounting Standards Board being replaced by the Financial Reporting Council of Nigeria (FRCN).

The FRCN is responsible for developing and publishing accounting and Financial Reporting standards to be applied in the preparation of financial statements of public entities in Nigeria.

The Financial Reporting Council of Nigeria Act, 2011 requires that the FRCN "promote compliance with the adopted standards issued by the International Federation of Accountants and International Accounting Standards Board". Therefore, the act resulted in the replacement of Statements of Accounting Standards by International Financial Reporting Standards.

Adoption of IFRS in Nigeria

The FRCN oversaw the convergence of Nigerian GAAP to IFRS through a plan (known as a roadmap) which set out the route to conversion. This roadmap was structured as several phases with each phase requiring certain categories of companies to comply with IFRS by a given date.

The end result of this is that all public interest entities must prepare accounts in accordance with IFRS. Public interest entities', includes quoted and unquoted companies, government organisations and not-for-profit entities that are required by law to file returns with regulatory authorities.

The following are not public interest entities:

- Small and medium-sized entities (SMEs) which must apply the IFRS for SMEs. SMEs are entities that may not have public accountability and have the following characteristics:
- Their equity and debt instruments are not traded or in the process of becoming traded.
    - They do not hold assets in a fiduciary capacity for a broad group of outsiders as one of their primary businesses.
    - Their annual turnover (revenue) is not more than ₦120 million or such amount as might be fixed by the Corporate Affairs Commission as prescribed by section 394 (3) CAMA 2020.
    - Their total assets value is not more than ₦60 million or such amount as might be fixed by the Corporate Affairs Commission.
    - They do not have foreign board members.
    - No member of the entity is a government, government agency, government corporation or a nominee of any such body.
    - The directors hold not less than 51% of its equity share capital.
- Micro-sized entities, which may use either the IFRS for SMEs or the Small and Medium-sized Entities Guidelines on Accounting (SMEGA) Level 3 issued by the United Nations Conference on Trade and Development (UNCTAD). Micro-sized entities are entities that are not public interest entities or SMEs.

Comment on Nigerian Accounting Standards

Nigerian accounting standards have been replaced by International Financial Reporting Standards.

However, Nigerian standards included industry specific rules which are not found in IFRS. Companies in the industries covered are expected to continue to apply these rules (insofar as they do not conflict with IFRS). Such relevant standards include:

- SAS 14: Accounting in the petroleum industry: Down-stream activities
- SAS 17: Accounting in the petroleum industry: Up-stream activities
- SAS 25: Telecommunications activities)
- SAS 32: On accounting by not-for-profit organisations.

2.3 International Financial Reporting Standards – A list

This is a list of standards, provided so that you can appreciate the breadth of the GAAP.

Standard	Applicable in Nigeria?	Examinable at this level?
IAS 1 – Presentation of Financial Statements	Yes	Yes
IAS 2 – Inventories	Yes	No
IAS 7 – Cash Flow Statements	Yes	Yes
IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors	Yes	Yes
IAS 10 – Events occurring after the reporting period	Yes	No
IAS 12 – Income Taxes	Yes	Yes
IAS 16 – Property, Plant and Equipment	Yes	Yes
IAS 19 – Employee Benefits	Yes	Yes
IAS 20 – Accounting for Government Grants and Disclosure of Government Assistance	Yes	No
IAS 21 – The Effects of Changes in Foreign Exchange Rates	Yes	Yes
IAS 23 – Borrowing Costs	Yes	No
IAS 24 – Related Party Disclosures	Yes	Yes
IAS 26 – Accounting and Reporting by Retirement Benefit Plans	Yes	Yes
IAS 27 – Separate Financial Statements	Yes	Yes
IAS 28 – Accounting for Investments in Associates and Joint ventures	Yes	Yes
IAS 29 – Financial Reporting in Hyperinflationary Economies	Not relevant in Nigeria	No
IAS 32 – Financial Instruments: Presentation	Yes	Yes
IAS 33 – Earnings Per Share	Yes	Yes
IAS 34 – Interim Financial Reporting	Yes	Yes
IAS 36 – Impairment of Assets	Yes	Yes
IAS 37 – Provisions, Contingent Liabilities and Contingent Assets	Yes	Yes
IAS 38 – Intangible Assets	Yes	Yes
IAS 40 – Investment Property	Yes	Yes
IAS 41 – Agriculture	Yes	Yes

Standard	Applicable in Nigeria?	Examinable at this level?
IFRS 1 – First time adoption of IFRS	Yes (subject to specific guidance issued by FRCN)	Yes
IFRS 2 – Share-based payment	Yes	Yes
IFRS 3 – Business combinations	Yes	Yes
IFRS 5 – Non-current assets held for sale and discontinued operations	Yes	Yes
IFRS 6 – Exploration for and evaluation of mineral resources	Yes	Yes
IFRS 7 – Financial Instruments: Disclosures	Yes	Yes
IFRS 8 – Operating segments	Yes	Yes
IFRS 9 – Financial Instruments	Yes	Yes
IFRS 10 – Consolidated financial statements	Yes	Yes
IFRS 11 – Joint arrangements	Yes	Yes
IFRS 12 – Disclosure of interests in other entities	Yes	Yes
IFRS 13 – Fair value measurement	Yes	Yes
IFRS 14 – Regulatory deferral accounts	Yes	Yes
IFRS 15 – Revenue from contracts with customers	Yes	Yes
IFRS 16 – Leases	Yes	Yes
IFRS 17 – Insurance contracts	Yes	No
IFRS for SMEs	Yes	Yes

2.4 Companies and Allied Matters Act (CAMA) 2020

CAMA is the primary source of company law in Nigeria. Amongst other things, it establishes the requirements for Financial Reporting by all companies in Nigeria.

The rules are set out in Chapter 14 - Financial Statements, Audit and Accounting Records. Highlights of the chapter, sections 374 to 392, are stated below:

Section	Summary of content
374	This section sets out the requirement to keep accounting records and specifies details of content.
375	Accounting records must be kept at the company's registered office or such other place in Nigeria as the directors think fit and be kept for 6 years.
377	Directors have a duty to prepare annual accounts.
378	Form and content of annual accounts which must give a true and fair view (see later).
382	Additional disclosure required in notes to financial statements as per second schedule of the Act
383	Disclosure of loans in favour of directors and connected persons as per third schedule of the Act
386	Statement of financial position must be signed by two directors
387	Persons entitled to receive financial statements as of right.
388	Directors' duty to lay and deliver financial statements
392	Shareholders' right to obtain copies of financial statements

True and fair view

The statement of financial position must give a true and fair view of the state of affairs of the company as at the year end and the profit or loss account must give a true and fair view of the profit or loss of the company for the year.

The true and fair requirement is of overriding importance:

(a) Additional information must be provided, if necessary, for the financial statements to give a true and fair view.

(b) If, owing to a special circumstance, compliance with an accounting requirement results in a failure to show a true and fair view, the directors must depart from that requirement in preparing the statement of financial position or profit or loss account (so far as necessary), in order that the financial statements achieve a true and fair view. In this case, the following must be disclosed in a note to the accounts:

- particulars of the departure;
- the reasons for it; and
- its effects.

Section: 385. Directors' report

Every company must prepare a directors' report which must contain the following:

(a) a fair view of the development of the business of the company and its subsidiaries during the year and of their position at the end of it;

(b) the amount (if any) which the directors recommend should be paid as dividend and the amount (if any) which they propose to carry to reserves;

(c) the names of the persons who were directors of the company at any time during the year;

(d) the financial activities of the company and its subsidiaries in the course of the year and any significant change in those activities in the year;

(e) particulars of significant changes (if any) in the fixed assets of the company in the financial year;

(f) the difference between the market value of land and the amount at which it is recognised in the statement of financial position if, in directors' opinion, the difference is of such significance that the attention of members or debenture holders;

(g) details of directors' interests in the company's shares and debentures;particulars of any important events affecting the company which have occurred since the end of the year; an indication of likely future developments in the business;

(h) an indication of the activities (if any) of the company in the field of research and development;

(i) names of distributors of the company's products; and

(j) particulars of donations and gifts made for any purpose.

3. ETHICS

Section overview

- Introduction
- The fundamental principles
- Threats to the fundamental principles
- Accountants in business
- Preparation and reporting of information
- Potential conflicts

b. Introduction

Ethics can be difficult to define but it is principally concerned with human character and conduct. Ethical behaviour is more than obeying laws, rules and regulations. It is about doing 'the right thing'. The accountancy profession is committed to acting ethically and in the public interest.

Professional accountants may find themselves in situations where values are in conflict with one another due to responsibilities to employers, clients and the public.

The International Federation of Accountants (IFAC) publishes the "Handbook of the International Code of Ethics for Professional Accountants". This code provides guidance in situations where ethical issues arise.

International accounting institutes often publish their own code of ethics in compliance with the IFAC code but taking account of local circumstances and requirements. ICAN has published its own code of conduct which members and student members must follow. The code provides guidance in situations where ethical issues arise.

Comment

Most people are honest and have integrity and will always try to behave in the right way in a given set of circumstances. However, accountants might face situations where it is not easy to see the most ethical course of action. One of the main roles of the ICAN code is to provide guidance in these situations.

Impact on members in practice

All members and student members of ICAN are required to comply with the code of ethics and it applies to both accountants in practice and in business.

This chapter explains ethical issues surrounding the preparation of financial statements and other financial information.

c. The fundamental principles

ICAN's Code of Ethics expresses its guidance in terms of five fundamental principles. These are:

(a) integrity;

(b) objectivity;

(c) professional competence and due care;

(d) confidentiality; and

(e) professional behavior.

Integrity

Members should be straightforward and honest in all professional and business relationships. Integrity implies not just honesty but also fair dealing and truthfulness.

A chartered accountant should not be associated with reports, returns, communications or other information where they believe that the information:

(a) contains a materially false or misleading statement;
(b) contains statements or information furnished recklessly; or

(k) omits or obscures information required to be included where such omission or obscurity would be misleading.

Objectivity

Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgements.

A chartered accountant may be exposed to situations that may impair objectivity. It is impracticable to define and prescribe all such situations.

Relationships that bias or unduly influence the professional judgment of the chartered accountant should be avoided.

Professional competence and due care

Practising as a chartered accountant involves a commitment to learning over one's entire working life.

Members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards.

Continuing professional development develops and maintains the capabilities that enable a chartered accountant to perform competently within the professional environments.

Confidentiality

Members must respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose such information to third parties without authority or unless there is a legal or professional right or duty to disclose.

Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

Professional behaviour

Members must comply with relevant laws and regulations and should avoid any action which discredits the profession. They should behave with courtesy and consideration towards all with whom they come into contact in a professional capacity.

a. Threats to the fundamental principles

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

i. self-interest;

ii. self-review;

iii. advocacy;

iv. familiarity; and

v. intimidation.

Members must identify, evaluate and respond to such threats. Unless any threat is clearly insignificant, members must implement safeguards to eliminate the threats or reduce them to an acceptable level so that compliance with the fundamental principles is not compromised.

Self- interest threats

Self-interest threats may occur as a result of the financial or other interests of members or their immediate or close family members.

Such financial interests might cause members to be reluctant to take actions that would be against their own interests.

Examples of circumstances that may create self-interest threats include, but are not limited to:

(i) financial interests, loans or guarantees;

(ii) incentive compensation arrangements;

(iii) inappropriate personal use of corporate assets;

(iv) concern over employment security; or

(v) commercial pressure from outside the employing organisation.

Example: Self- interest threats

Adeola is member of ICAN working as a unit accountant.

He is a member of a bonus scheme under which, staff receive a bonus of 10% of their annual salary if profit for the year exceeds a trigger level.

Adeola has been reviewing working papers prepared to support this year's financial statements. He has found a logic error in a spreadsheet used as a measurement tool for provisions.

Correction of this error would lead to an increase in provisions. This would decrease profit below the trigger level for the bonus.

Analysis:

Adeola faces a self-interest threat which might distort his objectivity.

Self-review threats

Self-review threats occur when a previous judgement needs to be re-evaluated by members responsible for that judgement. For example, where a member has been involved in maintaining the accounting records of a client he may be unwilling to find fault with the financial statements derived from those records. Again, this would threaten the fundamental principle of objectivity.

Circumstances that may create self-review threats include, but are not limited to, business decisions or data being subject to review and justification by the same chartered accountant in business responsible for making those decisions or preparing that data.

Advocacy threats

A chartered accountant in business may often need to promote the organisations position by providing financial information. As long as information provided is neither false nor misleading such actions would not create an advocacy threat.

Familiarity threats

Familiarity threats occur when, because of a close relationship, members become too sympathetic to the interests of others. Examples of circumstances that may create familiarity threats include:

i. A chartered accountant in business in a position to influence financial or non-Financial Reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.

ii. Long association with business contacts influencing business decisions.

iii. Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

Intimidation threats

Intimidation threats occur when a member's conduct is influenced by fear or threats (for example, when he encounters an aggressive and dominating individual at a client or at his employer).

Examples of circumstances that may create intimidation threats include:

(i) Threat of dismissal or replacement over a disagreement about the application of an accounting principle or the way in which financial information is to be reported.

(ii) A dominant personality attempting to influence decisions of the chartered accountant.

a. Accountants in business

Accountants in business are often responsible for the preparation of accounting information.

Accountants in business need to ensure that they do not prepare financial information in a way that is misleading or that does not show a true and fair view of the entity's operations.

Accountants who are responsible for the preparation of financial information must ensure that the information they prepare is technically correct, reports the substance of the transaction and is adequately disclosed.

There is a danger of influence from senior managers to present figures that inflate profit or assets or understate liabilities. This puts the accountant in a difficult position. On one hand, they wish to prepare proper information and on the other hand, there is a possibility they might lose their job if they do not comply with their managers wishes.

In this case, ethics starts with the individual preparing the information. They have a difficult decision to make; whether to keep quiet or take the matter further. If they keep quiet, they will certainly be aware that they are not complying with the ethics of the accounting body they belong to. If they speak out, they may be bullied at work into changing the information or sacked.

b. Preparation and reporting of information

Chartered accountants in business are often involved in the preparation and reporting of information that may either be made public or used by others inside or outside the employing organisation. Such information may include financial or management information, for example:

i. forecasts and budgets;
ii. financial statements;
iii. management discussion and analysis; and
iv. the management letter of representation provided to the auditors as part of an audit of financial statements.

Information must be prepared and presented fairly, honestly and in accordance with relevant professional standards. In particular, financial statements must be prepared and presented in accordance with the applicable Financial Reporting standards.

A chartered accountant in business must maintain information for which he is responsible in a manner that:

(i) describes clearly the true nature of business transactions, assets or liabilities;
(ii) classifies and records information in a timely and proper manner; and
(iii) represents the facts accurately and completely in all material respects.

Threats to compliance with the fundamental principles, for example self-interest or intimidation threats to objectivity or professional competence and due care, may be created where a chartered accountant in business may be pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others.

The significance of such threats will depend on factors such as the source of the pressure and the degree to which the information is, or may be, misleading.

The significance of the threats should be evaluated and unless they are clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include consultation with superiors within the employing organisation, for example, the audit committee or other body responsible for governance, or with a relevant professional body.

Where it is not possible to reduce the threat to an acceptable level, a chartered accountant should refuse to remain associated with information they consider is or may be misleading.

If the chartered accountant is aware that the issuance of misleading information is either significant or persistent, he should consider informing appropriate authorities in line with the guidance in this code. The chartered accountant in business may also wish to seek legal advice or resign.

c. Potential conflicts

There may be times when the responsibilities of a chartered accountant to an employing organisation come into conflict with their professional obligations to comply with the fundamental principles in the Code. Where compliance with the fundamental principles is threatened, a chartered accountant in business must consider a response to the circumstances.

Responsibilities to an employer may put a chartered accountant under pressure to act or behave in ways that could directly or indirectly threaten compliance with the fundamental principles. Such pressure may be explicit or implicit; it may come from a supervisor, manager, director or another individual within the employing organisation.

A chartered accountant in business may face pressure to:

i. Act contrary to law or regulation;

ii. Act contrary to technical or professional standards;

iii. Lie to, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular:

- ❑ The auditors of the employing organisation; or
- ❑ Regulators;

iv. Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for example:

- ❑ The financial statements;
- ❑ Tax compliance;
- ❑ Legal compliance; or
- ❑ Reports required by securities regulators.

The significance of threats must be evaluated and unless they are clearly insignificant, safeguards should be considered and applied to eliminate them or reduce them to an acceptable level.

Such safeguards may include:

(i) Obtaining advice where appropriate from within the employing organisation, or an independent professional advisor or a relevant professional body;

(ii) The existence of a formal dispute resolution process within the employing organization; and

(iii) Seeking legal advice.

Example: Self-interest threat

Adeola is a member of ICAN working as a unit accountant.

He is a member of a bonus scheme under which, staff receive a bonus of 10% of their annual salary if profit for the year exceeds a trigger level.

Adeola has been reviewing working papers prepared to support this year's financial statements. He has found a logic error in a spreadsheet used as a measurement tool for provisions.

Correction of this error would lead to an increase in provisions. This would decrease profit below the trigger level for the bonus.

Analysis:

Adeola faces a self-interest threat which might distort his objectivity.

Adeola has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.
Adeola must make the necessary adjustment even though it would lead to a loss to himself.

Example: Self-interest threat

Olawale is a chartered accountant recruited on a short-term contract to assist the finance director, Adeyemi (who is not a chartered accountant) in finalising the draft financial statements.

The decision on whether to employ Olawale on a permanent basis rests with Adeyemi.

Olawale has been instructed to prepare information on leases to be included in the financial statements. He has identified a number of large leases which are being accounted for as operating leases even though the terms of the contract contain clear indicators that the risks and benefits have passed to the company. Changing the accounting treatment for the leases would have a material impact on asset and liability figures.

Olawale has explained this to Adeyemi. Adeyemi responded that Olawale should ignore this information as the company needs to maintain a certain ratio between the assets and liabilities in the statement of financial position.

Analysis

Olawale faces a self-interest threat which might distort his objectivity.

The current accounting treatment is incorrect.

Olawale has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Possible course of action

Olawale must explain his professional obligations to Adeyemi in particular that he cannot be a party to the preparation and presentation of knowingly misleading information.

Olawale should refuse to remain associated with information that is misleading.

If Adeyemi refuses to allow the necessary changes to the information, Olawale should report the matter to the audit committee or the other directors.

As a last resort, if the company refuses to change the information, Olawale should resign from his post.

Olawale may need to consider informing the appropriate authorities in line with the ICAN guidance on confidentiality.

Example: Intimidation threat

Efe is a chartered accountant who works in a team that reports to Kunle, the finance director of Oshogbo Holdings.

Kunle is also a chartered accountant. He has a domineering personality.

Oshogbo Holdings revalues commercial properties as allowed by IAS 16. Valuation information received last year showed that the fair value of the property portfolio was 2% less than the carrying amount of the properties (with no single property being more than 4% different). A downward revaluation was not recognised on the grounds that the carrying amount was not materially different from the fair value.

This year's valuation shows a continued decline in the fair value of the property portfolio. It is now 5% less than the carrying amount of the properties with some properties now being 15% below the carrying amount.

Efe submitted workings to Kunle in which he had recognised the downward revaluations in accordance with IAS 16.

Kunle has sent him an email in response in which he wrote "Stop bothering me with this rubbish. There is no need to write the properties down. The fair value of the portfolio is only 5% different from its carrying amount. Restate the numbers immediately".

Analysis

Efe faces an intimidation threat which might distort his objectivity.

The current accounting treatment might be incorrect. The value of the properties as a group is irrelevant in applying IAS 16's revalution model. IAS 16 allows the use of a revalution model but requires that the carrying amount of a property should not be materially different from its fair value. This applies to individual properties not the whole class taken together.

(It could be that Kunle is correct because there is insufficient information to judge materiality in this circumstance. However, a 15% discrepancy does sound significant).

Efe has a professional responsibility to ensure that financial information is prepared and presented fairly, honestly and in accordance with relevant professional standards. He has further obligations to ensure that financial information is prepared in accordance with applicable accounting standards and that records maintained represent the facts accurately and completely in all material respects.

Possible course of action

Efe should arrange a meeting with Kunle to try to explain Kunle's misapplication of the IAS 16 guidance and to try to persuade Kunle that a change might be necessary.

Kunle should be reminded that he too is bound by the same guidance that applies to Efe. Indeed he has a greater responsibility as the more senior person to show leadership in this area.

Efe cannot be party to the preparation and presentation of knowingly misleading information. He should explain that he cannot remain associated with information that is misleading. If Kunle refuses to allow the necessary changes to the information Efe should report the matter to the audit committee or the other directors.

As a last resort if the company refuses to change the information Efe should resign from his post.

Efe may need to consider informing the appropriate authorities in line with the ICAN guidance on confidentiality.

4. CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the role of the IASB in convergence of accounting standards;
- Explain the extent of convergence;
- Explain the sources of accounting regulation in Nigeria; and
- Identify ethical issues in relation to Financial Reporting.

Professional level
Corporate

CHAPTER 2

Accounting and reporting concepts

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

D	Current developments in and beyond Financial Reporting (continued)		
	2	**New international accounting standards and exposure drafts**	
		c	Discuss any current issues in relation to the conceptual framework for Financial Reporting.

The IASB Conceptual Framework is an examinable document.

Exam context

Much of the content of this chapter will already be familiar to you. The regulatory framework has already been examined in your previous studies. This subject is still examinable, but the focus is slightly different. The Examiner expects higher level skills, expecting you to be able to assess an accounting scenario or case study and give advice on dealing with problems that are evident in the scenario.

For example you may be given a situation where an entity is not following the guidance of an accounting standard, and you may be asked to provide advice. These questions will require that you have a good understanding of the relevant accounting standards as well as the Framework, which provides the underpinning for accounting standards.

At the end of this chapter, you should be able to:

- Explain the objectives of financial statements;
- List and explain the components of the conceptual framework;
- Explain the measurement bases available under IFRS;
- Explain and illustrate the capital maintenance concepts described in the conceptual framework; and
- Explain the meaning of true and fair or fairly presented.

1 A CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Section overview

- The meaning of GAAP
- The meaning of a conceptual framework
- The purpose of a conceptual framework
- The alternative to a conceptual framework

1.1 Introduction

All the concepts, principles, conventions, laws, rules and regulations that are used to prepare and present financial statements are known as Generally Accepted Accounting Principles or GAAP.

A conceptual framework is a system of concepts and principles that underpin the preparation of financial statements. These concepts and principles should be consistent with one another.

The IASB published a new conceptual framework in March 2018 called" The *conceptual framework for Financial Reporting"*.

Note that the changes are not fundamental in terms of their impact on IFRS.

The new document is made up of the following sections:

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

1.1 Chapter 1: Objective of general purpose financial statements

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

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

- ❑ In order to make these decisions the users need information to help them assess the prospects for future net cash inflows to an entity.
- ❑ In order to assess an entity's prospects for future net cash inflows, users need information about:
  - the resources of the entity;
  - claims against the entity; and
  - how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources. (This information is also useful for decisions by those who have the right to vote on or otherwise influence management performance).

Information provided

General purpose financial statements provide information about:

- ❑ the financial position of the entity – information about economic resources and the claims against them; and
- ❑ changes in its financial position which could be due to:
  - financial performance; and/or
  - changes in equity;
  - cashflow position; and
  - other events or transactions (e.g share issues).

Economic resources and claims

Information about the nature and amounts of economic resources and claims can help users to:

- ❑ identify the financial strengths and weaknesses of a reporting entity; and
- ❑ to assess a reporting entity's liquidity and solvency and its needs for additional financing.

Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

Objectives of financial statements: summary

The objectives of financial statements are met by:

- ❑ the main financial statements (statement of financial position, statement of profit or loss and other comprehensive income (or statement of profit or loss and statement of other comprehensive income), statement of cash flows, and statement of changes in equity); and
- ❑ supporting notes to the accounts, which provide additional details.

1.2 Chapter 2: Qualitative characteristics of useful financial information

Information must have certain characteristics in order for it to be useful for decision making. The *IASB Conceptual Framework* describes:

- fundamental qualitative characteristics; and
- enhancing qualitative characteristics.

Fundamental qualitative characteristics:

- relevance; and
- faithful representation

The qualitative characteristics that enhance the usefulness of information that is relevant and a faithful representation are:

- comparability;
- verifiability;
- timeliness; and
- understandability.

Relevance

Information must be relevant to the decision-making needs of users. Information is relevant if it can be used for predictive and/or confirmatory purposes.

- It has **predictive value** if it helps users to predict what might happen in the future.
- It has **confirmatory value** if it helps users to confirm the assessments and predictions they have made in the past.

The relevance of information is affected by its materiality.

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions of the primary users based on financial statements.

- Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.
- Therefore, it is not possible for the IASB to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

Faithful representation

Financial reports represent economic phenomena (economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims) by depicting them in words and numbers.

To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent.

A perfectly faithful representation would have three characteristics. It would be:

- complete – the depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations;

- neutral – the depiction is without bias in the selection or presentation of financial information; and
- free from error – where there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

1.3 Chapter 3: Financial statements and the reporting entity

Objective and scope of financial statements

The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources.

That information is provided in the statement of financial position, statement(s) of financial performance and in other statements and notes.

Financial statements provide information viewed from the perspective of the reporting entity as a whole.

Going concern assumption

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future.

The reporting entity

A reporting entity is one that is required or chooses to prepare financial statements.

A reporting entity can be a single entity or a portion of an entity or can comprise more than one entity (e.g. a group).

A reporting entity is not necessarily a legal entity.

1.4 Chapter 4: Elements of financial statements

Assets

An asset is a present economic resource controlled by the entity as a result of past events.

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

Liabilities

A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

An obligation is a duty or responsibility that an entity has no practical ability to avoid.

Equity

Equity is the residual interest in an entity after the value of all its liabilities (current and non-current) has been deducted from the value of all its assets.

Income

Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses

Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

1.5 Chapter 5: Recognition and derecognition

Recognition

Recognition is the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the

Recognition criteria

Only items that:

- ❑ meet the definition of an asset, a liability or equity are recognised in the statement of financial position; or
- ❑ meet the definition of income or expenses are recognised in the statement(s) of financial performance.

Under the previous framework, an asset or liability would be recognised when:

- ❑ it meets the definition of an element: and
- ❑ satisfies the following two criteria:
    - it must be **probable** that the future economic benefit associated with the item will flow either into or out of the entity;
    - The item should have a cost or value that can be measured reliably; and
    - It must arise from past event.

The IASB's deliberations on this and other projects have led them to the conclusion that the probability of an inflow or outflow is not a recognition attribute but a measurement attribute.

The practical impact of the change in focus of the criteria will be negligible but is believed to provide a stronger conceptual foundation to the recognition process.

Derecognition

Derecognition is the removal of all or part of a recognised asset or liability from an entity's statement of financial position.

1.6 Chapter 6: Measurement of elements of financial statements

The conceptual framework allows that several measurement bases are used for the elements in financial statements. These include:

- Historical cost;
- Current cost or current value (the amount that would be paid to purchase the same or a similar asset or to settle the obligation currently (e.g. revaluation model and/or fair value model);
- Realisable value (or settlement value); and
- Present value (e.g. value in use).

Historical cost is the most commonly used measurement basis. However, the other bases of measurement are often used to modify historical cost.

Currently, certain standards favour one measurement base over others. Example, fair value measurement was used under many standards.

1.7 Chapter 7: Presentation and Disclosure

All presentation and disclosure should be made in financial statements in line with relevant standards applied.

1.7.1 Presentation and disclosure as communication tools

A reporting entity communicates information about its assets, liabilities, equity, income and expenses by presenting and disclosing information in its financial statements.

Effective communication of information in financial statements makes that information more relevant and contributes to a faithful representation of an entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of information in financial statements.

Effective communication of information in financial statements requires:

(a) focusing on presentation and disclosure objectives and principles rather than focusing on rules;
(b) classifying information in a manner that groups similar items and separates dissimilar items; and
(c) aggregating information in such a way that it is not obscured either by unnecessary detail or by excessive aggregation.

1.7.2 Presentation and disclosure objectives and principles

(a) To facilitate effective communication of information in financial statements, when developing presentation and disclosure requirements in Standards a balance is needed between.

(b) giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses.

(c) requiring information that is comparable, both from period to period for a reporting entity and in a single reporting period across entities.

Effective communication in financial statements is also supported by considering the following principles:

a) entity-specific information is more useful than standardised descriptions, sometimes referred to as 'boilerplate'; and

b) duplication of information in different parts of the financial statement is usually unnecessary and can make financial statements less understandable.

1.7.3 Classification

a) Classification is the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes. Such characteristics include—but are not limited to—the nature of the item, its role (or function) within the business activities conducted by the entity, and how it is measured.

b) Classifying dissimilar assets, liabilities, equity, income or expenses together can obscure relevant information, reduce understandability and comparability and may not provide a faithful representation of what it purports to represent.

- **Offsetting**

  Offsetting occurs when an entity recognises and measures both an asset and liability as separate units of account, but groups them into a single net amount in the statement of financial position. Offsetting classifies dissimilar items together and therefore is generally not appropriate.

- **Classification of equity**

  To provide useful information, it may be necessary to classify equity claims separately if those equity claims have different characteristics (see paragraph 4.65).

  Similarly, to provide useful information, it may be necessary to classify components of equity separately if some of those components are subject to particular legal, regulatory or other requirements. For example, in some jurisdictions, an entity is permitted to make distributions to holders of equity claims only if the entity has sufficient reserves specified as distributable (see paragraph 4.66). Separate presentation or disclosure of those reserves may provide useful information.

- **Classification of income and expenses**
  Classification is applied to:
  a) income and expenses resulting from the unit of account selected for an asset or liability; or
  b) components of such income and expenses if those components have different characteristics and are identified separately. For example, a change in the current value of an asset can include the effects of value changes and the accrual of interest (see Table 6.1). It would be appropriate to classify those components separately if doing so would enhance the usefulness of the resulting financial information.

- **Profit or loss and other comprehensive income**
  Income and expenses are classified and included either:
  a) in the statement of profit or loss; or
  b) outside the statement of profit or loss, in other comprehensive income.

1.7.4 Aggregation

- Aggregation is the adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification.

- Aggregation makes information more useful by summarising a large volume of detail. However, aggregation conceals some of that detail. Hence, a balance needs to be found so that relevant information is not obscured either by a large amount of insignificant detail or by excessive aggregation.

- Different levels of aggregation may be needed in different parts of the financial statements. For example, typically, the statement of financial position and the statement(s) of financial performance provide summarised information and more detailed information is provided in the notes.

1.8 Chapter 8: Capital maintenance concepts

Financial capital maintenance

With the **financial concept of capital maintenance**, a profit is not earned during a period unless the financial value of equity at the end of the period exceeds the financial value of equity at the beginning of the period (after adjusting for equity capital raised or distributed).

Physical capital maintenance

With a physical concept of capital maintenance, a profit is not earned during a period unless (excluding new equity capital raised during the period and adding back any distribution of dividends to shareholders) the operating capability of the business is greater at the end of the period than at the beginning of the period.

2 ACCOUNTING CONCEPTS

Section overview

- Consistency of presentation
- Materiality and aggregation
- Offsetting
- Fair presentation

2.1 Consistency of presentation

Consistency of presentation is needed if financial information is to be comparable. IAS 1 states that there should be consistency in the presentation and classification of items in the financial statements from one year to the next.

2.2 Aggregation

In addition, items of a dissimilar nature should not be aggregated together in the financial statements (combined as a single item and in a single total), unless their value is immaterial.

2.3 Offsetting

IAS 1 states that:

- Assets and liabilities should not be offset against each other.
- Similarly incomes and expenses should not be offset against each other.

Instead they should be reported separately.

The **exceptions to this rule** are when:

- offsetting is required or permitted by an accounting standard or the Interpretation of a standard; and
- offsetting reflects the economic substance of a transaction. An example specified in IAS 1 is reporting of a gain or loss on disposal of a non-current asset at sale value minus the carrying value of the asset and the related selling expenses.

2.4 Fair presentation or a true and fair view?

IAS 1 requires financial statements to present fairly the financial position, financial performance and cash flows of the entity.

The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.' IAS 1 states that:

- When the financial statements of an entity comply fully with International Financial Reporting Standards, this fact should be disclosed; and
- An entity should not claim to comply with IFRSs unless it complies with **all** the requirements of **every** applicable Standard.

IAS 1 acknowledges that in extremely rare circumstances, compliance with a standard or an Interpretation may produce financial statements that are so misleading that they do not provide useful information and no longer give a fair presentation. In these cases, an entity may depart from the rules in order that the financial statements are fairly presented.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the objectives of financial statements;
- List and explain the components of the conceptual framework;
- Explain the measurement bases available under IFRS;
- Explain and illustrate the capital maintenance concepts described in the conceptual framework; and
- Explain the meaning of true and fair or fairly presented.

Professional level
Corporate

CHAPTER 3

Presentation of financial statements

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	**Reporting of entity's performance to stakeholders**		
	1	**Performance reporting**	
		b	Apply accounting standards relating to performance reporting such as IFRS 15, IFRS 8, IFRS 5, IAS 33 and IAS 34 to the preparation of financial statements.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	3	**Non-financial liabilities**	
		c	Discuss the financial statement disclosure requirements for non-financial liabilities.
	5	**Segment reporting**	
		a	Determine and assess the nature and extent of reportable segments (IFRS 8).
		b	Discuss the nature of segment information to be disclosed and its overall impact on reported performance of the reporting entity.
	6	Related party transaction	
			Appraise the effects of related parties' transactions and disclosures on reported performance in line with relevant accounting standards.

IAS 1, IAS 34, IAS 24 and IFRS 8 are examinable standards.

Exam context

This chapter explains the main features of IAS 1, IAS 34, IAS 24 and IFRS 8.

At the end of this chapter, you should be able to:

- Explain the general features of financial statements described in IAS 1
- Describe the requirements of IAS 34
- Explain the objective of IAS 24 in setting out rules on disclosure of related party relationships and transactions
- Define and identify related parties
- Prepare related party disclosures based on a scenario
- Explain why the information provided by IFRS 8 is useful to users of financial statements
- Define and identify operating segments

1 IAS 1: PRESENTATION OF FINANCIAL STATEMENTS

Section overview

- Form and content
- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changes in equity (SOCIE)
- Notes to the financial statements

1.1 Form and content

IAS 1: Presentation of Financial Statements sets out the rules on the form and content of financial statements.

A complete set of financial statements consists of:

- a statement of financial position as at the end of the period;
- a statement of comprehensive income for the period (made up of a statement of profit or loss and a statement of other comprehensive income);
- a statement of changes in equity for the period;
- a statement of cash flows (this is dealt with in a later chapter); and
- notes to these statements, consisting of a summary of significant accounting policies used by the entity and other explanatory notes;
- comparative information in respect of the previous period (as specified); and
- a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or retrospectively restates or reclassifies items (as specified).

1.2 Statement of financial position

Current and non-current assets and liabilities

IAS 1 requires an entity to present current and non-current assets, and current and non-current liabilities, as separate classifications on the face of its statement of financial position unless a liquidity presentation provides more relevant and reliable information. In such cases, all assets and liabilities must be presented broadly in order of liquidity.

Some items may be presented using a current/non-current distinction and others in order of liquidity if this provides information that is more relevant and reliable.

Whichever method of presentation is adopted an entity must disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item that combines current and non-current amounts.

Information to be presented on the face of the statement of financial position

IAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of financial position as a 'line item' (in other words, on a separate line in the statement):

Additional line items should be included in the statement of financial position when presenting them separately and is 'relevant to an understanding of the entity's financial position.

Some of the line items in the statement of financial position should be sub-classified into different categories, giving details of how the total figure is made up. This sub-classification may be presented either:

- as additional lines on the face of the statement of financial position (adding up to the total amount for the item as a whole); or in notes to the financial statements.

1.3 Statement of profit or loss and other comprehensive income

A single statement or two statements

The statement provides information about the performance of an entity in a period. It consists of two parts:

- a statement of profit or loss – a list of income and expenses which result in a profit or loss for the period; and
- a statement of other comprehensive income – a list of other gains and losses that have arisen in the period.

IAS 1 allows an entity to present the two sections in a single statement or in two separate statements.

IAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of profit or loss and other comprehensive income.

Additional line items should be presented on the face of the statement of comprehensive income when it is relevant to an understanding of the entity's financial performance.

Information to be shown on the face of the statement of comprehensive income (or the statement of profit or loss, if separate) or in the notes

The following information may be shown either on the face of the statement of comprehensive income or in a note to the financial statements:

- **material items** of income and expense
- an **analysis of expenses**, providing either:
  - expenses analysed by their nature, or
  - expenses analysed by the function that has incurred them.

Information to be presented in the other comprehensive income section

The other comprehensive income section must present line items for amounts of other comprehensive income in the period, classified by nature (including share of the other comprehensive income of associates and joint ventures accounted for using the equity method) and grouped into those that, in accordance with other IFRSs:

- ❑ will not be reclassified subsequently to profit or loss:
  - revaluation surpluses on property, plant and equipment (IAS 16);
  - revaluation surpluses on intangible assets (IAS 38);
  - remeasurements of defined benefit pension schemes (IAS 19); and
- ❑ will be reclassified subsequently to profit or loss when specific conditions are met, including:
  - gains and losses on retranslation of foreign operations (IAS 21);
  - gains and losses recognised on the effective element of cash flow hedges (IFRS 9); and
  - gain/loss on available for sales investment.

Example: Reclassification adjustments

Year 1:

A company buys a foreign subsidiary at the start of year 1.

At the end of year 1, the financial statements of the subsidiary are retranslated resulting in an exchange loss of ₦100,000.

	Debit	Credit
Other comprehensive income	100,000	
Net assets of S		100,000

This debit is transferred to a separate balance in equity.

Year 2:

The company sells the subsidiary at the start of year 2.

This debit is transferred to a separate balance in equity.

The loss previously recognised in OCI must now be recognised in P&L. The double entry to achieve this is:

	Debit	Credit
Profit or loss	100,000	
Other comprehensive income		100,000

This credit in OCI in turn is transferred to the separate balance in equity where it nets the debit that was taken there in year 1 back to zero.

1.4 Statement of changes in equity (SOCIE)

A SOCIE shows the amount at the beginning of the period, changes during the period, and the amount at the end of the period for each component of equity.

For each component of equity, the SOCIE should show changes resulting from:

- ❑ profit (gain) or loss for the period;
- ❑ each item of other comprehensive income;
- ❑ transactions with owners in their capacity as owners.
  - new issues of shares;
  - payments of dividends;
  - repurchases and cancellation of its own shares by the company; and
  - charges in respect of equity-settled share based payment transactions.

Transactions with owners in their capacity as owners are not gains or losses so are not shown in the statement so comprehensive income but they do affect equity. The SOCIE highlights such transactions.

1.5 Notes to the financial statements

Notes contain information in addition to that presented in the statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows.

Notes provide narrative descriptions of items in those statements and information about items that do not qualify for recognition in those statements. They also explain how totals in those statements are formed.

Disclosure of accounting policies

An entity must disclose the following in the summary of significant accounting policies:

- ❑ the measurement basis (or bases) used in preparing the financial statements; and
- ❑ the other accounting policies used that are relevant to an understanding of the financial statements.
- ❑ the judgements (apart from those involving estimations) made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements. For example:
  - when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities;
  - whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue; and
  - whether the contractual terms of financial assets give rise on specified dates to cash flows that are solely payments of principle and interest.

Which policies?

Management must disclose those policies that would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position.

If an IFRS allows a choice of policy, disclosure of the policy selected is especially useful.

Some standards specifically require disclosure of particular accounting policies. For example, IAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment.

It is also appropriate to disclose an accounting policy not specifically required by IFRSs, but selected and applied in accordance with IAS 8.

Key measurement assumptions

An entity must disclose information regarding key assumptions about the future, and other key sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

In respect of those assets and liabilities, the notes must include details of:

- their nature; and
- their carrying amount as at the reporting date.

Examples of key assumptions disclosed are:

- future interest rates;
- future changes in salaries;
- future changes in prices affecting other costs; and,
- useful lives.

Examples of the types of disclosures made are:

- the nature of the assumption or other measurement uncertainty;
- the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
- the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

Capital disclosures

An entity must disclose information to enable users to evaluate its objectives, policies and processes for managing capital.

An entity must disclose the following:

- qualitative information including:
  - a description of what it manages as capital;
  - the nature of any externally imposed capital requirements and how they are incorporated into the management of capital;

- how it is meeting its objectives for managing capital;

- ❑ summary quantitative data about what it manages as capital; and
- ❑ whether any externally imposed capital requirements have been complied with and if not the consequences of such non-compliance.

These disclosures must be based on information provided internally to key management personnel.

2 IAS 34: INTERIM FINANCIAL REPORTING

Section overview

- Scope of IAS 34
- Form and content of interim financial statements
- Periods for which interim financial statements must be presented
- Recognition and measurement
- Use of estimates in interim financial statements
- Interim reporting in Nigeria

2.1 Scope of IAS 34

IAS 1 requires that financial statements should be produced at least annually. Many companies are required by national regulations to produce accounts on a half-yearly basis or sometimes on a quarterly basis. For example, in the UK the Financial Services Authority requires listed companies whose shares are traded on the London Stock Exchange to produce accounts at the half year stage ('interim accounts') and at the year-end ('annual report'). This is one of their conditions of listing.

IAS 34 **Interim Financial Reporting** does not specify the frequency of interim reporting: this is a matter for national regulations, which may vary between countries. IAS 34 focuses on providing guidance on the form and content of these interim accounts.

It encourages publicly-traded companies to prepare interim accounts and to file them with the national authority no later than 60 days after the end of the interim period.

2.2 Form and content of interim financial statements

IAS 34 requires that, as a minimum, an interim financial report should include:

- a condensed statement of financial position;
- a condensed statement of profit or loss and other comprehensive income, presented as either a condensed single statement or a condensed separate statement of profit or loss followed by a condensed statement of other comprehensive income;
- a condensed statement of changes in equity;
- a condensed statement of cash flows; and
- selected explanatory notes.

In the statement that presents the components of profit or loss an entity should present the basic and diluted EPS for the period.

An entity could provide a full set of financial statements or additional selected information if it wishes to do so. If it chooses to produce a full set of financial statements for its interim accounts, the entity must comply with IAS 1.

The interim statements are designed to provide an update on the performance and position of the entity. It should focus on new activities, events, and circumstances that have occurred since the previous annual financial statements

were issued. They should not duplicate information that has already been reported in the past.

2.3 Periods for which interim financial statements must be presented

Interim reports must include the following financial statements (condensed or complete):

- a statement of financial position at the end of the current interim period and a comparative Statement of financial Position at the end of the previous financial year.
- statements of profit or loss and other comprehensive income for the current interim period and cumulatively for the current financial year to date.
- comparative statements of profit or loss and other comprehensive income for the comparable interim period last year, and the comparable cumulative period last year.
- a statement of changes in equity for the current financial year to date, with a comparative statement for the comparable year-to-date period in the previous year.
- a statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period in the previous year.

Example: Periods for which interim financial statements must be presented

X plc publishes interim financial reports quarterly.

The entity's financial year ends 31 December (calendar year).

The statements that must be presented in the quarterly interim report as of 30 June 20x9:

	30th June 20x8	31st December 20X8	30th June 20X9
Statement of financial position	-	✔	✔
Statement of profit or loss and other comprehensive income			
6m ending	✔	-	✔
3m ending	✔	-	✔
Statement of cash flows			
6m ending	✔	-	✔
3m ending	-	-	-
Statement of changes in equity			
6m ending	✔	-	✔
3m ending	-	-	-

2.4 Recognition and measurement

An entity should use the same accounting policies in the interim accounts that it uses in the annual financial statements.

Measurement for interim purposes should be made on a year-to-date basis. For example, suppose that a company uses quarterly reporting and in the first quarter of the year, it writes down some inventory to zero. If it is then able to sell the inventory in the next quarter, the results for the six-month period require no write-down of inventory, and the write-down of inventory should be reversed for the purpose of preparing the interim accounts for the first six months of the year.

An appendix to IAS 34 gives some guidance on applying the general recognition and measurement rules from the IASB Conceptual Framework to the interim accounts. Some examples are given below.

Intangible assets

The guidance in IAS 34 states that an entity should follow the normal recognition criteria when accounting for intangible assets. Development costs that have been incurred by the interim date but do not meet the recognition criteria should be expensed. It is not appropriate to capitalise them as an intangible asset in the belief that the criteria will be met by the end of the annual reporting period.

Tax

Interim period tax should be accrued using the tax rate that would be applicable to expected total earnings.

2.5 Use of estimates in interim financial statements

The interim financial statements should be reliable and relevant. However, IAS 34 recognises that the preparation of interim accounts will generally rely more heavily on estimates than the annual financial statements. An appendix of IAS 34 provides examples.

Pensions

A company is not expected to obtain an actuarial valuation of its pension liabilities at the interim date. The guidance suggests that the most recent valuation should be rolled forward and used in the interim accounts.

Provisions

The calculation of some provisions requires the assistance of an expert. IAS 34 recognises that this would be too costly and time-consuming for the interim accounts. IAS 34 therefore states that the figure included in the annual financial statements for the previous year should be updated without reference to an expert.

Inventories

A full count of inventory may not be necessary at the interim reporting date. It may be sufficient to make estimates based on sales margins to establish a valuation for the interim accounts.

2.6 Interim reporting in Nigeria

The Nigerian Stock Exchange is regulated by the Securities and Exchange Commission and subject to its regulations.

Securities and Exchange Commission (SEC)

Companies wishing to be admitted to the official list of the Nigerian Stock Exchange must, in addition to complying with the exchange's listing rules, comply with the relevant provisions of the Companies and Allied Matters Act 2020 and the Investment and Securities Act, 1999 Rules and Regulations.

The SEC regulations contain the following requirements with respect to interim reporting.

Quarterly report

Public quoted companies are required prepare a report prepared in accordance with IFRS. Therefore, IAS 34 applies.

The report must be filed with the commission and simultaneously with the relevant securities exchanges and the investing public within 30 days of the end of the quarter. The report must be accompanied by a certification letter signed by the chief executive officer and chief financial officer.

The quarterly report must contain the following by way of notes

- accounting policy changes;
- seasonality or cyclicality of operations;
- Changes in estimates;
- issuance, repurchase and repayment of debts and equity securities;
- dividends;
- items of segment information;
- significant events after the end of the interim period;
- business combinations;
- long term investments;
- restructuring and reversals of restructuring provisions;
- discontinuing operations;
- correction of prior errors;
- write down of inventory to net realisable value;
- the impairment loss of property, plant and equipment intangible or other assets and reversal of such impairment loss;
- the litigation settlements;
- any debt defaults or any breach of a debt that has not been corrected subsequently;
- related party transactions;
- acquisitions and disposals of property, plant and equipment;
- commitments to purchase property, plant and equipment.

All public companies must publish the signed quarterly statement of financial position, statement of profit or loss and other comprehensive income and statement of cash flows in at least one national daily newspaper. However the accounting policy notes and other relevant information must be posted on the company's website the address of which must be disclosed in the newspaper publication.

Half yearly returns

Public companies shall file half yearly returns with the commission in the prescribed manner and shall contain the following:

- general information;
- corporate governance issues;
- unclaimed dividends;
- audit committee; and
- an undertaking by the company secretary, chief internal auditor, financial controller, managing director, board chairman and chairman of the audit committee certifying the reliability of the information in the format provided.

This must be filed with the Commission within 30 days of the end of the half year period either in hard or electronic copy.

3 IAS 24: RELATED PARTY DISCLOSURES

Section overview

- Impact on the financial statements
- The objective of IAS 24
- Definitions
- Disclosure requirements

3.1 Impact on the financial statements

A user of financial statements will normally expect the financial statements to reflect transactions that have taken place on normal commercial terms ('at arm's length'). The user of the financial statements would want to be informed if:

- Transactions have taken place that were not at 'arm's length'; or
- There are parties that could enforce transactions on the entity that are not on an 'arm's length' basis.

For example, in a group of companies, an entity might sell goods to its parent or fellow-subsidiaries on more favourable terms than it would sell to other customers.

In this situation, the financial performance or financial position reported by the financial statements would be misleading. In each situation there is a special relationship between the parties to the business transactions. This is referred to as a 'related party relationship'.

3.2 The objective of IAS 24

The objective of IAS 24 is to ensure that an entity's financial statements contain sufficient disclosures to draw attention to the possibility that the entity's financial position, or profit or loss may have been affected by:

- the existence of related parties; and
- transactions and outstanding balances with related parties.

IAS 24 is a **disclosure** standard. It does not require the redrafting of financial statements. Such redrafting would be difficult as without the related party relationship the transactions might never have taken place, and even if they had, it may not be possible to determine at what amount.

Specified disclosures are required of:

- related party relationships; and
- related party transactions.

3.3 Definitions

IAS 24 provides a lengthy definition of a related party and also a definition of a related party transaction.

Related party

Related party: A party is related to an entity (it is a related party) in **any** of the following circumstances:

- The party controls the entity, or is controlled by it: (e.g. parent and subsidiaries' relationship);
- It has significant influence over the entity: (e.g. investor and associate relationship);
- It has joint control over the entity: (e.g. joint venturers' relationship);
- The parties are under common control. (e.g. fellow subsidiaries' relationship);
- The party is a member of the key management personnel of the entity or its parent; and
- The party is a **close family member** of any of the above.

A parent entity is related to its subsidiary entities (because it controls them) and its associated entities (because it exerts significant influence over them). Fellow subsidiaries are also related parties, because they are under the common control of the parent.

In considering each possible related party relationship, the entity must look to the **substance** of the arrangement, and not merely its legal form. Although two entities that have the same individual on their board of directors would not meet any of the above conditions for a related party, a related party relationship would nevertheless exist if influence can be shown.

Some examples are given by IAS 24 of **likely exemptions**, where a related party relationship would usually not exist. However, the substance of the relationship should always be considered in each case.

Examples of **entities that are usually not related parties** are:

- Two venturers that simply share joint control over a joint venture;
- Providers of finance (such as a lending bank or a bondholder);
- Trade unions;
- Public utilities;
- Government departments and agencies; and
- Customers, suppliers, franchisors, distributors or other agents with whom the entity transacts a significant volume of business.

Close family members are those family members who may be expected to influence, or be influenced by that individual. They include:

- The individual's partner, children and dependants; and
- Children or dependants of the individual's partner.

Related party transactions

A related party transaction is:

- A transfer of resources, services, or obligations between related parties; and
- Whether or not a price is charged.

The following examples of related party transactions are given in IAS 24. (These are related party transactions when they take place between related parties):

- Purchases or sales of goods;
- Purchases or sales of property and other assets;
- Rendering or receiving of services;
- Leases;
- Transfer of research and development costs;
- Finance arrangements (such as loans or contribution to equity);
- Provision of guarantees; and
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

Example: Related party transactions

In the following examples, identify related party relationships between all parties and state any additional factors to consider in order to form a conclusion:

(a) W Plc holds a controlling interest in X Ltd and Y Ltd. Z Ltd is a wholly owned subsidiary of X Ltd.

(b) Mr Z holds 75% of the voting capital of A Ltd and 40% of the voting capital of B Ltd.

(c) H and W (who are husband and wife) are the directors and majority shareholders of Q Ltd. The company makes purchases from P Ltd, a company jointly controlled by W and their daughter, D. D is a director of P Ltd but holds no share in Q Ltd.

Answer

(a) W Plc

W PLC is related to both X Ltd and Y Ltd (both subsidiaries) because of its controlling interest.

X Ltd and Y Ltd are related because they are under the common control of W PLC.

Z Ltd is related to X Ltd because of its subsidiary status.

Z Ltd is also related to W PLC as he is indirectly controlled by W PLC through W PLC's holding of X Ltd.

(b) Mr Z

Mr Z is related to A Ltd because of the subsidiary status of A Ltd.

As an associate of Mr Z, B Ltd is also a related party

A Ltd and B Ltd are not related. Although they are both owned by Mr Z, there is no common control because Mr Z only has a 40% stake in B Ltd.

(c) Q Ltd

H and W are both related to Q Ltd, because they are key management of the entity

D could be considered to be close family to H and W, but this is only true if it can be shown that she is influenced by them in business dealings (and there is insufficient information in this example to ascertain whether this is true).

P Ltd is related to Q Ltd as it is jointly controlled by a member of the key management of Q Ltd. Therefore, any business dealings between the two entities will need to be disclosed.

3.4 Disclosure requirements

IAS 24 requires disclosure in the notes to the financial statements of the following, **whether or not transactions have taken place** between those related parties:

- the name of the entity's parent; and
- if different, the name of the ultimate controlling party.

Where transactions have taken place between the related parties, irrespective of whether a price was charged, or price charged is at arm's length, the following should be disclosed:

- The nature of the related party relationship;
- The amount of the transactions;
- In respect of outstanding balances:
  - the amount;
  - their terms and conditions;
  - any guarantees given or received;
  - any provision for doubtful/irrecoverable debts; and
- The expense recognised in the period in respect of irrecoverable debts due from related parties.

The above disclosures should be given separately for each of the following categories of related party:

- The parent;
- Entities with joint control or significant influence over the entity;
- Subsidiaries;
- Associates;
- Joint ventures in which the entity is a venture;
- Key management personnel of the entity or its parent; and
- Other related parties.

In addition, IAS 24 requires disclosure of **compensation to key management personnel**, in total, and for each of the following categories:

- Short-term employee benefits;
- Post-employment benefits;
- Other long-term benefits;
- Termination benefits; and
- Share-based payments.

Illustration: Disclosure note

An example of a note to the financial statements for related party transactions of a large quoted company is shown below:

Trading transactions

	Sales to related parties	Purchases from related parties	Amounts owed by related parties	Amounts owed to related parties
	₦m	₦m	₦m	₦m
Associates		48		17
Joint ventures	57	14	12	

Non-trading transactions

	Loans to related parties	Loans from related parties
	₦m	₦m
Associates		11
Joint ventures	33	

4 IFRS 8: OPERATING SEGMENTS

Section overview

- Scope of IFRS 8
- Operating segments

4.1 Scope of IFRS 8

Many companies operate in several different industries (or 'product markets') or diversify their operations across several geographical locations. A consequence of diversification is that companies are exposed to different rates of profitability, different growth prospects and different amounts of risk for each separate 'segment' of their operations.

Objective of IFRS 8

IFRS 8 requires quoted companies to disclose information about their different operating segments, in order to allow users of the financial statements to gain a better understanding of the company's financial position and performance.

Users are able to use the information about the main segments of the company's operations to carry out ratio analysis, identify trends and make predictions about the future. Without segment information, good performance in some segments may 'hide' very poor performance in another segment, and the user of the financial statements will not see the true position of the company.

Segment reporting is required for any entity whose debt or equity is **quoted** on a public securities market (stock market) and also entities that are in the process of becoming quoted. If an entity includes some segment information in the annual report that doesn't comply with IFRS 8, it cannot call it 'segmental information.'

4.2 Operating segments

IFRS 8 defines an operating segment as a component of an entity:

- that engages in business activities from which it earns revenues and incurs expenses;
- whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete financial information is available.

Not every part of an entity is necessarily an operating segment. For example a corporate head office may not earn revenue and would not be an operating segment.

The standard requires a segment to have its results reviewed by the chief operating decision maker. The reason for this part of the definition of an operating segment is to ensure that an entity reports segments that are used by management of the entity to monitor the business.

Aggregation of segments

Two or more operating segments may be aggregated into a single operating segment if they have similar economic characteristics, and the segments are similar in each of the following respects:

- The nature of the products and services;
- The nature of the production process;
- The type or class of customer for their products and services;
- The methods used to distribute their products or provide their services; and
- If applicable, the nature of the regulatory environment, for example, banking insurance or public utilities.

Quantitative thresholds

An entity must report separately information about an operating segment that meets any of the following quantitative thresholds:

- Its reported revenue, including external sales and intersegment sales is 10% or more of the combined internal and external revenue of all operating segments;
- Its reported profit is 10% or more of the greater of the combined profit of all segments that did not report a loss and the combined reporting loss of all segments that reported a loss; and
- Its assets are 10% or more of the combined assets of all operating segments.

Reportable segments

An entity must report separately information about each operating segment that:

- Has been identified in accordance with the definition of an operating segment shown above;
- Or is aggregated with another segment; and
- Or exceeds the quantitative thresholds.

If the total external revenue reported by operating segments constitutes less than 75% of the entity's total revenue, then additional operating segments must be identified as reporting segments, even if they do not meet the criteria, until 75% of revenue is included in reportable segments.

Example:

The following information relates to Oakwood, a quoted company with five divisions of operation:

	Wood sales	Furniture sales	Veneer sales	Waste sales	Other sales	Total
	₦m	₦m	₦m	₦m	₦m	₦m
Revenue from external customers	220	256	62	55	57	650
Inter segment revenue	38	2	-	5	3	48
Reported profit	54	45	12	9	10	130
Total assets	4,900	4,100	200	400	600	10,200

Which of the business divisions are reportable segments under IFRS 8 Operating segments?

Answer

IFRS 8 states that a segment is reportable if it meets any of the following criteria:

1. its internal and external revenue is more than 10% of the total entity internal and external revenue;
2. its reported profit is 10% or more of the greater of the combined profit of all segments that did not report a loss; and
3. its assets are 10% or more of the combined assets of all operating segments.

From the table above, only the Wood and Furniture department sales have more than 10% of revenue, assets and profit and meet the requirements for an operating segment. The other three divisions do not meet the criteria: none of them pass the 10% test for assets, profit or revenue.

Additionally IFRS 8 states that if total external revenue reported by operating segments constitutes less than 75% of the entity's revenue then additional operating segments must be identified as reporting segments, until 75% of revenue is included in reportable segments.

The total external revenue of Wood and Furniture is ₦476m and the total entity revenue is ₦650m, which means that the revenue covered by reporting these two segments is only 73%. This does not meet the criteria so we must add another operating segment to be able to report on 75% of revenue. It doesn't matter that any of the other entities do not meet the original segment criteria.

In this case, we can add on any of the other segments to achieve the 75% target. If we add in Veneer sales, this gives total sales of ₦538m, which is 83% of the sales revenue of ₦650m. This is satisfactory for the segmental report.

Disclosure

IFRS 8 states that an entity must disclose information so that users of the financial statements can evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

The information that is to be disclosed is:

- A measure of profit or loss for each reportable segment;
- A measure of total assets liabilities for each reportable segment if such an amount is reported regularly to the chief operating decision maker;
- Information about the following items if they are specified and included in the measure of segment profit that is reported to the chief operating decision maker:
    - revenues from external customers;
    - revenues from transactions with other operating segments of the same entity;
    - interest revenue;
    - interest expense;
    - depreciation and amortisation;
    - material items of income and expense in accordance with IAS 1;
    - the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;
    - income tax expense or income; and
    - material non-cash items other than depreciation and amortisation.
- the amount of investment in associates and joint ventures accounted for by the equity method and the amounts of additions to non-current assets (excluding financial instruments, deferred tax assets, post-employment benefit assets and rights arising under insurance contracts), providing these amounts are included in segment assets.

Additionally, the following reconciliations are required:

- Reconciliation of the totals of segment revenues to the entity's revenue;
- Reconciliation of the total of reported segment profits or losses to the entity's profit before tax and discontinued operations;
- Reconciliation of the total of the assets of the reportable segments to the entity's assets;
- Reconciliation of the total of the liabilities of the reportable segments to the entity's liabilities (but only if segment liabilities are reported); and
- Reconciliation of the total of the assets of the other material items to the entity's corresponding items.

Also, the factors used to identify the entity's reportable segments, including the basis of organisation, (i.e. whether the entity is organised around different products and services or geographical area), and the types of products and service from which the reportable segments derive their income must all be disclosed.

Measurement

IFRS 8 requires that the amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. This is based on the internal structure of how division of the entity report their results to the chief operating decision maker. Any adjustments and eliminations made in preparing an entity's financial statements shall be included in determining segment results only if they are included in the measure of the segment's results used by the chief operating decision maker.

The minimum amount the entity must disclose is:

- The basis of accounting for any transactions between reportable segments;
- The nature of any differences between the measurement of the reportable segments' profit or loss before tax and the entity's profit or loss, for example, the allocation of centrally incurred costs;
- The nature of any differences between the measurement of the reportable segments' assets and the assets of the entity;
- The nature of any differences between the measurement of the reportable segments' liabilities and the liabilities of the entity;
- The nature of any changes from prior periods in measurement methods used to determine segment profit or loss and the effect on profit or loss from those changes; and
- The nature of asymmetrical allocations to reportable segments. For example, a reportable segment may be charged the depreciation expense for a particular asset but the depreciable asset might not have been allocated to the segment.

Entity wide disclosures

The reporting entity must also make the following disclosures in the financial statements, even if it only has one reportable segment:

- Revenue from external customers for each product and service or each group of similar products and services;
- Revenue from external customers attributed to the entity's country of domicile and attributed to all foreign countries in total where revenue is made;
- Non-current assets located in the country of domicile and located in all foreign countries in total where the entity holds assets; and
- If revenue from any customer is more than 10% of total revenue, then it must be disclosed along with the total of revenues from these customers and the identity of the segment reporting the revenue.

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the general features of financial statements described in IAS 1
- Describe the requirements of IAS 34
- Explain the objective of IAS 24 in setting out rules on disclosure of related party relationships and transactions
- Define and identify related parties
- Prepare related party disclosures based on a scenario
- Explain why the information provided by IFRS 8 is useful to users of financial statements
- Define and identify operating segments
- Prepare operating segment disclosure notes based on a simple scenario

Professional level
Corporate

CHAPTER 4

Other information in the annual report

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

A	Ethical issues in and regulatory framework of Corporate Reporting		
	2	**f**	Evaluate disclosures of corporate governance, chairman's report, management commentary and audit committee's report as they relate to a company's annual report.

Exam context

This chapter describes and explains additional information that might be included in annual reports.

At the end of this chapter, readers should be able to:

- List other types of information found in annual reports;
- Describe the general requirements for the content of governance reports;
- Explain the purpose and describe the content of a management commentary;
- Explain the purpose and describe the content of effective risk reports; and
- Describe other financial information that might appear in annual reports.

1 ANNUAL REPORTS

Section overview

- Introduction
- Content of annual reports
- Voluntary disclosures

1.1 Introduction

An annual report is a comprehensive report on a company's activities throughout the preceding year. Annual reports are intended to give shareholders and other users, who are interested, information about the company's activities and financial performance.

Most jurisdictions, including Nigeria, require companies to prepare and disclose annual reports, and many require the annual report to be filed at the company's registry, in Nigeria the Corporate Affairs Commission (CAC). Companies listed on a stock exchange are also required to report at more frequent intervals (depending upon the rules of the stock exchange involved).

1.2 Content of annual reports

In addition to the audited financial statements, annual reports contain a great deal of extra information.

This information might be:

- numerical and/or narrative; and
- financial and non-financial.

A lot of the information is provided in narrative form. There is a view that narrative reports can be much easier to understand than financial statements and notes to the financial statements.

The extra information provided may be provided on a mandatory or voluntary basis.

Mandatory and voluntary disclosures

Disclosures may be a mandatory requirement of the law or other regulations, or they may be provided as voluntary disclosures by a company. In practice, the disclosures by a company are likely to be a mixture of mandatory and voluntary disclosures.

The nature and amount of mandatory disclosures depends on the laws and regulations of the country.

- Some disclosures are required by law. For example, companies are required to prepare an annual report and accounts, and present these to the shareholders. Company law specifies what the directors' report and the accounts must contain, and in addition other regulations about content apply such as the requirements of Financial Reporting standards.
- Some disclosures are required by stock market rules or FRN. For example, the SEC/FRN rules require listed companies to provide information relating to corporate governance and a chairman's report in their annual report and accounts. There are also stock market rules about other announcements by

the company, such as profit warnings and announcements of proposed takeovers.

1.3 Voluntary disclosures

In addition to the mandatory disclosures required by law or regulation, many companies provide additional information, as part of their normal reporting cycle. Typically, these include

- an operating and financial review;
- a social and environmental report;
- corporate social responsibility report;
- financial summaries;
- details of key performance indicators (KPIs).

There are several reasons why a company might make voluntary disclosures:

- some voluntary information might be provided as a public relations or marketing exercise, to present 'good news' about the company to investors and other users of the company's published reports.
- providing information on a voluntary basis might persuade the government or financial service regulator that compulsory disclosures and regulation are not necessary.
- companies might publish social and environmental reports out of a genuine ethical and cultural belief in the responsibilities of the company to society and the environment. If a company believes that it has social and environmental responsibilities, publishing a report on these issues is a way of making itself accountable.
- a company might use voluntary disclosures as a way of improving communications with its shareholders. By giving more disclosures to shareholders, companies might encourage shareholders to respond, and enter into a dialogue with the company about its strategies and plans for the future.

The main limitations of information provided on a voluntary basis are that:

- the company can decide what to include in the report and what to leave out;
- The information is often presented in a very positive form, as public relations for investors, and might not be entirely reliable.

2 GOVERNANCE REPORTS

Section overview

- Requirements for disclosures about corporate governance
- Requirements in Nigeria
- Requirements in the European Union

2.1 Requirements for disclosures about corporate governance

Institutional investors need information about corporate governance in order to make better investment decisions. Such information is provided in corporate governance statements as part of the annual report.

Corporate governance statements by listed companies are often quite long. Typically, they fill five or six pages in the annual report and accounts.

The specific content of a corporate governance statement may vary from jurisdiction to jurisdiction, although modern corporate governance reports often rest on similar foundations and require similar disclosures.

2.2 Requirements in Nigeria

Nigeria has a modern and comprehensive corporate governance code. The Financial Reporting Council of Nigeria has unified the various sectoral corporate governance codes into one, the Nigerian Code of Corporrate Governance 2018. The Securities and Exchange Commission (SEC) requires that the annual reports of all quoted companies should include a corporate governance statement.

The corporate governance report should convey clear information on the strength of the company's governance structures, policies and practices to stakeholders.

General requirements

The report should include the following:

- ❑ details of the composition of board of directors stating the names of chairmen, CEO and non-executive directors;
- ❑ the roles and responsibilities of the board setting out matters which are reserved for the board and those delegated to management;
- ❑ details of the process for making board appointments and the induction and training of board members;
- ❑ details of the evaluation process for the board as a whole, its committees and each individual director with a summary of evaluation results;
- ❑ details of directors standing for re-election and their biographical details;
- ❑ the composition of board committees including names of chairmen and members of each committee;
- ❑ a description of the roles and responsibilities of the board committees and how the committees have discharged those responsibilities;
- ❑ the number of meetings of the board and the committees held during the year and details of attendance;
- ❑ disclosure of the code of business conduct and ethics, if any, for directors and employees;

- human resource policies, internal management structure, relations with employees, employee share ownership schemes and other work place development initiatives;
- companies sustainability policies and programmes covering issues such as corruption, community service, environmental protection, HIV/AIDs and general corporate social responsibility issues.

Statement of compliance

The annual report should contain a statement from the board with regards to the company's degree of compliance with the provisions of this code.

In particular it should provide:

- assurances that effective internal audit function exists and that risk management control and compliance systems are operating efficiently and effectively in all respects;
- justification where the board does not accept the audit committee's recommendation on the appointment, reappointment or removal of an existing external auditor; explaining the recommendation and the reason for the board decision;
- statement on sustainability initiatives;
- related party transactions;
- the nature of the related party relationships and transactions as well as information about the transactions necessary to understand the potential effect of the relationship on the financial statements.

Accounting and risk management issues

The board of every public company should ensure that the company's annual report makes sufficient disclosure on accounting and risk management issues.

In particular, the following matters must be disclosed:

- the statement of the directors' responsibilities in connection with the preparation of financial statements;
- details of accounting policies utilised and reasons for changes in accounting policies;
- where the accounting policies applied do not conform to standard practice, the external auditor should express an opinion on whether they agreed with the departure and the reasons for such departure;
- a statement from the directors that the business is a going concern;
- executive directors remuneration and share options;
- non-executive directors fees and allowances and share options if any;
- risk management indicating the board's responsibility for the total process as well as its opinion on the effectiveness of the risk management procedures.

Chairman's report

The chairman of the board is a non-executive director and as such should not be involved in the day-today operations of the company.

The chairman's primary responsibility is to ensure effective operation of the board and that it works towards achieving the company's strategic objectives.

The Securities and Exchange Commission (SEC) require that the annual report includes a chairman's statement which provides a balanced and readable summary of the company's performance for the period under review and future prospects and should reflect the collective view of the board.

Typically, the report will be one or two pages addressed to the clients, shareholders, members or others with an interest in the organisation.

There is no mandatory content but typically the report might contain the following:

- comments on the results;
- an overview of trading and the business including management, succession planning, diversity and values;
- a governance overview including the impact of governance and risk management processes;
- comments on corporate responsibility, sustainability and communities;
- commentary on markets and the environment; and
- an outlook statement.

2.3 Requirements in the European Union

In the European Union and in other countries, the principle of 'comply or explain' is applied. Major companies are required to comply with a recognised code of corporate governance, or explain their non-compliance.

Major companies are required to prepare a corporate governance statement each year. This is included in their annual report and accounts. In the UK for example, the Listing Rules of the London Stock Exchange require a statement in the annual report and accounts (of listed companies) relating to compliance with the UK Corporate Governance Code.

In 2018, the Nigerian Financial Reporting Council issued the Corporate Governance Code for listed and non-listed firms in Nigeria, with commencement date of January, 2019. This Code has six key governance pillars, containing 28 principles with recommended practices for their implementation, which are required to result in four expected outcomes. These are: enhancement of business integrity; rebuild public trust and confidence; facilitation of trade and investment; and drive business sustainability.

3 MANAGEMENT COMMENTARY

Section overview

- Definition and purpose of management commentary
- IFRS Practice Statement: Management commentary

3.1 Definition and purpose of management commentary

'Management commentary' is additional information about an entity that complements the information provided in the financial statements of an entity. Two important features of management commentary are that:

- it is provided by management, and expresses the view of the management of the entity;
- it is a commentary; therefore much of it is in a narrative form.

The *Canadian Accounting Standards Board* has defined management commentary as follows:

Definition

Management commentary: A narrative explanation, through the eyes of management, of how your company performed during the period covered by the financial statements and of your company's financial condition and future prospects.

The IASB agrees with most of this definition, but believes that management commentary should include quantitative information as well as narrative; therefore to call it a 'narrative' explanation is misleading.

Management commentary is useful to the users of financial statements because it provides them with additional information that supplements the figures in the accounts. It also gives them an insight into how management view the performance of the business and what they hope to achieve in the future. An assessment of the risks and opportunities facing the entity can also be useful for an investor who may want to make a decision as to whether to continue investing in the entity.

Management commentary is common in many countries. In the European Union, companies are required to include a business review in their annual report and accounts.

A business review is a management commentary, and might sometimes be called an *Operating and Financial Review* (OFR). In the UK there is a statement of best practice that gives guidance on the content and presentation of information in an OFR, which is consistent with the statutory requirements for the content of the business review.

3.2 IFRS Practice Statement: Management commentary

This is a non-mandatory document that sets out guidelines to be followed by companies who wish to or are required to produce a management commentary in accordance with IFRS.

The guidance is intended to provide a basis for the development of good management commentary. It offers a non-binding framework which could be adapted to the legal and economic circumstances of individual jurisdictions.

The Practice Statement (PS) defines management commentary as a narrative report accompanying financial statements prepared in accordance with IFRSs that provides users with historical and prospective commentary on the entity's financial position, financial performance and cash flows, and a basis for understanding management's objectives and its strategies for achieving those objectives.

The PS prescribes a framework for the preparation and presentation of management commentary to assist management in preparing decision-useful management commentary to accompany financial statements prepared in accordance with IFRS.

Management commentary may help users to understand:

- the entity's risk exposures, its strategies for managing risks and the effectiveness of those strategies;
- how resources that are not presented in the financial statements could affect the entity's operations;
- how non-financial factors have influenced the information presented in the financial statements.

Management commentary should:

- provide management's view of the entity's performance, position and development;
- supplement and complement information presented in the financial statements; and
- be orientated to the future.

The relevant focus of management commentary will vary with facts and circumstances but a decision-useful management commentary should include information that is essential to an understanding of:

- the nature of the business;
- management's objectives and strategies for meeting those objectives;
- the entity's most significant resources, risks and relationships;
- the results of operations and prospects; and
- the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

4 RISK REPORTING

Section overview

- Risk management
- Situation in Nigeria
- Components of effective risk reporting
- Situation in the UK

4.1 Risk management

A company may be exposed to a wide range of risks which might affect its ability to achieve its corporate objectives.

Risk management is a corporate governance issue. A board should safeguard the assets of the company and protect the shareholders' investment from a loss of value. In order to achieve this, the board should manage risks.

The publication of information on risk management activities enables shareholders (and other stakeholders) to evaluate the importance that a company attaches to risk management and its effectiveness in managing those risks identified as significant.

Risk reports help boost shareholders' confidence that the company has adopted a responsible attitude towards risk.

ICGN Corporate Risk Oversight Guidelines

The *International Corporate Governance Network (ICGN)* has issued guidelines on responsibilities for the oversight and management of corporate risk (2010).

Key features are as follows:

- the risk oversight process begins with the board. The board is responsible for deciding the company's risk strategy and business model, and it should understand and agree the level of risk that goes with this. It should then have oversight of the implementation by management of a strategic and operational risk management system.
- management has the responsibility for developing and implementing the company's strategic and routine operational risk management system, within the strategy set by the board and subject to board oversight.
- shareholders have responsibility for assessing the effectiveness of the board in overseeing risk. Investors are not themselves responsible for the oversight of risk in the company.

The ICGN Guidelines provide guidance on processes for the oversight of corporate risk by the board and within the company, for investor responsibility and for disclosures by a company on its risk management oversight processes.

Shareholders need information about risk in order to fulfil their responsibility.

IFRS 7 Financial Instruments: Disclosure requires companies to make disclosure in respect of specified financial risks including, credit risk, liquidity risk and market risk. These disclosures could be included in the financial statements or incorporated as part of the risk report (in which case they are still subject to audit even though presented outside the financial statements). These are only part of

the risks that a company faces. A risk report should be broader in scope than just the financial risks.

Illustration: Other risks

BP's 2013 financial statements explain a number of risk areas including:

a. Climate change and carbon pricing;
b. Geopolitical;
c. Competition;
d. Reserves progression;
e. Major project deliveries; and
f. Digital infrastructure.

4.2 Situation in Nigeria

SEC rules require the following:

- ❑ the board of every public company must establish a risk management committee to assist it in its oversight of risk.
- ❑ every public company must include risk management as part of its accounting policies.
- ❑ public companies must disclose, by way of notes:
  - any material effect of unmitigated risk on corporate profitability; and
  - strategies for preventing risks the company is exposed to.

4.3 Components of effective risk reporting

The required content of effective risk reports can be stated using the following five components that would be expected in an effective risk management system:

- ❑ risk agenda;
- ❑ risk assessment;
- ❑ risk response;
- ❑ risk communication; and
- ❑ risk governance.

Risk agenda

This explains the reasons for undertaking risk management activities and expected benefits from doing so.

Good risk reports would include the following:

- ❑ a clear statement of the drivers for the company when planning and undertaking risk management activities;
- ❑ a description of the benefits from the risk management processes established; and
- ❑ information on resources allocated to risk management activities.

Risk assessment

Good risk reports would include the following:

- a clear description of the procedures in place and information used to identify risks;
- an explanation of how risk is evaluated;
- a list of significant risk.

Risk response

Good risk reports would include the following:

- description of appropriate responses for each risk;
- information on how the efficiency and effectiveness of existing controls is assessed;
- description of disaster response and business continuity plans.

Risk communication

Good risk reports would include the following:

- a description of how risk management processes and responsibilities are communicated throughout the company;
- information on risk management recordkeeping and on risk reporting and whistleblowing arrangements in the company.

Risk governance

Good risk reports would include the following:

- a description of risk governance arrangements;
- a description of how emerging risks are being managed.

4.4 Situation in the UK

The UK Corporate Governance Code requires the board of directors to maintain a sound system of risk management, to carry out a review of effectiveness of the risk management system at least once each year and report to shareholders that the system is effective.

The UK Corporate Governance Code requires companies listed on the London Stock Exchange to report their risk management activities.

All companies listed on the London Stock Exchange publish a list of significant risk factors with explanation of why they are deemed to be significant and the steps taken to mitigate the risk. Typically, good reports would satisfy all of the requirements in the previous section.

5 OTHER FINANCIAL INFORMATION

Section overview

- Financial summaries
- Financial highlights
- Key performance indicators
- Trends

5.1 Financial summaries

Financial statements contain a great deal of detail.

Public companies often publish summaries of key figures from the financial statements as an aid to users. Good practice would require that figures in the financial summaries should be referenced back to the financial statements.

There are no set formats for such summaries. A financial summary might contain the following information.

Illustration: Financial summaries

Financial performance	2015	2014
	₦m	₦m
Revenue	200	190
Profit before tax	80	75
Profit for the year	60	59
Other comprehensive income (net of tax)	15	10
Total comprehensive income	75	69
Financial position		
Non-current assets	700	600
Current assets	800	825
	1,500	1,425
Equity reserves	500	425
Non-current liabilities	400	350
Current liabilities	600	650
	1,500	1,425

Financial summaries are useful to provide an overview of financial performance and financial position but a true understanding can only come from a detailed analysis of the financial statements in the light of knowledge of the industry within which the company operates.

5.2 Financial highlights

Financial highlights constitute information that, in the company's view, are important to an understanding of financial performance and financial position in a period.

Financial highlights can overlap financial summaries but might also include other information including performance statistics and narrative information about key events in the period (for example, relating to a major acquisition).

Illustration: Financial summaries

Financial performance	2015	2014	Increase
	₦m	₦m	
Revenue	200	190	5.3%
Profit before tax	80	75	6.7%
Profit for the year	60	59	1.7%
Other comprehensive income (net of tax)	15	10	50%
Total comprehensive income	75	69	8.7%
Financial position			
Total assets	1,500	1,425	
Equity reserves	500	425	
Total liabilities	1,000	1,000	
	1,500	1,425	
Earnings per share			
Basic	25.0	24.9	
Diluted	23.0	20.0	
Share price at year end	135.0	128.0	
Dividend per share	15.0	10.0	

A problem with financial highlights is that companies might use them to promote a particular agenda by focussing on certain areas to detract attention from others.

Once again, remember that a true understanding can only come from a detailed analysis of the financial statements in the light of knowledge of the industry within which the company operates.

5.3 Key performance indicators

Many companies might include key performance indicators in the annual report, perhaps, as part of the financial highlights.

Companies can choose to include whatever they like but ideally, the information reported would be on true KPIs, that is to say, those used by management in running the business.

There are no standard versions of many KPIs so best practice would dictate that the company should define how they are calculated. Best practice would also require that the KPIs should be supported by narrative commentary.

KPIs might include both financial (e.g. ROCE, gross profit margin etc.) and non-financial (e.g. growth in market share, quality scores etc.).

5.4 Trends

Many companies include tables or diagrams in the annual reports to indicate performance in key areas over time.

Such information might include revenue, operating profit, profit after tax, eps and share price, typically over a five or ten year period.

Some companies also include non-financial information, for example, the number of employees.

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- List other types of information found in annual reports;
- Describe the general requirements for the content of governance reports;
- Explain the purpose and describe the content of a management commentary;
- Explain the purpose and describe the content of effective risk reports; and
- Describe other financial information that might appear in annual reports.

Professional level
Corporate

CHAPTER 5

Beyond Financial Reporting

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

D	Current developments in and beyond Financial Reporting		
	3	Social, environmental and ethical reporting	
		a	Discuss the need for social, environmental and ethical reporting and why companies may engage in these types of reporting.
		b	Appraise the impact of social, environmental and ethical factors on corporate performance measurement.
	4	Sustainability and integrated reporting	
		a	Discuss the progress from social and environmental accounting to sustainability reporting.
		b	Discuss the principles and content elements of the Global Reporting Initiative (GRI) and United States (US) Sustainability Accounting Standards Board (SASB) frameworks for sustainability reporting.
		c	Evaluate the impact of sustainability reporting on corporate performance measures.
		d	Discuss the principles and content elements of the International Integrated Reporting Council (IIRC) Integrated Reporting (IR) framework.
		e	Discuss the need for and advantages of integrated reporting.
		f	Discuss the progress towards global adoption of integrated reporting.

Exam context

This chapter does not address a specific competence but aims to explain references in the "Purpose" section of the syllabus.

At the end of this chapter, you should be able to:

- Explain the meaning of corporate social responsibility;
- Describe the content of corporate responsibility reports;
- Explain the meaning of sustainability and sustainability reporting; and
- Discuss and explain integrated reporting.

1 CORPORATE SOCIAL RESPONSIBILITY

Section overview

- Introduction
- Corporate social responsibility explained
- Reporting requirements
- Voluntary CSR reporting
- Consequences of poor track record on CSR issues

1.1 Introduction

Historically, companies have considered themselves responsible to their shareholders by generating dividends and capital growth on their investment. More recently, companies have been criticised for striving to maximise profits at the expense of social and environmental concerns, for example, by such means as underpaying their workforce or by abusing their power over their smaller suppliers to negotiate prices and terms.

There is now a widely-accepted view that companies should be answerable to a wider range of 'stakeholders' who are taking an increasing interest in their activities. They are interested in the good and bad aspects of a company's operations – its products and services, its impact on the environment and local communities and how it treats and develops its workforce.

Many large companies now accept (possibly for commercial reasons) that their responsibilities extend beyond their shareholders to other stakeholders – their employees, the government, the local community and society in general.

Initiatives include sourcing goods from deprived countries at fair prices, campaigns to promote re-cycling of materials, job-sharing and flexi-time working to improve working opportunities and conditions for employees.

In some aspects of reporting and disclosures, many large quoted companies publish an annual corporate social responsibility report. This may be given a different name, such as a social and environmental report or a sustainability report, and is usually published as a separate document from the annual report and accounts, but at the same time.

1.2 Corporate social responsibility explained

Corporate social responsibility (CSR) is a term for the responsibility that a company should have towards society and the environment in which it operates.

CSR has been defined in various ways:

- It is 'a concept whereby companies integrate social and environmental concerns in their business operations and their interaction with their stakeholders on a voluntary basis.'
- 'While there is no single, commonly-accepted definition of corporate social responsibility … it generally refers to business decision-making linked to ethical values, compliance with legal requirements, and respect for people, communities and the environment' (Business for Social Responsibility).

An important element of CSR is that it goes beyond compliance with legal and regulatory obligations, and involves voluntary initiatives and investment in people

and the environment, and better relations with all stakeholders, not just shareholders and other investors.

The practice of CSR increases the transparency and accountability of an organisation. Transparency is important as stakeholders want to know about an organisation's activities. (They want to 'see into' an entity, to understand what it is doing and which strategic directions it is taking.) For example, if a local community believe that a company is dumping waste in the local area, then it will be important to understand what is actually happening.

Likewise, the company needs to accept that it is accountable for its actions. Stakeholders believe that they have a right to know whether a company is acting in the best interests of society and the environment and wish to understand what the company is doing to remedy any faults.

With the exception of the disclosures in the business review, described above, UK companies are under no obligation to report on the corporate social responsibility policies or initiatives. However, many listed companies now publish voluntary annual reports on CSR. They may be called social and environmental reports or CSR reports, and are usually published each year at the same time as the annual report and accounts but in a separate document or booklet. These reports set out their ethical values and commitment to CSR principles, and describe what they have done in this area during the financial year.

A CSR report might be largely descriptive, providing narrative descriptions of how the company has contributed to reductions in waste or pollution, promoting sustainable business or engaging in charitable activities and community development activities.

There is now growing recognition of the need to provide social and environmental information as quantified performance measurements, so that actual achievements can be assessed better against targets or benchmarks.
Sustainability reports provide quantified measurements of performance in three areas of achievement: financial performance, social performance and environmental performance. Since these reports provide quantified performance measurements or results, sustainability reports are also described as triple bottom line reporting.

Scope of CSR

CSR covers the following areas:

- ethical behaviour by a company and its employees (business ethics);
- the treatment of employees by the entity (employer);
- the treatment of human beings generally (for example, respect for human rights, refusing to use suppliers who employ slave labour or child labour, and so on);
- the entity's relationship with society at large, and the communities in which it operates; and
- environmental issues, such as the responsibility of companies to protect and sustain the natural environment.

Possible approaches

CSR issues are not the same for each company, because companies operate in different environments. However, for most companies there are some CSR issues, which they might deal with in any of the following ways:

- they might ignore the issues, regardless of the effect of any bad publicity on their reputation and public image;
- they might comply with legislation and regulations on CSR issues, but do very little of a voluntary nature; and
- they might seek to promote active CSR initiatives, which will probably involve communicating information about these initiatives both to shareholders and the general public.

1.3 Reporting requirements

There are no international accounting standards on social and environmental reporting.

In some countries, large companies are required to present social and environmental information on an annual basis.

USA

In the US the Securities and Exchange Commission, which regulates the stock markets, requires listed companies to quantify their environmental expenditure. They are also required to discuss the effects that compliance may have on their profits and any lawsuits against them relating to environmental issues.

European Union

Denmark and the Netherlands require mandatory environmental reporting and other countries such as Sweden and France require environmental information to be published alongside the financial information in the annual report.

In the European Union, quoted companies are now required to present certain information in the annual directors' report, as a narrative business review. This review should contain information about the main trends and factors likely to affect the future development, performance and position of the company's business, and information about:

- environmental matters (including the impact of the company's business on its environment);
- the company's employees; and
- social and community issues.

The review should also include:

- analysis using financial key performance indicators; and
- where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

In the UK, for example, the government has issued guidance on key environmental performance indicators, including 22 quantifiable performance measures relating to emissions into the air, emissions into the water, emissions into the earth and the use of non-renewable resources.

Since the business review is a part of the annual directors' report, the external auditors are required to give an opinion on whether the information in the report is consistent with the financial statements.

However, this requirement for a business review applies only in the EU, not internationally.

1.4 Voluntary CSR reporting

Because of the potential importance of CSR issues for their reputation and public image, many large companies voluntarily publish an annual CSR report. This is often called an Environmental Report, or a Social and Environmental Report. The intended users of social and environmental reports, or environmental, social and governance (ESG) reports, include other stakeholders in addition to shareholders.

The IASB is happy for companies to present such information, but does not prescribe the content or the format of reports. As a result, the length and style of such reports differs significantly between companies, and the content can vary substantially for companies in different industries.

Some companies include their report on social and environmental issues as part of their financial statements (normally in the directors' report), whereas other companies publish a report as a separate document. Preparing the information as a separate document helps to distinguish between the readers; the annual report is designed for the shareholders, whereas the corporate social responsibility report is prepared for the other stakeholders in addition to the shareholders.

Contents of an environmental report

Typically, an environmental report will include an outline of:

- the entity's policies towards environmental issues;
- any improvements since previous years;
- an assessment of the key risks faced and how the company intends to respond;
- government legislation on environmental matters and how the entity ensures compliance with the legislation;
- significant initiatives taken by the company to improve environmental issues;
- key environmental performance indicators: targets of the industry and the relative performance of the entity; and
- financial information relating to environmental costs, including the entity's accounting policy.

Contents of a social report

A social report (which may be combined with the environmental report) may refer to:

- employee numbers and employee involvement;
- employee sick leave, health and safety issues, accidents at work, recruitment of ethnic minorities and the disabled;
- involvement with local charities and local communities; and
- working groups to communicate with stakeholders.

Voluntary guidelines for the content of social and environmental reports

The information provided does not have to be audited, but most organisations will request some kind of audit on the information before it is published to enhance its credibility.

Even so, since the content of these voluntary reports is not regulated and not audited, companies can include whatever they choose (the 'good news') and omit whatever they do not want in the report (the bad news). For this reason, voluntary environmental reports have been treated with some caution by readers.

Although there are no international standards on CSR reporting, there is a strong trend towards the provision of more information, on a statutory or a voluntary basis, and this trend in Corporate Reporting can be expected to continue in the future.

UN Global Compact

There has been a significant increase in the demand by major institutional investors for companies in which they invest to pursue social and environmental policies. One such initiative was launched by the United Nations, with the support of 32 major international institutional investors.

The UN Global Compact issued the *Principles for Responsible Investment*. The ten principles are intended to encourage institutional investors to give attention to environmental, social and corporate governance issues when making their investment decisions.

The UN Global Compact states that companies should be encouraged by their shareholders to provide disclosures on environmental, social and corporate governance issues – in other words, to report on these issues.

The ten principles are that businesses should:

- support and respect the protection of international proclaimed human rights within their sphere of influence;
- make sure that they are not compliant in human rights abuses;
- uphold the freedom of association and the effective recognition to the right of collective bargaining;
- uphold the elimination of all forms of forced and compulsory labour;
- uphold the effective abolition of child labour;
- eliminate discrimination in respect of employment and occupation;
- support a precautionary approach to environmental challenges;
- undertake initiatives to promote greater environmental responsibility;
- encourage the development and diffusion of environmentally-friendly technologies;
- work against all forms of corruption, including extortion and bribery.

1.5 Consequences of poor track record on CSR issues

It is important to understand how a company might suffer financially from a poor track record on CSR issues:

- Bad publicity about social and environmental issues could damage the public image of the company and its brands ('brand reputation risk'); and
- Companies may be affected by preferences of stakeholders, for companies with positive policy objectives on social and environmental issues. There are some investment organisations that focus on these issues. More significantly, perhaps, high-quality employees may prefer to work for 'ethical' companies.

Companies also need to understand the growing significance of CSR for many institutional investors. For example, the UNEP Finance Initiative (UNEP is the United Nations Environment Programme) has over 200 members from the financial services sector, such as banks and investment institutions. The aim of this initiative is to promote a set of principles that define best practice for responsible investment by institutional investors that have the full support of the UN and also of leading institutional investors worldwide.

A view underlying the initiative is that institutional investors should make sustainable development an issue when making decisions on investment in companies. The UN Global Compact, which launched the UNEP Financial Initiative, has stated: 'Institutional investors with clear information on company behaviour can take action, via proxy voting and other means, to pressure companies not to focus on short-term gains at the expense of long-term performance particularly in developing and developed nations.'

In the UK, the Association of British Insurers updated its guidelines and issued 'Responsible Investment Disclosure Guidelines'. These are directed at listed companies, and specify information about environmental, social and governance issues that they should be expected (as a minimum) to disclose.

2 SUSTAINABILITY REPORTING

Section overview

- Introduction
- Sustainability
- Sustainability reporting
- Global Reporting Initiative
- The Sustainability Accounting Standards Board (SASB)
- Other bodies
- Sustainability reporting guidelines in Nigeria

2.1 Introduction

CSR is also associated with the concept of sustainable business development, which is the view that businesses should seek to develop in a way that can be sustained into the future, without depleting the earth's natural resources or causing irrecoverable environmental damage.

Sustainability reporting is an organisation's practice of reporting publicly on its economic, environmental, and social impacts.

Companies that are seen to cause damage to the environment may suffer from a loss of reputation among customers, suppliers and government. This can have implications for fines and other penalties, civil legal action, lost contracts, clean-up costs and possibly falling sales.

The impact on oil group BP of the explosion at a drilling rig in the Gulf of Mexico in 2010, and the subsequent environmental damage it caused, is a clear example of the potential risks and the need for companies to consider social and environmental issues, particularly in industries such as oil extraction, mining and energy production.

Interest in sustainable development has come from several sources:

- governments, concerned about the implications for society of environmental damage and loss of natural resources;
- investors, many of whom now consider the ethical, social and environmental implications of the investments they make ('socially responsible investment' or SRI); and
- companies themselves, who may identify business opportunities – developing new products or reducing costs – in environmentally-friendly initiatives.

For example, in 2009, Mars announced a strategy for producing its entire cocoa supply in a sustainable manner by 2010.

Pharmaceuticals group GlaxoSmithKline announced targets to cut waste in medicine production at its factories by two-thirds by 2015.

2.2 Sustainability

The concept of sustainability is that organisations and individuals should meet their own needs today without compromising the needs of future generations. It requires organisations and individuals to preserve the environment and better serve society at large.

More and more companies have are recognizing the need to make their operations more sustainable. Over the past twenty years or so the number of organisations that have made sustainability a key strategic focus has increased significantly.

This increase is due to a number of factors, including:

- a broader understanding and acceptance of the links between economic activity and global sustainability issues;
- a recognition of the risk-management and economic benefits that organisations can gain from integrating sustainability into their strategies; and
- a growing demand from stakeholders, including investors, customers, employees and NGOs, for organisations to manage their operations in a more sustainable manner.

Also some governments and regulators have required companies to report on their environmental and social impacts.

Companies can enhance their value by developing an understanding about the connections between sustainability and business and communicating this to their stakeholders. This also allows companies to drive improvement and innovation.

2.3 Sustainability reporting

Organisations tend to communicate their sustainability activities through sustainability reports. Many companies worldwide (over 3,000) issue annual reports on sustainability and corporate responsibility. These companies represent all sectors and industries across the globe.

Sustainability reporting is largely voluntary although a few governments have introduced mandatory sustainability reporting. For example:

- French law requires the annual reports of companies to include information on their environmental and social performance.
- All state-owned companies in Sweden must present a sustainability report using Global Reporting Initiative (GRI) guidelines on a 'comply or explain' basis.

Furthermore some stock exchanges have sustainability reporting as a listing requirement. One such stock exchange is the Johannesburg Stock Exchange in South Africa, which has been a leading light in this area.

Greater transparency on sustainability and the consequent attention to sustainability issues is of benefit to both companies and their stakeholders.

Experience has shown that the process of sustainability reporting can add value in a number of ways, including:

- increased efficiency;
- higher levels of employee retention; and
- lower cost of capital.

A number of organisations have produced codes of practice and guidelines for companies to follow, but to date these are non-mandatory. This can lead to problems in comparability of the content of these reports, although having the information in the annual report is better than not disclosing at all.

Two such organisations are ***The Global Reporting Initiative*** and ***The Sustainability Accounting Standards Board.***

2.4 Global Reporting Initiative

The Global Reporting Initiative (GRI) is an international not-for-profit organisation whose mission is to make sustainability reporting standard practice.

GRI promotes the use of sustainability reporting as a way for companies and organisations to become more sustainable and contribute to a sustainable global economy.

GRI helps businesses and governments worldwide understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance and social well-being. This enables real action to create social, environmental and economic benefits for everyone. The GRI Sustainability Reporting Standards are developed with true multi-stakeholder contributions and rooted in the public interest.

GRI publish a very influential set of standards on sustainability. The first GRI guidelines were published in 1999 and have evolved into the GRI Sustainability Reporting Standards (GRI Standards).

The standards are used by several thousand organisations, in over 90 counties and are referenced in over 20 stock exchanges and in legislation and regulation in over 40 countries.

The GRI Standards are structured as a set of interrelated standards issued in a modular structure and comprise:

- Universal standards (100 series)
  - GRI 101: Foundation – sets out reporting principles;
  - GRI 102: General disclosures – contextual information about the organisation and its sustainability practices;
  - GRI 103: Management approach – how an organisation manages a material topic and to be used for each material topic in a sustainability report.
- Topic specific standards
  - 200 series (economic topics)
  - 300 series (environmental topics)
  - 400 series (social topics)

They have been developed primarily to be used together to help an organisation prepare a sustainability report which is based on the reporting principles and which focuses on material topics.

Reporting principles

The reporting principles are fundamental to achieving high quality sustainability reporting. An organisation is required to apply the reporting principles if it wants

to claim that its sustainability report has been prepared in accordance with the GRI Standards. The reporting principles are divided into two groups.

Reporting principles for defining report content:

- Stakeholder inclusiveness: The reporting organisation must identify its stakeholders, and explain how it has responded to their reasonable expectations and interests.
- Sustainability context: The report must present the reporting organisation's performance in the wider context of sustainability.
- Materiality: The report must cover topics that:
  - reflect the reporting organisation's significant economic, environmental, and social impacts; or
  - substantively influence the assessments and decisions of stakeholders.
- Completeness: The report must include coverage of material topics and their boundaries, sufficient to reflect significant economic, environmental, and social impacts, and to enable stakeholders to assess the reporting organisation's performance in the reporting period. (The topic boundary is the description of where the impacts occur for a material topic and the organisation's involvement with those impacts).

Reporting principles for defining report quality:

- Accuracy: The reported information must be sufficiently accurate and detailed for stakeholders to assess the reporting organisation's performance.
- Balance: The reported information must reflect positive and negative aspects of the reporting organisation's performance to enable a reasoned assessment of overall performance.
- Clarity: The reporting organisation must make information available in a manner that is understandable and accessible to stakeholders using that information.
- Comparability:
  - The reporting organisation must select, compile, and report information consistently.
  - The reported information must be presented in a manner that enables stakeholders to analyse changes in the organisation's performance over time, and that could support analysis relative to other organisations.
- Reliability: The reporting organisation must gather, record, compile, analyse, and report information and processes used in the preparation of the report in a way that they can be subject to examination, and that establishes the quality and materiality of the information.
- Timeliness: The reporting organisation must report on a regular schedule so that information is available in time for stakeholders to make informed decisions.

Approach to using GRI Standards

GRI Standards may be used in different ways:

- They may be used as a set to prepare a sustainability report in accordance with the standards in one of the following ways:
  - **Core:** This option indicates that a report contains the minimum information needed to understand the nature of the organisation, its material topics and related impacts, and how these are managed.
  - **Comprehensive:** This builds on the core option by requiring additional disclosures on the organisation's strategy, ethics and integrity, and governance. In addition, the organisation is required to report more extensively on its impacts by reporting all the topic-specific disclosures for each material topic covered by the GRI Standards.
- Alternatively, selected standards (or parts thereof) can be used to report specific information.
  - This option is referred to as a 'GRI-referenced' claim.
  - It is appropriate for an organisation that wants to report on specific economic, environmental, and/or social impacts, but which is not looking to use the GRI Standards to provide a full picture of its material topics and related impacts.

2.5 The Sustainability Accounting Standards Board (SASB)

SASB is an independent non-profit organisation. SASB publishes sustainability accounting standards which provide disclosure guidance on sustainability for mandatory filings to the U.S. Securities and Exchange Commission (SEC).

SASB produces standards for different industries. Each standard is comprised of:

- disclosure guidance; and
- accounting standards on sustainability topics for use by U.S. and foreign public companies in their annual filings with the U.S. Securities and Exchange Commission (SEC).

The disclosure guidance identifies sustainability topics at an industry level, which may be material to a company within that industry, depending on that company's specific operating context.

Example: Sustainability topics – Oil and gas exploration and production

SASB has identified the following material industry-level material sustainability topics for the oil and gas - exploration and production industry

Greenhouse gas emissions	Community relations
Air quality	Health, safety, and emergency management
Water management	Business ethics & payments transparency
Biodiversity impacts	Reserves valuation & capital expenditures
Security, human rights, and rights of indigenous people's	Management of the legal & regulatory environment

Each company is ultimately responsible for determining those sustainability topics that are material to it.

Activity metrics

SASB's accounting standards provide companies with standardised activity metrics to account for performance on industry-level sustainability topics. The aim is to help ensure that disclosure is standardised and therefore useful, relevant, comparable and auditable.

Activity metrics disclosed should:

- Convey contextual information that would not otherwise be apparent from SASB accounting metrics.
- Be deemed useful for users in performing their own calculations and creating their own ratios.
- Be explained and consistently disclosed from period to period to the extent they continue to be relevant.

The following table shows activity metrics for the sustainability topic "water management" in the oil and gas (exploration and production) industry.

Accounting metric	Unit of measure
Total fresh water withdrawn, percentage recycled, percentage in regions with high or extremely high baseline water stress.	Cubic meters (m3), Percentage (%)
Volume of produced water and flowback generated percentage (1) discharged, (2) injected, (3) recycled hydrocarbon content in discharged water.	Cubic meters (m3), Percentage (%) Metric tons (t)
Percentage of hydraulically fractured wells for which there is public disclosure of all fracturing fluid chemicals used.	Percentage (%)
Percentage of hydraulic fracturing sites where ground or surface water quality deteriorated compared to a baseline.	Percentage (%)

2.6 Other bodies

The Sustainable Stock Exchanges

This is an initiative aimed at exploring how exchanges can work together with investors, regulators, and companies to enhance corporate transparency, and ultimately performance, on ESG (environmental, social and corporate governance) issues and encourage responsible long-term approaches to investment.

Partner exchanges to the SSE initiative include the following:

- the Nigerian Stock Exchange;
- Johannesburg Stock Exchange (JSE);
- London Stock Exchange Group (LSE);
- the NYSE;
- the NASDAQ OMX; and
- Deutsche Börse.

The Institute of Social and Ethical Accountability

The Institute of Social and Ethical Accountability (ISEA) has developed a series of principles-based standards that are intended to provide the basis for improving the sustainability performance of organisations. These standards (which are called Accountability standards or the AA1000 Series) include standards on sustainability and social reporting. On the GRI website, individual company sustainability reports are noted as complying with the GRI guidelines and the AA1000 series if that is the case.

Some sustainability reports are referred to as 'triple bottom line reporting' because they report on performance and targets in three major areas: economic (financial), social and environmental.

2.7 Sustainability reporting guidelines in Nigeria

Nigeria's 2020 Voluntary National Review (VNR) on Sustainable Development Goals (SDGs) focuses on the key issues of poverty (SDG-1) and an inclusive economy (SDG-8), health and wellbeing (SDG-3), Education (SDG-4), Gender equality (SDG-5), and the enabling environment of peace and security (SDG-16), and partnerships (SDG-17). This focus is based on Nigeria's current development priorities and the development objectives of President Muhammadu Buhari's administration. This VNR is being developed while facing huge challenges from the COVID-19 pandemic testing Nigeria's public health systems, and of the collapse in oil prices, for an economy still getting 86% of public revenue from oil and gas.

Nigeria's 2017 VNR outlined the institutional dimensions for creating an enabling policy environment for the implementation of the SDGs through its Economic and Recovery Growth Plan (ERGP) (2017-2020). The ERGP's focus on economic, social and environmental dimensions of development makes it consistent with the aspirations of the SDGs.

2.7.1 Nigerian Stock Exchange sustainability disclosure

(a) Introduction

In 2018, the Nigerian Stock Exchange (NSE), issued its Sustainability Disclosure Guidelines. The guidelines comprise the following principles and core elements:

(b) Principles and core elements

Section 3 of the Guidelines advocates for businesses to go beyond compliance and seek sustainability as part of their business operations. There are nine (9) principles and core elements under the Economic, Environmental, Social and Governance factors that serve as indicators of what constitutes responsible business conduct.

These include:

(i) Governance

- Businesses should conduct and govern themselves with Ethics, Transparency and Accountability.
- Businesses, when engaged in influencing public and regulatory policy, should do so in a responsible manner.
- Businesses should provide products and services that are safe and contribute to sustainability throughout their life cycle.
- Businesses should engage with and provide value to their customers and consumers in a responsible manner.

(ii) Social

- Businesses should promote the wellbeing of all employees.
- Businesses should respect the interests of, and be responsive towards all stakeholders, especially those who are disadvantaged, vulnerable and marginalised.
- Businesses should respect and promote human rights.
- Businesses should support inclusive growth and equitable development.

(iii) Environment

Business should respect, protect, and make efforts to restore the environment.

(c) Reporting Requirements

Section 4 of the Guidelines stipulates that all listed companies are to issue sustainability reports which can be contained in the Annual Report or issued in a separate sustainability report. The time for issuance of the report mirrors the annual report. The sustainability report shall contain information that is relevant and meaningful to stakeholders. To identify material sustainability matters, listed companies should also consider the themes and guidance provided in internationally accepted standards such as the Global Reporting Initiative (GRI) Standard. The guidelines also state the format and reporting obligations.

2.7.2 Securities and Exchange Commission (SEC) guidelines on sustainability Reporting

In 2018, the SEC released its guidelines mandating all companies on the stock exchange to report on its social and environmental activities, whether in the annual report or a separate sustainability report.

The SEC Sustainability Disclosure Guidelines cover economic, environmental, social and governance themes. The following nine principles have been used to guide the activities and actions of companies:

(a) Businesses should conduct and govern themselves with ethics, transparency and accountability;

(b) Businesses, when engaged in influencing public and regulatory policy, should do so in a responsible manner;
(c) Businesses should provide products and services that are safe and contribute to sustainability throughout their life cycle;
(d) Businesses should engage with and provide value to their customers and consumers in a responsible manner;
(e) Businesses should promote the wellbeing of all employees;
(f) Businesses should respect the interests of, and be responsive towards all stakeholders, especially those who are disadvantaged, vulnerable and marginalised;
(g) Businesses should respect and promote human rights;
(h) Businesses should support inclusive growth and equitable development; and
(i) Business should respect, protect, and make efforts to restore the environment.

The guidelines also specified the following indicators across all themes, and companies are expected to report their performance in respect of these indicators:

- Economic indicators are around standards for selecting suppliers and purchasing, and the ethical impact of products and services on stakeholders;
- Social indicators are around workplace diversity (including management), inclusive work environment (e.g. fair remuneration, employability, etc., occupational health and safety, human rights, and company's impact on society and local communities;
- Governance indicators are around activities to combat corruption; and
- Environmental indicators are around the environmental impact of products and services, waste management, water consumption, energy consumption and compliance to environmental laws.

2.7.3 The Nigerian Sustainable Banking Principles

Principle 1 | Business Activities: Environmental and Social Risk Management. Integration of environmental and social considerations into decision-making processes relating to business activities to avoid, minimise or offset negative impacts.

Principle 2 | Business Operations: Environmental and Social. Avoidance, minimisation or offseting the negative impacts of business operations on the environment and local communities in which banks operate and, where possible, promote positive impacts.

Principle 3 | Human Rights: Respecting human rights in business operations and business activities.

Principle 4 | Women's Economic Empowerment: Promotion of women's economic empowerment through a gender inclusive workplace culture in business operations and seeking to provide products and services designed specifically for women through business activities.

Principle 5 | Financial Inclusion: Promotion of financial inclusion, seeking to provide financial services to individuals and communities that traditionally have had limited or no access to the formal financial sector.

Principle 6 | Environmental and sustainability (E&S) governance: Implementation of robust and transparent environmental and sustainability (E&S) governance practices in respective institutions and assessment of the E&S governance practices of clients.

Principle 7 | Capacity Building: Development of individual, institutional and sector capacity necessary to identify, assess and manage the environmental and social risks and opportunities associated with business activities and business operations.

Principle 8 | Collaborative Partnerships: Collaborating across the sector and leveraging international partnerships to accelerate collective progress and moving the sector as one, ensuring the approach is consistent with international standards and Nigerian development needs.

Principle 9 | Reporting: Regularly review and report on progress in meeting these principles at the individual, institution and sector level.

2.7.4 Nigerian code of corporate governance 2018

(a) Introduction

The Financial Reporting Council of Nigeria (FRC) issued the Nigerian code of corporate governance in 2018, to harmonise the various sectoral codes of corporate governance which include:

i. Code of corporate governance for the telecommunication industry 2016;
ii. Code of corporate governance for banks and discount houses in Nigeria 2014;
iii. Code of corporate governance for public companies in Nigeria 2011;
iv. Code of good corporate governance for insurance industry in Nigeria 2009; and
v. Code of corporate governance for licensed pension fund operators 2008.

Principle 26 of this code deals with sustainability.

This principle places emphasis on paying adequate attention to sustainability issues including environment, social, occupational and community health and safety ensures successful long term business performance and projects the company as a responsible corporate citizen contributing to economic development.

(b) Recommended practices

26.1 The Board should establish policies and practices regarding its social, ethical, safety, working conditions, health and environmental responsibilities as well as policies addressing corruption.

26.2 The policies should include the following:

26.2.1 The company's business principles, practices and efforts towards achieving sustainability;

26.2.2 The management of safety issues including workplace accidents, fatalities, occupational and safety incidents;

26.2.3 Plans and strategy for addressing and managing the impact of serious diseases on the Company's employees and their families;

26.2.4 The most environmentally beneficial options particularly for companies operating in disadvantaged regions or in regions with delicate ecology, in order to minimise environmental impact of the company's operations;

26.2.5 The nature and extent of employment equity and diversity (gender and other issues);

26.2.6 Training initiatives, employee development and the associated financial investment;

26.2.7 Opportunities created for physically challenged persons or disadvantaged individuals;

26.2.8 The environmental, social and governance principles and practices of the Company; and

26.2.9 Corruption and related issues.

26.3 The Board should monitor the implementation of sustainability policies and R eport on the extent of compliance with the policies.

3 INTEGRATED REPORTING

Section overview

- Introduction
- IIRC Framework

3.1 Introduction

There is an acceptance that using traditional Financial Reporting as the sole measure of a company's performance and financial standing is a flawed approach. Financial reports are historical in nature, providing little information on the future potential of a company. Corporate sustainability reports help to fill this gap, but are not often linked to a company's strategy or financial performance, and provide insufficient information on value creation.

Businesses need a reporting environment that allows them to explain how their strategy drives performance and leads to the creation of value over time. This should make it easier to attract financial capital for investment.

Integrated reporting is a new approach to reporting which tries to do this.

Definition

An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.

International Integrated Reporting Council

The Johannesburg Stock Exchange (JSE) has mandated integrated reporting through its listing requirements. This is the first national attempt to enforce integrated reporting across all listed companies.

International Integrated Reporting Council (IIRC)

The International Integrated Reporting Council (IIRC) is an influential global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs who share the view that communication about value creation should be the next step in the evolution of Corporate Reporting.

The aims of the IIRC are as follows:

- to improve the quality of information available to providers of financial capital;
- to promote a more cohesive and efficient approach to Corporate Reporting;
- to enhance accountability and stewardship; and
- to support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.

3.2 IIRC Framework

The IIRC has developed and published *The International <IR> Framework* to provide a foundation for the development of integrated reports. Note that the symbol <*IR*> is used by the IIRC as a designation for integrated reports and reporting.

The international framework (like IFRS) contains principles based requirements set out in bold paragraphs. Paragraphs which are not bold provide guidance to assist in applying the requirements.

(*Much of the following is extracted from The International <IR> Framework. Copyright © December 2013 and updated in 2021 by the International Integrated Reporting Council ('the IIRC'). All rights reserved. Used with permission of the IIRC).*

Using the framework

An integrated report should be a designated, identifiable communication. Any communication claiming to be an integrated report and referencing the *Framework* should apply all the requirements identified in bold unless:

- the unavailability of reliable information or specific legal prohibitions results in an inability to disclose material information; or
- disclosure of material information would cause significant competitive harm.

In the case of the unavailability of reliable information or specific legal prohibitions, an integrated report should:

- indicate the nature of the information that has been omitted;
- explain the reason why it has been omitted; and
- in the case of the unavailability of data, identify the steps being taken to obtain the information and the expected time frame for doing so.

An integrated report should include a statement from those charged with governance that includes:

- an acknowledgement of their responsibility to ensure the integrity of the integrated report;
- an acknowledgement that they have applied their collective mind to the preparation and presentation of the integrated report;
- their opinion or conclusion about whether the integrated report is presented in accordance with this *Framework*;

An integrated report that does not include such a statement, should explain:

- the role those charged with governance played in its preparation and presentation;
- the steps being taken to include such a statement in future reports; and
- the time frame for doing so, which should be no later than the organisation's third integrated report that references this *Framework*.

Guiding principles

Area	Guiding principle
Strategic focus and future orientation	An integrated report should provide insight into the organisation's strategy, and how that relates to its ability to create value in the short, medium and long term and to its use of and effects on the capitals.
Connectivity of information	An integrated report should show a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organisation's ability to create value over time.
Stakeholder relationships	An integrated report should provide insight into the nature and quality of the organisation's relationships with its key stakeholders, including how and to what extent the organisation understands, takes into account and responds to their legitimate needs and interests.
Materiality	An integrated report should disclose information about matters that substantively affect the organisation's ability to create value over the short, medium and long term.
Conciseness	An integrated report should be concise.
Reliability and completeness	An integrated report should include all material matters, both positive and negative, in a balanced way and without material error.
Consistency and comparability	The information in an integrated report should be presented on a basis that is consistent over time and in a way that enables comparison with other organisations to the extent it is material to the organisation's own ability to create value over time.

Content elements

An integrated report should answer the following questions:

- ❑ What does the organisation do and what are the circumstances under which it operates?
- ❑ How does the organisation's governance structure support its ability to create value in the short, medium and long term?
- ❑ What is the organisation's business model?
- ❑ What are the specific risks and opportunities that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?
- ❑ Where does the organisation want to go and how does it intend to get there?
- ❑ To what extent has the organisation achieved its strategic objective: for the period and what are its outcomes in terms of effects on the capitals?
- ❑ What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?
- ❑ How does the organisation determine what matters to include in the integrated report and how are such matters quantified or evaluated?

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the meaning of corporate social responsibility;
- Describe the content of corporate responsibility reports;
- Explain the meaning of sustainability and sustainability reporting; and
- Discuss and explain integrated reporting.

Professional level
Corporate

CHAPTER 6

IAS 8: Accounting policies, changes in accounting estimates and errors

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		c	Formulate and evaluate entity's accounting policies (including group entities) in accordance with the provisions of IAS 8.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.

IAS 8 is an examinable standard.

This chapter explains the IAS 8 rules on the selection of accounting policies, accounting for change in accounting policies and the use of accounting estimates and the correction of errors.

This standard was examinable in a previous paper. It is covered here again in detail for your convenience

At the end of this chapter, readers should be able to:

- Define accounting policy
- Explain the guidance on the selection of accounting policies;
- Account for changes in accounting policy;
- Distinguish between accounting policy and accounting estimate;
- Account for changes in accounting estimates; and
- Correct errors.

1 ACCOUNTING POLICIES

Section overview

- Introduction to IAS 8
- Accounting policies
- Selection of accounting policies
- Changes in accounting policies
- Retrospective application of a change in accounting policy
- Limitation on retrospective application
- Disclosure of a change in accounting policy

1.1 Introduction to IAS 8

The aim of *IAS 8: Accounting policies, changes in accounting estimates and errors* is to enhance comparability of the entity's financial statements to previous periods and to the financial statements of other entities.

It does this by prescribing:

- the criteria for selecting accounting policies; and,
- the accounting treatment and disclosure of:
  - changes in accounting policies;
  - changes in accounting estimates; and
  - errors.

Much of IAS 8 is concerned with how changes or corrections should be reported in the financial statements.

1.2 Accounting policies

Definition: Accounting policies

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

IFRSs set out accounting policies that result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial.

Definition: Material

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

Materiality depends on the nature or magnitude of information, or both. Information might be material on an individual basis or in combination with other information in the context of its financial statements taken as a whole.

Information is obscured if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or misstating it.

1.3 Selection of accounting policies

Selection of accounting policies – Areas covered by IFRS

If an IFRS (or an Interpretation) applies to an item in the financial statements, the accounting policy or policies applied to that item must be determined by applying the Standard or Interpretation and any relevant implementation guidance issued.

Selection of accounting policies – Area not covered by IFRS

If there is no rule in IFRS that specifically applies to an item in the financial statements, management must use its judgement to develop and apply an accounting policy that results in information that is:

- relevant to the decision-making needs of users; and
- reliable in that the financial statements;
- represent faithfully the results and financial position of the entity;
- reflect the economic substance of transactions and other events, and not merely the legal form;
- are neutral, i.e. free from bias;
- are prudent; and
- are complete in all material respects.

In making the judgement management must consider the following sources in descending order:

- the requirements and guidance in IFRS dealing with similar and related issues;
- the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the “Framework”.

Management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to the extent that these do not conflict with the above sources.

Consistency of accounting policies

An entity must apply consistent accounting policies in a period to deal with similar transactions, and other events and circumstances, unless IFRS specifically requires or permits categorisation of items for which different policies may be appropriate.

Illustration: Consistency

IAS 16: Property, plant and equipment allows the use of the cost model or the revaluation model for measurement after recognition.

This is an example of where IFRS permits categorisation of items for which different policies may be appropriate.

If chosen, each model must be applied to an entire class of assets. Each model must be applied consistently within each class that has been identified.

1.4 Changes in accounting policies

Users of financial statements need to be able to compare financial statements of an entity over time, so that they can identify trends in its financial performance or financial position. Frequent changes in accounting policies are therefore undesirable because they make comparisons with previous periods more difficult.

The same accounting policies must be applied within each period and from one period to the next unless a change in accounting policy meets one of the following criteria. A change in accounting policy is permitted only if the change is:

- required by IFRS; or
- results in the financial statements providing reliable and more relevant financial information.

A new or revised standard usually include specific ***transitional provisions***' to explain how the change required by the new rules should be introduced.

In the absence of specific transitional provisions, a change in policy should be applied retrospectively. This is explained shortly.

Determining when there is a change in accounting policy

A change in accounting policy can be established as follows. The accounting policies chosen by an entity should reflect transactions and events through:

- recognition (e.g. capitalising or writing off certain types of expenditure);
- measurement (e.g. measuring non-current assets at cost or valuation); and
- presentation (e.g. classification of costs as cost of sales or administrative expenses).

If at least one of these criteria is changed, then there is a change in accounting policy.

Illustration: Determining when there is a change in accounting policy

IAS 23 requires the capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset.

Previously, IAS 23 allowed companies to expense or capitalise borrowing costs.

The revision to IAS 23 led to a change in accounting policy for some companies as it affected:

- recognition – the interest cost previously recognised as an expense had to be recognised as an asset; and
- presentation – the interest cost previously presented in the statement of comprehensive income had to be presented in the statement of financial position.

IAS 8 specifies that the application of a new accounting policy to transactions or events that did not occur previously or differ in substance from those that occurred previously, is **not** a change of accounting policy. It is simply the application of a suitable accounting policy to a new type of transaction.

The initial application of a policy to revalue assets in accordance with IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets is a change in an accounting policy. However, it is accounted for in accordance guidance in those standards rather than in accordance with IAS 8.

1.5 Retrospective application of a change in accounting policy

When a change in accounting policy is required, and there are no transitional provisions relating to the introduction of a new accounting standard, the change in policy should be applied retrospectively.

Definition: Retrospective application

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

The entity should adjust the opening balance for each item of equity affected by the change, for the earliest prior period presented, and the other comparative amounts for each prior period presented, as if the new accounting policy had always been applied.

IAS 1: Presentation of Financial Statements requires a statement of financial position at the beginning of the earliest comparative period when a new accounting policy is applied retrospectively.

Illustration: Retrospective application

A company presents comparatives for the previous year only.

During the year ended 31 December 20X9 it changes an accounting policy and this change must be applied retrospectively.

If there were no change in accounting policy the company would present statements of financial position as at December 20X9 and December 20X8 only.

However, because there is a change in policy the company must also present a statement of financial position as at 1 January 20X8 (the beginning of the earliest comparative period).

The change in accounting policy is applied retrospectively. This means that the change should be applied to the balances at as at 1 January 20X8 as if the new policy had always been applied.

Similarly, any other comparative amounts in previous periods should be adjusted as if the new accounting policy had always been applied.

If this is impracticable, retrospective application should be applied from the earliest date that is practicable.

1.6 Limitation on retrospective application

It might be impracticable to retrospectively apply an accounting policy. This could be because the information necessary for the application of the policy to earlier periods is not available because it had not been collected then.

Definition: Impracticable

Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

  (i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

  (ii) would have been available when the financial statements for that prior period were authorised for issue from other information.

There are different degrees of impracticability.

Period specific effect

It might be impracticable to determine the effect of changing an accounting policy on comparative information for one or more prior periods presented. For example, it might be impracticable to determine the impact on profit for the prior year.

In this case a company must apply the new accounting policy to the carrying amounts of assets and liabilities (and therefore equity) as at the beginning of the earliest period for which retrospective application is practicable. This may be the current period.

Cumulative effect

It might be impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods,

In this case a company must adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

When the cumulative effect of applying the policy to all prior periods cannot be determined, a company must apply the new policy prospectively from the start of the earliest period practicable. This means that it would disregard the portion of the cumulative adjustment to assets, liabilities and equity arising before that date.

Definition: Prospective application

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

(a) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and

(b) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

1.7 Disclosure of a change in accounting policy

When a change in accounting policy has an effect on the current period or any prior period (or would have an affected that period except that it is impracticable to determine the amount of the adjustment) or might have an effect on future periods the following must be disclosed:

Disclosure:	Change due to IFRS	Voluntary change
The title of the Standard or Interpretation	✓	
The nature of the change in accounting policy	✓	✓
A description of any transitional provisions	✓	
The reason why the new accounting policy provides reliable and more relevant information		✓
For the current and previous period(s), to the extent practicable, the amount of the adjustment to each item in the financial statements.	✓	✓
To the extent practicable, the adjustment relating to accounting periods before those presented in the financial statements	✓	✓
If retrospective application is impracticable, an explanation of how the accounting policy change has been applied	✓	✓

2 ACCOUNTING ESTIMATES

Section overview

- Accounting estimates
- Changes in accounting estimates
- Disclosures

2.1 Accounting estimates

An accounting estimate is made for an item in the financial statements when the item cannot be measured with precision, and there is some uncertainty about it.

An estimate is therefore based, to some extent, on management's judgement. Management estimates might be required, for example, for the following items:

- bad debts;
- inventory obsolescence;
- the fair value of financial assets or liabilities;
- the useful lives of non-current assets;
- the most appropriate depreciation pattern (depreciation method, for example straight line or reducing balance) for a category of non-current assets; and
- measurement of warranty provisions.

The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Accounting policy vs accounting estimate

It is important to distinguish between an accounting policy and an accounting estimate.

Sometimes it can be difficult to distinguish between changes in accounting policy from changes in accounting estimate. In such cases any change is treated as a change in accounting estimate.

Illustration: Accounting policy vs accounting estimate

Accounting policy: Depreciating plant and equipment over its useful life

Accounting estimate: How to apply the policy - for example, whether to use the straight line method of depreciation or the reducing balance method is a choice of accounting estimate.

A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate.

Illustration: Accounting policy vs accounting estimate

IAS 16: Property, plant and equipment allows the use of the cost model or the revaluation model for measurement after recognition.

This is a choice of accounting policy.

2.2 Changes in accounting estimates

Definition: Change in accounting estimate

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

A change in accounting estimate may be needed if changes occur in the circumstances on which the estimate was based, or if new information becomes available. A change in estimate is **not** the result of discovering an error in the way an item has been accounted for in the past and it is **not** a correction of an error.

IAS 8 requires a change in an accounting policy to be accounted for retrospectively whereas a change in an accounting estimate is normally recognised from the current period.

The effect of a change in accounting estimate should be recognised prospectively, by including it:

- in profit or loss for the period in which the change is made, if the change affects that period only; or
- in profit or loss for the period of change and future periods, if the change affects both.

To the extent that a change in estimate results in a change in assets and liabilities, it should be recognised by adjusting the carrying amount of the affected assets or liabilities in the period of change.

Example: Change in accounting estimate

A non-current asset was purchased for ₦200,000 two years ago, when its expected economic life was ten years and its expected residual value was nil. The asset is being depreciated by the straight-line method.

A review of the non-current assets at the end of year 2 revealed that due to technological change, the useful life of the asset is only six years in total, and the asset therefore has a remaining useful life of four years.

The original depreciation charge was ₦20,000 per year ($^{₦200,000}/_{10\ years}$) and at the beginning of Year 2, its carrying value was ₦180,000 (₦200,000 - ₦20,000).

The change in the estimate occurs in Year 2. The change in estimate should be applied prospectively, for years 2 onwards (years 2 – 6). From the beginning of year 2, the asset has a revised useful remaining life of five years.

The annual charge for depreciation for year 2 (the current year) and for the future years 3 – 6 will be changed from ₦20,000 to ₦36,000 ($^{₦180,000}/_{5\ years}$).

2.3 Disclosures

The following information must be disclosed:

- The nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the effect on future periods when it is impracticable to estimate that effect; and
- The fact that the effect in future periods is not disclosed because estimating it is impracticable (if this is the case).

3 ERRORS

Section overview

- Errors
- The correction of prior period errors
- Limitation on retrospective restatement
- Disclosure of prior period errors

3.1 Errors

Errors might happen in preparing financial statements. If they are discovered quickly, they are corrected before the finalised financial statements are published. When this happens, the correction of the error is of no significance for the purpose of Financial Reporting.

A problem arises, however, when an error is discovered that relates to a prior accounting period. For example, in preparing the financial statements for Year 3, an error may be discovered affecting the financial statements for Year 2, or even Year 1.

Definition: Prior period errors

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

(a) was available when financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

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

3.2 Correction of prior period errors

All material prior period errors should be corrected retrospectively in the first set of financial statements following the discovery of the error.

Comparative amounts for the previous period should be re-stated at their corrected amount.

If the error occurred before the previous year, the opening balances of assets, liabilities and equity for the previous period should be re-stated at their corrected amount unless that is impracticable.

The correction of a prior period error is excluded from profit or loss in the period when the error was discovered.

Illustration: Correction of prior period errors

In preparing its financial statements for 31 December 20X8 Company A discovers an error affecting the 31 December 20X7 financial statements.

The error should be corrected in the 31 December 20X8 financial statements by re-stating the comparative figures for 31 December 20X7 at their correct amount.

If the error had occurred in 31 December 20X6, the comparative opening balances for the beginning of 31 December 20X7 should be re-stated at their correct amount.

The reported profit for 31 December 20X8 is not affected.

Example: Correction of prior period errors

Kano Transport Company (KTC) is preparing its financial statements for 20X8.

The draft statement of changes in equity is as follows:

	Share capital	Share premium	Retained earnings	Total
	₦000	₦000	₦000	₦000
Balance at 31/12/X6	500	50	90	640
Profit for the year	-	-	150	150
Balance at 31/12/X7	500	50	240	790
20X8				
Dividends			(100)	(100)
Profit for the year			385	385
Balance at 31/12/X8	500	50	525	1,075

KTC has now discovered an error in its inventory valuation. Inventory was overstated by ₦70,000 at 31 December 20X8 and by ₦60,000 at 31 December 20X7. The rate of tax on profits was 30% in both 20X7 and 20X8.

The error in 20X8 is corrected against the current year profit.

The error in 20X7 is corrected against the prior year profit. (Note that the 20X7 closing inventory is the opening inventory in 20X8 so the 20X7 adjustment will impact both periods statements comprehensive income.

Profit adjustments:	20X8	20X7
	₦000	₦000
Profit (20X8 draft and 20X7 actual)	385	150
Deduct error in closing inventory	(70)	(60)
Add error in opening inventory	60	
	(10)	(60)
Tax at 30%	3	18
	(7)	(42)
Adjusted profit	378	108

The statement of changes in equity as published in 20X8 becomes:

	Share capital	Share premium	Retained earnings	Total
	₦000	₦000	₦000	₦000
Balance at 31/12/X6	500	50	90	640
Profit for the year **(restated)**	-	-	**108**	108
Balance at 31/12/X7	500	50	198	748
20X8				
Dividends			(100)	(100)
Profit for the year			378	378
Balance at 31/12/X8	500	50	476	1,026

3.3 Limitation on retrospective restatement

A prior period error must be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error.

Period specific effect

It might be impracticable to determine the effect of correcting an error in comparative information for one or more prior periods presented. For example, it might be impracticable to determine the impact on profit for the prior year.

In this case a company must restate the carrying amounts of assets and liabilities (and therefore equity) as at the beginning of the earliest period for which retrospective restatement is practicable. This may be the current period.

Cumulative effect

It might be impracticable to determine the cumulative effect, at the beginning of the current period, of correcting an error in all prior periods,

In this case a company must correct the error prospectively from the earliest date practicable.

3.4 Disclosure of prior period errors

The following information must be disclosed:

- the nature of the prior period error;
- for each period presented in the financial statements, and to the extent practicable, the amount of the correction for each financial statement item and the change to basic and fully diluted earnings per share;
- the amount of the correction at the beginning of the earliest prior period in the statements (typically, a the start of the previous year); and
- if retrospective re-statement is not practicable for a prior period, an explanation of how and when the error has been corrected.

IAS 8 therefore requires that a note to the financial statements should disclose details of the prior year error, and the effect that the correction has had on 'line items' in the prior year.

Example: Disclosure of prior period errors

Returning to the above example the following note would be needed to the financial statements for the year to 31 December 20X8 to explain the adjustments made to figures previously published for the year to 31 December 20X7.

Note about statement of comprehensive income.	**₦000**
(Increase) in cost of goods sold	(60)
Decrease in tax	18
(Decrease) in profit	(42)
Note about statement of financial position	**₦000**
(Decrease) in closing inventory	(60)
Decrease in tax payable	18
(Decrease) in equity	(42)

4 JUDGEMENTS – IAS 8

IAS 8: Areas of judgement and estimate

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:

- Development of an accounting policy for events, transactions or balances that are not specifically covered by an IFRS;
- Categorising items for the purpose of applying policies consistently to like items;
- Whether or not a voluntary change in accounting policy provides reliable and more relevant information;
- Distinguishing changes in accounting policies from changes in accounting estimates; and
- Impracticability arguments.

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define accounting policy;
- Explain the guidance on the selection of accounting policies;
- Account for changes in accounting policy;
- Distinguish between accounting policy and accounting estimate;
- Account for changes in accounting estimates; and
- Correct errors.

Professional level
Corporate

CHAPTER 7

Impact of differences in accounting policies

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	**Reporting of entity's performance to stakeholders**		
	1	**Performance reporting**	
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.
	2	**Non- financial assets**	
		a	Assess the effects of different recognition and measurement methods and timing of recognition of non-financial assets on reported financial position.
E	**Analysis of financial and other reports to appraise entity's financial performance and position**		
	2	**Suitability of accounting policies and reported numbers**	
		f	Discuss and evaluate earnings management and creative accounting and assess their impact on the usefulness of ratios.

Exam context

This chapter explains the meaning of creative accounting and earnings management with examples.

At the end of this chapter, you should be able to:

- Explain creative accounting and earnings management;
- Provide examples of creative accounting;
- Provide examples of earnings management; and
- Identify the impact that different accounting policies have on reported position and performance.

1 INTRODUCTION TO THE ISSUES

Section overview

- What is fair presentation?
- Mechanisms to reduce the problem

1.1 What is fair presentation?

Directors are required to issue financial statements that present fairly the financial position, financial performance and cash flows of an entity.

This means that the financial statements must be a faithful representation of the effects of transactions and other events in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in IFRS.

The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

A component of this involves the selection and application of accounting policies in accordance with ***IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors***;

Auditors are required to give an independent opinion on whether financial statements are presented fairly. If in the opinion of the auditor fair presentation is not achieved the auditor will issue a qualified audit report.

These requirements do not result in a statement of financial position that is correct in the sense that there is only one possible answer to different accounting questions.

In reality, a fair presentation can encompass a range of different figures.

This is due to the fact that:

- alternative accounting policies can produce different results: and
- the application of accounting policies in accordance with IAS 8 is often based on estimates and judgements. Indeed valuation and estimation are key factors in drafting financial information.

Example: Different accounting policy

This example explains the impact of revalution of a depreciable asset.

Year 1

A company buys plant for ₦100,000 on the first day of the accounting period.

The company's depreciation policy is to write the asset off on a straight line basis over its useful life which is estimated to be 10 years.

Carrying amount at the year-end is ₦90,000.

The example no compares the figures at the end of the following year on two bases:

a. The company continues to account for the asset on a cost basis;

b. The company revalues the asset to ₦135,000 on the first day of year 2 (leading to a surplus of ₦135,000 - ₦90,000 = ₦45,000).

Further information is introduced.

	a	b
Statement of financial position	₦000	₦000
Non-current assets	80	120
Current assets	120	120
	200	240
Equity (1)	100	140
Loan (2)	100	100
	200	240
Statement of profit or loss		
Profit before depreciation	50	50
Depreciation	(10)	(15)
Profit for the year (3)	40	35
Statement of changes in equity		
Brought forward	60	60
Profit for the year	40	35
Revaluation surplus		45
Profit for the year	100	140
Ratios		
ROCE ($^{3}/_{1+2}$)	20.0%	14.6%
Gearing ($^{2}/_{1+2}$)	50.0%	41.7%

Working

W1: The year 2 depreciation of the revalue asset = 135,000/9 years (the remaining useful life = ₦15,000)

In the above example, there has been no underlying change in the business but figures would look very different were the asset to be revalued.

The gearing would be improved by the revaluation (falling from 50% to 41.7%) but ROCE would fall. Also note that the smaller profit would cause EPS to fall.

Example: Differing estimates when applying an accounting policy

Two companies each buy identical plant for ₦100,000 on the first day of the accounting period.

Company A estimates that the useful life of the plant is 10 years and that it will have a residual value of ₦20,000.

Company B estimates that the useful life of the plant is 8 years and that it will have zero residual value.

	Company A	Company B
Annual depreciation charge	₦000	₦000
Non-current assets (cost)	100.0	100.0
Accumulated depreciation	(8.0)	12.5
	102.0	87.5
Annual depreciation charge	8.0	12.5

Differences such as those above might arise in the normal course of events with no attempt to engineer the figures. This can lead to loss of comparability.

Also, the situations described and others like them allow for accountants to manipulate figures to achieve a certain result. This is called creative accounting and is covered later in this chapter.

The problem is exacerbated by the fact that some transactions are not covered by IFRS. Also, some transactions might be very complex making it very difficult to devise an accounting approach. Different accountants might arrive at different figures for such transactions.

1.2 Mechanisms to reduce the problem

IFRS has tried to reduce the impact of the above in a number of ways including:

- Removing choices of accounting policy – there are fewer areas of choice now than there were 10 years ago.
- Providing rules on the selection of accounting policies (IAS 8);
- Requiring disclosure of judgements, estimates and key sources of measurement uncertainty (IAS 1);
- Requiring disclosure of significant accounting policies (IAS 1);
- Including firmer guidance on fair values (IFRS 13).

The IAS 1 disclosure requirements in respect of accounting policies do not ensure comparability but they do allow a user to understand the potential impact of any differences in approach.

2 CREATIVE ACCOUNTING AND EARNINGS MANAGEMENT

Section overview

- Creative accounting
- Earnings management
- Revenue recognition
- Asset recognition
- Liability recognition
- Reducing current year profit

2.1 Creative accounting

Definition

Creative accounting: Accounting practices that follow required laws and regulations, but deviate from what those standards intend to accomplish.

Creative accounting: The use of aggressive and/or questionable accounting techniques in order to produce a desired accounting result.

Management may use various forms of **creative accounting** to manipulate the view given by the financial statements while complying with all applicable accounting standards and regulations.

Creative accounting is not necessarily illegal but the practice might cross the line into fraudulent reporting.

Creative accounting techniques include the following:

- **Window dressing**: an entity enters into a transaction just before the year end and reverses the transaction just after the year end. For example, goods are sold on the understanding that they will be returned immediately after the year end; this appears to improve profits and liquidity. The only reason for the transaction is to artificially improve the view given by the financial statements.
- **'Off balance sheet' finance:** transactions are deliberately arranged so as to enable an entity to keep significant assets and particularly liabilities out of the statement of financial position ('off balance sheet'). This improves gearing and return on capital employed. Examples include sale and repurchase agreements and some forms of leasing.
- **Changes to accounting policies or accounting estimates**: for example, an entity can revalue assets (change from the cost model to the revaluation model) to improve gearing or change the way in which it depreciates assets to improve profits.
- **Capitalising expenses**: recognising 'assets' which do not meet the definition in the IASB Conceptual Framework or the recognition criteria. Examples include: human resources, advertising expenditure and internally generated brand names.
- **Profit smoothing:** manipulating reported profits by recognising (usually) artificial assets or liabilities and releasing them to profit or loss as required.

- **Aggressive earnings management**: artificially improving earnings and profits by recognising sales revenue before it has been earned.

2.2 Earnings management

Earnings management is a type of creative accounting.

Definition

Earnings management: An attempt by management to influence or manipulate reported earnings by using specific accounting methods or changing the methods used.

Earnings management techniques include deferring or accelerating expense or revenue transactions, or using other methods designed to influence short-term earnings.

Aggressive earnings management results in stakeholders being misled to some extent about an entity's performance and profitability. At the extreme, aggressive earnings management can involve acts that may constitute a criminal offence.

Commercial pressures

The strength of a regulatory framework may be undermined by commercial pressures on those responsible for preparing financial statements.

Examples of these commercial pressures are:

- Adverse market reactions to the share price of a listed entity when results fail to meet the market's expectations (which directors and management may have encouraged), whether or not the expectations were reasonable;
- Directors and management's incomes being highly geared to results and/or heavily supplemented by stock options;
- The importance of meeting targets to ensure protection of the jobs of directors, management and other employees;
- The desire to understate profits to reduce taxation liabilities;
- Legal and regulatory requirements to meet specific financial thresholds or ratios; and
- The need to ensure compliance with loan covenants or to pacify bankers.

Syllabus

The syllabus includes a requirement that candidates be able to evaluate and advise upon how alternative choices of revenue recognition, asset and liability recognition and measurement can affect the understanding of the performance, position and prospects of an entity.

This chapter will proceed to illustrate generic examples of each of these.

2.3 Revenue recognition

Example: Revenue recognition

The before column represents the draft financial statements.

The after column shows the figures after the inclusion of an extra sale for ₦100,000 (cost ₦50,000). This would increase current assets by ₦50,000 (being an extra ₦100,000 receivables less ₦50,000 inventory).

	Before	After
	₦000	₦000
Non-current assets	300	300
Current assets	500	550
	800	850
Share capital	50	50
Retained earnings	360	410
	410	460
Non-current liabilities	90	90
	500	550
Current liabilities	300	300
	800	850
Revenue	650	750
Cost of sales	(350)	(400)
Gross profit	300	350
Operating expenses	(200)	(200)
	100	150
Interest	(20)	(20)
Profit for the year	80	130
ROCE	20.0%	27.3%
GP%	46.2%	46.7%
EPS	16	26
Gearing	18.0%	16.4%

Note the impact this has on the ratios. A common creative accounting technique is to book a sale just before the year end and then reverse it in the next year. This is called ***window dressing***.

2.4 Asset recognition

Example: Asset recognition

The before column represents the draft financial statements.

The after column shows the figures after capitalising an expense that was initially recognised in profit or loss.

	Before	After
	₦000	₦000
Non-current assets	300	320
Current assets	500	500
	800	820
Share capital	50	50
Retained earnings	360	380
	410	430
Non-current liabilities	90	90
	500	520
Current liabilities	300	300
	800	820
Revenue	650	650
Cost of sales	(350)	(350)
Gross profit	300	300
Operating expenses	(200)	(200)
	100	100
Interest	(20)	
Profit for the year	80	100
ROCE	20.0%	19.2%
GP%	46.2%	46.2%
EPS	16	20
Gearing	18.0%	17.3%

Asset measurement

The impact of asset measurement was illustrated by the examples in section 1.1 of this chapter.

2.5 Liability recognition

Example: x

The before column represents the draft financial statements.

The after column shows the figures after they have been adjusted to remove a liability of ₦50,000. This also reduces expenses in the statement of profit or loss.

	Before	After
	₦000	₦000
Non-current assets	300	300
Current assets	500	500
	800	800
Share capital	50	50
Retained earnings	360	410
	410	460
Non-current liabilities	90	90
	500	550
Current liabilities	300	250
	800	800
Revenue	650	650
Cost of sales	(350)	(350)
Gross profit	300	300
Operating expenses	(200)	(150)
	100	150
Interest	(20)	(20)
Profit for the year	80	130
ROCE	20.0%	27.3%
GP%	46.2%	46.2%
EPS	16	26
Gearing	18.0%	16.4%

If the adjustment had been made against an expense related to cost of sales the gross profit margin would have improved.

Liability measurement

A similar picture would be obtained by remeasuring a liability by ₦50,000.

2.6 Reducing current year profit

Creative accountants do not always work to increase profit. Sometimes they want to decrease the current year profit.

The reason for this is that it might allow them to increase profits in the future. For example, if an asset is written off this year but used in the future there will be no future expense to set against the future revenue.

Similarly, if a liability were to be set up this year it would reduce profit. If the liability was found to be unnecessary in the future it could be reversed back to the statement of profit or loss.

Big bath accounting

This refers to recognising all the bad news in one year so that later years can look stronger. If a company expects disappointing results it might decide to make them even worse by writing down assets and recognising liabilities. In future years the assets could be used without any corresponding cost and a decision made that the liabilities are no longer required. They would then be reversed back through the statement of profit or loss.

IFRS of course has rules to prevent or limit such flagrant abuses.

IAS 37: Provisions, contingent liabilities and contingent

Before the publication of IAS 37 the absence of accounting rules for provisions allowed entities to 'manipulate' their financial statements, especially their reported profit or loss in each year, by making provisions, increasing provisions or reducing provisions to suit management's reporting requirements.

Companies made provisions based simply on 'management intent' and used the argument of prudence to support their accounting treatment of provisions.

Creating a provision would reduce profit in the current year.

However, by creating a provision for expenses that would otherwise be charged in future years, a company was able to improve reported profits in future years.

Quite often management would 'change their mind' about the intention that had led to the creation of the provision, and the provision would be 'released back' to increase profit in a subsequent year.

Provisions might contain a mixture of items such as provisions for future reorganisation costs, redundancy costs, closure costs, warranty claims and staff re-training costs. It was apparent that companies were exploiting the absence of rules and using provisions to move profit from one year to the next.

Alternatively, provisions might be created in a year of poor performance so as to report the 'bad news' in the current year so that future profits could be made to seem much better.

Example: Provisions

A company had a disappointing year in 20X1.

As a result, the chief executive officer (CEO) resigned and a replacement CEO was appointed two months before the year-end. The CEO introduced several initiatives and performance is expected to slowly recover over the coming two years.

In order to make his appointment appear highly successful, the new CEO might want to create provisions to report a very bad year in 20X1 and blame this on his predecessor, and use the provisions to improve results in later years.

For example, this might be achieved by the creation in 20X1 of a ₦1 million provision for the cost of future restructuring plans.

In 20X2 the company might then decide to abandon the restructuring plans and so reduce the provision to zero, thereby increasing profit in 20X2.

Using the illustrative figures below, this would allow the company to show a breakeven position in 20X2 under the management of the CEO following losses in 20X1, and then to report even better results in 20X3.

	20X1	20X2	20X3
	₦000	₦000	₦000
Original result	(2,000)	(1,000)	1,000
Provision	(1,000)		
Release of provision		1,000	
Reported results	(3,000)	0	1,000

IAS 37 includes rules which try to prevent situations like this from happening. For example it prohibits the recognition of a restructuring provision until that point in time where the company has no realistic alternative but to proceed with the restructuring.

However, IAS 37 is a standard that requires use of estimates and remeasurement of the provisions at each reporting date. There is still potential to use provisions to transfer profit form one period to the next.

Closing comment

Any rule where a different amount might be recognised or recognition could be delayed or accelerated could be used in creative accounting.

The syllabus expects you to be able to identify the impact of different accounting policies (which would include the estimates inherent in their application).

It is recommended that whenever you study a standard that you try to think of areas in which judgements and estimates are required. Try to consider the impact of different judgements and estimates on the figures presented. It would also be useful if you were to think in terms of the impact on key ratios (for example, ROCE, gearing and EPS).

Sections covering such areas are included in many later chapters.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain creative accounting and earnings management;
- Provide examples of creative accounting;
- Provide examples of earnings management; and
- Identify the impact that different accounting policies have on reported position and performance.

Professional level
Corporate

CHAPTER 8

IFRS 15: Revenue from contracts with customers

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		b	Apply accounting standards relating to performance reporting such as **IFRS 15**, IFRS 8, IFRS 5, IAS 33 and IAS 34 to the preparation of financial statements.

IFRS 15 is an examinable document

Exam context

This chapter explains the IFRS 15 rules on revenue recognition.

At the end of this chapter, you should be able to:

- Explain the core principle and the five step approach to revenue recognition;
- Apply the five step approach to revenue recognition;
- Explain and apply the rules on variable consideration;
- Explain how the existence of a significant financing components affects revenue recognition;
- Account for contract costs; and
- Explain the required accounting treatment in a series of specific areas.

1 INTRODUCTION TO IFRS 15

Section overview

- Introduction
- Core principle and the five step model

1.1 Introduction

The IASB issued IFRS 15: *Revenue from contracts with customers* in May 2014. This standard is the end product of a major joint project between the IASB and the US Financial Accounting Standards Board and replaces IAS 18 and IAS 11.

IFRS 15 sets out principles to be applied in order to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

Definitions

Revenue is income arising in the course of an entity's ordinary activities**.**

A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities.

1.2 Core principle and the five step model

A contract to supply goods and services places a performance obligation (or a number of performance obligations) on the seller to deliver goods and services in accordance with the contract. Goods and services being sold are often described as "deliverables".

Core principle

IFRS 15 is based on a core principle that requires an entity to recognise revenue:

- ❑ in a manner that depicts the transfer of goods or services to customers;
- ❑ at an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

Five step model

Applying this core principle involves following a five step model as follows:

- **Step 1:** Identify the contract(s) with the customer
- **Step 2:** Identify the separate performance obligations
- **Step 3:** Determine the transaction price
- **Step 4:** Allocate the transaction price to the performance obligations
- **Step 5:** Recognise revenue when or as an entity satisfies performance obligations.

Example: Summary of guidance

X Ltd is a software developer.

X Ltd enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support for a two-year period.

IFRS 15 provides guidance in the following areas

Step 1	Whether the contract is within the scope of IFRS 15 and what to do if IFRS 15 does not apply.
Step 2	If IFRS 15 applies, whether the contract contains a single performance obligation or separate performance obligations (say for the licence, installation and updates).
Step 3	How to identify the transaction price and whether this should be adjusted for time value of money. What to do if the consideration might vary depending on circumstance.
Step 4	How the transaction price should be allocated to the separate performance obligations.
Step 5	Whether the performance obligation is satisfied (and thus revenue recognised) over time or at a point in time.

The application of IFRS 15 is straightforward for many contracts. However, IFRS 15 provides guidance for complex contracts where there are several deliverables.

Note that revenue recognition and invoicing are two separate processes. Revenue recognised and amounts invoiced might be the same in many cases but are not the same in many others.

2 THE FIVE STEP MODEL

Section overview

- Step 1: Identify the contract(s) with a customer
- Step 2: Identify the separate performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations
- Step 5: Recognise revenue when or as an entity satisfies performance obligations
- Example of revenue recognition where transaction price covers more than one deliverable

2.1 Step 1: Identify the contract(s) with a customer

The first step in IFRS 15 is to identify the contract. This may be written, oral, or implied by an entity's customary business practices.

Definition

A contract is an agreement between two or more parties that creates enforceable rights and obligations.

A contract does not exist if each party has an enforceable right to terminate a wholly unperformed contract without compensating the other party.

Combination of contracts

Two or more contracts entered into at or near the same time with the same customer (or related parties) must be combined and treated as a single contract if one or more of the following conditions are present:

- ❑ the contracts are negotiated as a package with a single commercial objective;
- ❑ the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- ❑ the goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation.

Application criteria

The general IFRS 15 model applies only when or if:

- ❑ the parties have approved the contract and are committed to perform their respective obligations;
- ❑ the entity can identify each party's rights;
- ❑ the entity can identify the payment terms for the goods and services to be transferred;
- ❑ the contract has commercial substance (i.e. it is expected to change the risk, timing or amount of an entity's future cash flows); and
- ❑ it is probable the entity will collect the consideration.

Example: Application criteria

X Ltd is a real estate developer.

X Ltd enters into a contract with Mr. A for the sale of a building for ₦1m.

Mr. A intends to open a restaurant in the building.

The building is located in an area where new restaurants face high levels of competition and Mr. A has little experience in the restaurant industry

Mr. A pays a non-refundable deposit of ₦50,000, and enters into a long-term financing agreement for the remaining 95% which he will pay out of the proceeds of the restaurant.

X Ltd can repossess the building if Mr. A defaults but cannot seek further compensation.

Analysis

Have the parties approved the contract and are committed to perform their respective obligations	Yes
Can X Ltd identify each party's rights?	Yes
Can X Ltd identify the payment terms for the goods and services to be transferred?	Yes
Does the contract have commercial substance?	Yes
Is it probable the entity will collect the consideration?	No (see below)

It is not probable that X Ltd will collect the consideration because:

(a) Mr A intends to repay the loan from income derived from a business which faces significant risks (high competition and Mr A's limited experience);

(b) Mr A lacks other income or assets that could be used to repay the loan; and

(c) Mr A's liability under the loan is limited because the loan is non-recourse.

Conclusion: The contract does not meet the IFRS 15 applicability criteria.

Any consideration received in respect of a contract that does not meet the criteria is recognised as a liability. This means that in the above example, X Ltd would recognise the ₦50,000 received as a liability. This amount would continue to be recognised as a liability until the application criteria are satisfied or until either of the following occurs, at which time the amount should be recognised as revenue;

- the entity's performance is complete and substantially all of the consideration in the arrangement has been collected and is non-refundable; and
- the contract has been terminated and the consideration received is non-refundable.

2.2 Step 2: Identify the separate performance obligations in the contract

Definition

A performance obligation is a promise in a contract with a customer to transfer to the customer either:

a. a good or service (or a bundle of goods or services) that is distinct; or

b. a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Performance obligations are normally specified in the contract but could also include promises implied by an entity's customary business practices, published policies or specific statements that create a valid customer expectation that goods or services will be transferred under the contract.

Distinct goods and services

At the inception of a contract the entity must assess the goods or services promised in a contract and identify as a performance obligation each promise to transfer to the customer either:

- a good or service (or a bundle of goods or services) that is **distinct**; or
- a series of **distinct** goods or services that are substantially the same and that have the same pattern of transfer to the customer (described by reference to promises satisfied over time, and progress to completion assessment).

A good or service is distinct if **both** of the following criteria are met:

- the customer can **benefit from the good or service** either on its own or together with other resources that are readily available to the customer; and
- the entity's promise to transfer the good or service is **separately identifiable** from other promises in the contract.

If a promised good or service is not distinct, it must be combined with other promised goods or services until a bundle of goods or services that is distinct can be identified. This could mean that all of the goods or services promised in a contract might be accounted for as a single performance obligation.

This sounds quite complicated but simply means that at the inception of a contract an entity must determine whether the contract is for the sale of a single deliverable or several deliverables. This is important as revenue is recognised as these separate goods and services are delivered to the customer.

Example: Distinct goods and services

X Ltd is a contractor which enters into a contract to build a hospital for a customer.

X Ltd is responsible for the overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, construction of the structure, installation of equipment and finishing.

Are the promised goods and services capable of being distinct?

Analysis

Can the customer benefit from the goods and services either on their own or together with other readily available resources?	Yes X Ltd or its competitors regularly sells many of these goods and services separately to other customers. Also, the customer could generate economic benefit from the individual goods and services by using, consuming, selling or holding those goods or services.
Is X Ltd's promise to transfer individual goods and services in the contract separately identifiable from other promises in the contract?	No X Ltd provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

Conclusion: X Ltd should account for all of the goods and services in the contract as a single performance obligation.

Example: Distinct goods and services

X Ltd is a software developer.

X Ltd enters into a contract with a customer to transfer a software licence, perform an installation service and provide unspecified software updates and technical support for a two-year period.

X Ltd sells the licence, installation service and technical support separately.

The installation service is routinely performed by other entities and does not significantly modify the software.

Are the promised goods and services capable of being distinct?

Analysis

Can the customer benefit from the goods and services either on their own or together with other readily available resources?	Yes The customer can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.
Is X Ltd's promise to transfer individual goods and services in the contract separately identifiable from other promises in the contract?	Yes The installation service does not significantly modify or customise the software so the software and the installation service are separate outputs instead of inputs used to produce a combined output

Conclusion: X Ltd should account for four separate performance obligations (the software licence, the installation service, software updates and technical support).

2.3 Step 3: Determine the transaction price

Definition

The **transaction price** is the amount of consideration an entity expects to be entitled to in exchange for the goods or services promised under a contract, excluding any amounts collected on behalf of third parties (for example, sales taxes).

An entity must consider the terms of the contract and its customary practices in determining the transaction price.

The transaction price assumes transfers to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

The transaction price is adjusted if the entity (e.g. based on its customary business practices) has created a valid expectation that it will enforce its rights for only a portion of the contract price.

The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. An entity must consider the effects of other factors when determining the transaction price including:

- variable consideration (including the constraining estimates of variable consideration); and
- time value of money.

These are covered in more detail later in this chapter.

2.4 Step 4: Allocate the transaction price to the performance obligations

The objective is to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

The transaction price is allocated to each performance obligation in proportion to those stand-alone selling prices determined at the inception of the contract.

Definition

A **stand-alone selling price** is the price at which an entity would sell a promised good or service separately to a customer.

Allocation of a discount

When the sum of the stand-alone selling prices of goods or services promised in a contract exceeds the promised consideration the customer is receiving a discount.

The discount should be allocated entirely to one or more (but not all) performance obligations in the contract if all of the following criteria are met:

- each distinct good or service (or each bundle of distinct goods or services) in the contract is sold regularly on a stand-alone basis;

- a bundle (or bundles) of some of those distinct goods or services are sold regularly at a discount to the stand-alone selling prices of the goods or services in each bundle; and
- such discounts are substantially the same as the discount in the contract.

Example: Allocation of discount

X Ltd sells three products at the following stand-alone selling prices:

	Stand-alone selling price
Product A	40
Product B	55
Product C	45

X Ltd sells one each of the products to Y Plc for ₦100 in total. Products B and C are sold regularly together for ₦60.

The products are to be delivered at three different points in time. The delivery of each product is a separate performance obligation.

X Ltd regularly sells Products B and C together for ₦60 and Product A for ₦40. Therefore, the entire discount should be allocated to the promises to transfer Products B and C.

The discount of ₦40 is allocated as follows:

	Stand-alone selling price	Allocated discount.	Allocated transaction price
Product A	40		40
Product B	55	(55 × 40/100) = 22	33
Product C	45	(45 × 40/100) = 18	27
	140		100

Note that if the contract required delivery of B and C at the same time, X Ltd could account for that delivery as a single performance obligation.

The discount of ₦40 would then be allocated as follows:

	Stand-alone selling price	Allocated discount.	Allocated transaction price
Product A	40		40
Product B and C	100	40	60
	140		100

In other cases, the discount is allocated proportionately to all performance obligations in the contract.

Example: Allocation of discount

X Ltd sells three products at the following stand-alone selling prices:

	Stand-alone selling price (₦)
Product A	50
Product B	25
Product C	75

Products are not usually sold at a discount but X Ltd agrees to sell one each of the products to Y Plc for ₦100 in total.

The products are to be delivered at three different points in time. The delivery of each product is a separate performance obligation.

There is no observable evidence about which performance obligation has attracted the discount.

The discount of ₦50 is allocated on a proportionate basis as follows:

	Stand-alone selling price (₦)	Allocated discount.	Allocated transaction price
Product A	50	(50 × 50/150) = 17	33
Product B	25	(25 × 50/150) = 8	17
Product C	75	(75 × 50/150) = 25	50
	150		100

2.5 Step 5: Recognise revenue when or as an entity satisfies performance obligations

Revenue is recognised when (or as) a company satisfies a performance obligation by transferring a promised good or service to a customer. The amount of revenue recognised is the amount of the transaction price allocated to the performance obligation.

Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). An asset is transferred when (or as) the customer obtains control of that asset. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

A performance obligation might be satisfied (i.e. goods and services might be transferred):

- over time (in which case revenue would be recognised over time); or
- at a point in time (in which case revenue is recognised at that point in time).

Performance obligations satisfied over time

A company must identify at the inception of the contract whether a performance obligation will be satisfied over time or at a point in time.

A company transfers control of a good or service over time (therefore, satisfying a performance obligation and recognising revenue over time), if **one of** the following criteria is met:

- the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
- the company's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced; or
- the company's performance does not create an asset with an alternative use (to the seller) **and** the entity has an enforceable right to payment for performance completed to date.

If a performance obligation is satisfied over time an entity needs a mechanism to identify the extent to which the performance obligation has been met.

Example: Performance obligation satisfied over time

X Ltd enters into a contract to provide monthly payroll processing services to a customer for one year

Is the performance obligation satisfied over time?

Analysis

a.	Does the customer simultaneously receive and consume the benefits provided?	Yes (criterion met)
b.	Does X Ltd's performance create or enhance an asset that the customer controls as it is created or enhanced	Yes (criterion met) The asset being the ability to process payroll
c.	Does X Ltd's performance create an asset with an alternative use **and** does X Ltd have an enforceable right to payment for performance completed to date	No (this part of the criterion met) Yes probably (this part of the criterion met)

Conclusion: The performance obligation is satisfied over time. (All three criteria are actually met)

There would be no need to consider criteria b or c once criterion a was met. Only one criterion need be achieved.

Performance obligations satisfied at a point in time?

If a performance obligation is not satisfied over time then it is satisfied at a point in time.

Measuring progress towards complete satisfaction of a performance obligation

For a performance obligation satisfied over time, revenue is recognised by measuring the progress towards complete satisfaction of that performance obligation.

- A single method of measuring progress should be used for each performance obligation and that method should be applied consistently to similar performance obligations and in similar circumstances.
- Progress must be remeasured at the end of each reporting period.

Possible methods of measuring progress include both output methods and input methods.

Output methods

Output methods recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.

Output methods include methods such as:

- surveys of performance completed to date;
- appraisals of results achieved;
- milestones reached;
- time elapsed and units produced; or
- units delivered.

The output should faithfully depict the entity's performance towards complete satisfaction of the performance obligation.

The disadvantages of output methods are that the outputs used may not be directly observable and the information required to apply them may not be available without undue cost. Therefore, an input method may be necessary.

Example: Performance obligations satisfied over time

X Ltd owns and manages health clubs.

X Ltd enters into a contract with a customer for one year of access to any of its health clubs.

The customer has unlimited use of the health clubs and promises to pay ₦100 per month.

(Note that the promise is to provide access to the health clubs. Whether the customer uses the club or not is irrelevant to how X Ltd accounts for revenue).

Is the performance obligation satisfied over time?

Analysis

a.	Does the customer simultaneously receive and consume the benefits provided?	Yes (criterion met) The customer receives and consumes the benefits of X Ltd's performance as X Ltd makes the health club available for the customer's use.

How should progress towards complete satisfaction of the performance obligation be measured?

The customer benefits from the entity's service of making the health clubs available evenly throughout the year.

The best measure of progress towards complete satisfaction of the performance obligation over time is a time-based measure.

X Ltd should recognise revenue of ₦100 per month.

Input methods

Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation by comparing input to date to the expected total input. For example:

- labour hours expended relative to total expected labour hours to satisfy the performance obligation; and
- costs incurred relative to expected total costs to satisfy the performance obligation.

It may be appropriate to recognise revenue on a straight-line basis where they are expended evenly throughout the performance period.

Example: Measure of progress based on inputs

X Ltd is engaged on a contract to construct a building at a transaction price of ₦3,200,000.

The contract represents a single performance obligation.

X Ltd recognises progress in satisfying the performance obligation by comparing costs incurred to date to total expected costs (costs incurred to date plus an estimate of expected future costs).

X Ltd has not yet recognised any revenue on this contract.

The following cost information is available:

	₦
Costs incurred to date	1,500,000
Estimated costs to complete	1,000,000
Total expected costs	2,500,000

Revenue should be recognised as follows:

Total transaction price	₦3,200,000
Measure of progress 1,500,000/2,500,000 × 100	60%
Revenue recognised	₦1,920,000

Note that ₦1,500,000 would also be recognised in cost of sales. The accounting treatment of contract costs is covered later.

Sometimes, there may not be a direct relationship between an entity's inputs and the transfer of control of goods or services to a customer.

Any input that does not represent performance in transferring control of goods or services must be excluded from the input method.

Adjustment to the measure of progress may be required in the following circumstances:

- When a cost incurred does not contribute to an entity's progress in satisfying the performance obligation. For example, an entity would not recognise revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity's performance that were not reflected in the price of the contract.
- When a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. In those circumstances, the best depiction of the entity's performance may be to adjust the input method to recognise revenue only to the extent of that cost incurred.

Example: Adjustment to the measure of progress due to inefficiencies

X Ltd is engaged on a contract to construct a building at a transaction price of ₦3,200,000.

The contract represents a single performance obligation.

X Ltd recognises progress in satisfying the performance obligation by comparing costs incurred to date to total expected costs (costs incurred to date plus an estimate of expected future costs).

X Ltd has not yet recognised any revenue on this contract.

X Ltd had to pay to re-lay a concrete foundation which did not set properly due to a sudden frost after it was laid

There is no provision in the contract for the customer to meet the cost of any necessary rectifications.

The following cost information is available:

	Without rectification	With rectification
Costs incurred to date	₦	₦
Rectification costs		100,000
Other costs	1,400,000	1,400,000
	1,400,000	1,500,000
Estimated costs to complete	1,000,000	1,000,000
Total expected costs	2,400,000	2,500,000

Revenue should be recognised as follows (excluding the effect of the inefficiency):

Total transaction price	₦3,200,000
Measure of progress 1,400,000/2,400,000 × 100	58.33%
Revenue recognised	₦1,866,667

Further explanation

Suppose the rectification had occurred on the last day of the accounting period. Before the rectification X Ltd had spent ₦1,400,000 out of an expected total of ₦,2,400,000 leading it to consider that the contract was 58.33% complete.

However, the need to replace the foundation meant that the contract was not as complete as thought. The rectification restored progress back to 58.33% but did not add to it.

The measurement of progress is cumulative. In other words, it measures the revenue that should be recognised by the period end.

Each of the above examples has assumed that revenue from each of the contracts had not been recognised until this period. If revenue had been recognised in an earlier period only the incremental revenue should be measured (total revenue to be recognised by the end of the period less total revenue recognised by the end of the previous period).

Example: Measure of progress based on inputs

X Ltd is engaged on a contract to construct a building at a transaction price of ₦3,200,000.

The contract represents a single performance obligation.

X Ltd recognises progress in satisfying the performance obligation by comparing costs incurred to date to total expected costs (costs incurred to date plus an estimate of expected future costs).

The following cost information is available:

	Year 1	Year 2
	₦	₦
Costs incurred to date	1,500,000	2,000,000
Total expected costs	2,500,000	2,500,000

Revenue should be recognised as follows:

Total transaction price	₦3,200,000	₦3,200,000
Measure of progress		
1,500,000/2,500,000 × 100	60%	
2,000,000/2,500,000 × 100		80%
Revenue to be recognised by the end of the period	₦1,920,000	₦2,560,000
Revenue recognised in previous period	nil	₦1,920,000
Revenue recognised this period	₦1,920,000	₦640,000

2.6 Example of revenue recognition where transaction price covers more than one deliverable

The following example illustrates steps 3 to 5 of the model (ignoring the time value of money).

Example: Revenue recognition

X Plc sells mobile phones and network contracts either together or separately.

Revenue from selling a bundle (handset together with a network contract) would be recognised using the following steps.

Step 3: Determine the transaction price

	Sold separately	Sold as a bundle
Handset	53,100	–
Monthly network fee	2,500	5,000
Number of months	24	24
	60,000	120,000
Total	113,100	120,000

Step 4: Allocate the transaction price for the bundle

The transaction price of the bundle (₦120,000) is allocated in proportion to the stand-alone selling prices of distinct goods and services promised in the contract.

Thus the revenue allocation is as follows:

	₦
Handset (₦120,000 × ₦53,100/₦113,100)	56,340
Network contract (₦120,000 × ₦60,000/₦113,100)	63,660
	120,000

Example (continued): Revenue recognition price (ignoring time value)

Step 5: Recognise revenue

The revenue for the handset is recognised when it is delivered at the start of the contract. There is no cash received at this point in time so a receivable is recognised to complete the revenue double entry.

Handset	**Dr**	**Cr**
Receivable	56,340	
Revenue		56,340

The revenue for the network contract is recognised over the life of the contract.

The difference between the cash received each month and the amount recognised as revenue in the statement of profit or loss pays for the handset and reduces the receivable to zero by the end of the 24 month contract period.

Network contract	**Dr**	**Cr**
Cash	5,000	
Revenue (₦63,660 ÷ 24 months)		2,653
Receivable (paying for the handset)		2,347

Or over the life of the contract (as a proof)

	Dr	**Cr**
Cash	120,000	
Revenue (₦2,653 × 24 months)		63,660
Receivable (₦2,347 × 24 months)		56,340

The above example does not take time value into account.

The standalone selling prices used above are inconsistent with each other. The ₦53,100 for the handset is payable up front but the ₦60,000 for the contract is payable by a series of monthly payments over a 24 month period. In practice, this should be taken into account. This is shown in the second use of this example at the end of the next section.

3 FACTORS AFFECTING THE TRANSACTION PRICE

Section overview

- Variable consideration
- Financing component
- Example of revenue recognition where transaction price covers more than one deliverable with time value

3.1 Variable consideration

The amount of consideration for the sale of goods and services might be variable due to the existence of discounts, price concessions, incentives, performance bonuses, penalties and similar items.

Consideration can also vary if its amount is contingent on the occurrence or non-occurrence of a future event. For example, where a product is sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

The variability relating to the consideration promised by a customer may be explicitly stated in the contract. However, in addition to the terms of the contract, the consideration is variable if either of the following circumstances exists:

- the customer has a valid expectation arising from an entity's customary business practices, published policies or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract.
- other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

If consideration includes a variable amount an entity must estimate the amount of consideration to which it will be entitled in exchange for transferring the promised goods or services to a customer.

The amount of variable consideration should be estimated by using either of the following methods:

- Expected value: the sum of probability weighted amounts in a range of possible consideration amounts. This may be an appropriate estimate if an entity has a large number of contracts with similar characteristics.
- The most likely amount: the single most likely amount in a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

The method used should be the method expected to better predict the amount of consideration and should be applied consistently throughout the contract.

Refund liabilities

An entity might expect to return some (or all) of the consideration received from a customer. Such consideration must be recognised as a refund liability.

A refund liability is measured at the amount of consideration received (or receivable) for which the entity does not expect to be entitled. It must be updated at the end of each reporting period for changes in circumstances.

Example: Variable consideration

X Ltd sells 100 products to customers at a cost of ₦100 per product.

Cash is received when control of a product transfers.

X Ltd allows customers to return any unused product within 30 days and receive a full refund.

The cost of each product to X Ltd is ₦60.

X Ltd has considerable experience of selling this type of product. Based on this experience it estimates that 97 products will not be returned. Therefore X Ltd will not recognise the revenue on three products.

X Ltd will recognise the following on the inception of the contracts:

	Dr	Cr
Cash (100 × ₦100)	10,000	
Revenue (97 × ₦100)		9,700
Refund liability (3 × ₦100)		300

In addition, X Ltd will recognise an asset of ₦180 (3 × ₦60) for its right to recover products on settling the refund liability.

This is of the nature of an inventory adjustment. (Remember that the cost of 100 items (₦6,000) would not be included in inventory after they are sold).

Constraining estimates of variable consideration

The ability to estimate variable consideration does not necessarily mean that it would be included in the transaction price as there might be constraints on the estimate.

Variable consideration is included in the transaction price only to the extent that it is highly probable that a significant reversal of the amount of cumulative revenue recognised will not occur when any uncertainty associated with the variable consideration is subsequently resolved.

This sounds complicated but it means that the variable consideration should only be included if it is highly probable that the entity will earn the amount after all uncertainties are resolved. (The variable consideration is included in the transaction price when the company expects to receive it).

Allocation of variable consideration

Variable consideration may be attributable to the entire contract or to a specific part of the contract.

A variable amount (and subsequent changes to that amount) should be allocated entirely to a performance obligation if both of the following criteria are met:

- the terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation; and
- the allocation is consistent with the IFRS 15 allocation objective.

Royalties

Regardless of the above, revenue for a sales-based or usage-based royalties promised in exchange for a licence of intellectual property is recognised only when (or as) the later of the following events occurs:

- the subsequent sale or usage occurs; and
- the performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

3.2 Financing component

The agreed timing of payments in a contract might have the effect of the contract containing a significant financing component. This could occur due to explicit or implied terms in the contract.

In such cases, the transaction price must be adjusted for the effects of the time value of money with the objective of recognising revenue at an amount that reflects the cash price that a customer would have paid for the goods or services.

No adjustment is necessary if the period between the transfer of, and payment for, the promised good or service is expected to be one year or less.

Discount rate

The discount rate used should be one that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The rate would reflect both credit characteristics and collateral or security provided by the parties. It might be possible to identify the rate as that rate which discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer.

Presentation

The effects of financing (interest revenue or interest expense) must be presented separately from revenue from contracts with customers in the statement of comprehensive income.

Example: Financing component

An enterprise sells a machine on 1 January 20X5. The terms of sale are that the enterprise will receive ₦5 million on 31 December 20X6 (2 years later).

An appropriate discount rate is 6%.

1 January 20X5 – Initial recognition

Initial measurement of the consideration ₦5m $\times \frac{1}{(1+0.06)^2}$ = ₦4,449,982

	Debit	Credit
Receivables	4,449,982	
Revenue		4,449,982

31 December 20X5

Recognition of interest revenue ₦4,449,982 @ 6% = 266,999

	Debit	Credit
Receivables	266,999	
Revenue – interest		266,999

Balance on the receivable	₦
Balance brought forward	4,449,982
Interest revenue recognised in the period	266,999
Carried forward	4,716,981

31December 20X6

Recognition of interest revenue ₦4,716,981 @ 6% = 283,019

	Debit	Credit
Receivables	283,019	
Revenue – interest		283,019

Balance on the receivable	₦
Balance brought forward	4,716,981
Interest revenue recognised in the period	283,019
Consideration received	(5,000,000)
Carried forward	–

3.3 Example of revenue recognition where transaction price covers more than one deliverable with time value

Example: Revenue recognition

X Plc sells mobile phones and network contracts either together or separately at the following prices.

The handset and contract are sold separately at a price of ₦53,100 for the handset and ₦2,500 per month for 24 months for the contract) or as a bundle for ₦5,000 per month for 24 months for the contract.

The discount rate is 1% per month.

Revenue from selling a bundle (handset together with a network contract) would be recognised using the following steps.

The 24 monthly payments are discounted to their [resent value (putting it into the same price terms as the handset).

Step 3: Determine the transaction price

	Sold separately	Sold as a bundle
Handset	53,100	–
Monthly network fee	2,500	5,000
24 month, 1% annuity factor	21.24	21.24
	53,100	106,200
Total	106,200	106,200

The steps would then proceed as follows:

Step 4: Allocate the transaction price for the bundle

The transaction price for the bundle is allocated in proportion to the stand-alone selling prices of distinct goods and services promised in the contract.

Thus the revenue allocation is as follows:

	₦
Handset (₦106,200 × ₦53.100/₦106,000)	53,100
Network contract (₦106,200 × ₦53.100/₦106,000)	53,100
	106,200

Example (continued): Revenue recognition

Step 5: Recognise revenue

The revenue for the handset is recognised when it is delivered at the start of the contract.

	Dr	Cr
Receivable	53,100	
Revenue		53,100

The monthly payments of ₦5,000 comprise 2 amounts. ₦2,500 pays for the network contract and the balance (also ₦2,500) pays off the receivable. Over the life of the contract the receivable is reduced to zero after taking time value into account.

The double entry at the end of the first month would be as follows:

	Dr	Cr
Cash	5,000	
Revenue		2,500
Receivable		2,500
and		
Receivable	53,100	
Revenue (interest)		53,100

Another way of thinking saying this is that the amount initially recognised for the hand set is the present value of the ₦2,500 per month that relates to the handset.

A full amortisation table is shown below in order to illustrate this.

Example (continued): Revenue recognition (taking time value into account)

Period	Amount receivable at the start	Interest at 1%	Cash flow	Amount receivable at the end
1	53,100	531	(2,500)	51,131
2	51,131	511	(2,500)	49,142
3	49,142	491	(2,500)	47,134
4	47,134	471	(2,500)	45,105
5	45,105	451	(2,500)	43,056
6	43,056	431	(2,500)	40,987
7	40,987	410	(2,500)	38,897
8	38,897	389	(2,500)	36,786
9	36,786	368	(2,500)	34,653
10	34,653	347	(2,500)	32,500
11	32,500	325	(2,500)	30,325
12	30,325	303	(2,500)	28,128
13	28,128	281	(2,500)	25,909
14	25,909	259	(2,500)	23,669
15	23,669	237	(2,500)	21,405
16	21,405	214	(2,500)	19,119
17	19,119	191	(2,500)	16,810
18	16,810	168	(2,500)	14,479
19	14,479	145	(2,500)	12,123
20	12,123	121	(2,500)	9,745
21	9,745	97	(2,500)	7,342
22	7,342	73	(2,500)	4,915
23	4,915	49	(2,500)	2,465
24	2,465	25	(2,500)	11

4 OTHER ASPECTS OF IFRS 15

Section overview

- Contract costs
- Costs to fulfil a contract
- Amortisation and impairment
- Presentation

4.1 Contract costs

Costs might be incurred in obtaining a contract and in fulfilling that contract.

The incremental costs of obtaining a contract with a customer are recognised as an asset if the entity expects to recover those costs.

The incremental costs of obtaining a contract are those costs that would not have been incurred if the contract had not been obtained.

Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are expensed as incurred (unless they can be recovered from the customer regardless of whether the contract is obtained).

Example: Incremental costs of obtaining a contract

X Ltd wins a competitive bid to provide consulting services to a new customer.

X Ltd incurred the following costs to obtain the contract:

	₦
Commissions to sales employees for winning the contract	10,000
External legal fees for due diligence	15,000
Travel costs to deliver proposal	25,000
Total costs incurred	50,000

Analysis

The commission to sales employees is incremental to obtaining the contract and should be capitalised as a contract asset.

The external legal fees and the travelling cost are not incremental to obtaining the contract because they have been incurred regardless of whether X Ltd obtained the contract or not.

An entity may recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less.

4.2 Costs to fulfil a contract

Costs incurred in fulfilling a contract might be within the scope of another standard (for example, IAS 2: *Inventories*, IAS 16: *Property, Plant and Equipment* or IAS 38: *Intangible Assets*). If this is not the case, the costs are recognised as an asset only if they meet all of the following criteria:

- the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify;
- the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and
- the costs are expected to be recovered.

Costs that relate directly to a contract might include:

- direct labour and direct materials;
- allocations of costs that relate directly to the contract or to contract activities;
- costs that are explicitly chargeable to the customer under the contract; and
- other costs that are incurred only because an entity entered into the contract (e.g. payments to subcontractors).

The following costs must be recognised as expenses when incurred:

- general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract);
- costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;
- costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (i.e. costs that relate to past performance).

4.3 Amortisation and impairment

An asset for contract costs recognised in accordance with this standard must be amortised on a systematic basis consistent with the transfer to the customer of the goods or services to which the asset relates.

The amortisation must be updated to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates.

An impairment loss must be recognised in profit or loss to the extent that the carrying amount of an asset recognised exceeds:

- the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
- the costs that relate directly to providing those goods or services and that have not been recognised as expenses.

When the impairment conditions no longer exist or have improved a reversal of the impairment loss is recognised. This will reinstate the asset but the increased carrying amount of the asset must not exceed the amount that would have been

determined (net of amortisation) if no impairment loss had been recognised previously.

Example: Amortisation of contract costs

X Ltd wins a 5 year contract to provide a service to a customer.

The contract contains a single performance obligation satisfied over time.

X Ltd recognises revenue on a time basis

Costs incurred by the end of year 1 and forecast future costs are as follows:

	₦
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis

Costs must be recognised in the P&L on the same basis as that used to recognise revenue.

X Ltd recognises revenue on a time basis, therefore 1/5 of the total expected cost should be recognised = ₦5,600 per annum.

Example: Amortisation of contract costs

X Ltd wins a contract to build an asset for a customer. It is anticipated that the asset will take 2 years to complete

The contract contains a single performance obligation. Progress to completion is measured on an output basis.

At the end of year 1 the assets is 60% complete.

Costs incurred by the end of year 1 and forecast future costs are as follows:

	₦
Costs to date	10,000
Estimate of future costs	18,000
Total expected costs	28,000

Analysis

Costs must be recognised in the P&L on the same basis as that used to recognise revenue.

Therefore 60% of the total expected cost should be recognised (₦16,800) at the end of year 1.

4.4 Presentation

This section explains how contracts are presented in the statement of financial position. In order to do this it explains the double entries that might result from the recognition of revenue. The double entries depend on circumstance.

An unconditional right to consideration is presented as a receivable.

The accounting treatment to record the transfer of goods for cash or for an unconditional promise to be paid consideration is straight forward.

Illustration: Possible double entries on recognition of revenue

	Debit	Credit
Cash	X	
Receivable	X	
Revenue		X

Example: Double entry – Unconditional right to consideration

1 January 20X8

X Ltd enters into a contract to transfer Products A and B to Y Plc in exchange for ₦1,000.

Product A is to be delivered on 28 February.

Product B is to be delivered on 31 March.

The promises to transfer Products A and B are identified as separate performance obligations. ₦400 is allocated to Product A and ₦600 to Product B.

X Ltd recognises revenue and recognises its unconditional right to the consideration when control of each product transfers to Y Plc.

The following entries would be required to reflect the progress of the contract).

Contract progress

28 February: X Ltd transfers Product A to Y plc.

At 28 February	Dr (₦)	Cr (₦)
Receivables	400	
Revenue		400

31 March: X Ltd transfers Product B to Y plc

31 March		
Receivables	600	
Revenue		600

In other cases, a contract is presented as a contract asset or a contract liability depending on the relationship between the entity's performance and the customer's payment.

Contract assets

A supplier might transfer goods or services to a customer before the customer pays consideration or before payment is due. In this case the contract is presented as a contract asset (excluding any amounts presented as a receivable).

A contract asset is a supplier's right to consideration in exchange for goods or services that it has transferred to a customer. A contract asset is reclassified as a receivable when the supplier's right to consideration becomes unconditional.

Example: Double entry – Recognition of a contract asset

1 January 20X8

X Ltd enters into a contract to transfer Products A and B to Y Plc in exchange for ₦1,000.

Product A is to be delivered on 28 February.

Product B is to be delivered on 31 March.

The promises to transfer Products A and B are identified as separate performance obligations. ₦400 is allocated to Product A and ₦600 to Product B.

Revenue is recognised when control of each product transfers to Y Plc.

Payment for the delivery of Product A is conditional on the delivery of Product B. (i.e. the consideration of ₦1,000 is due only after X Ltd has transferred both Products A and B to Y Plc). This means that X Ltd does not have a right to consideration that is unconditional (a receivable) until both Products A and B are transferred to Y Plc.

The following entries would be required to reflect the progress of the contract:

Contract progress

The following accounting entries would be necessary:

28 February: X Ltd transfers Product A to Y plc

X Ltd does not have an unconditional right to receive the ₦400 so the amount is recognised as a contract asset.

At 28 February	Dr (₦)	Cr (₦)
Contract asset	400	
Revenue		400

31 March: X Ltd transfers Product B to Y plc

X Ltd now has an unconditional right to receive the full ₦1,000. The ₦400 previously recognised as a contract asset is reclassified as a receivable and the ₦600 for the transfer of product B is also recognised as receivable.

31 March	Dr (₦)	Cr (₦)
Receivable	1,000	
Contract asset		400
Revenue		600

Contract liabilities

A contract might require payment in advance or allow the supplier a right to an amount of consideration that is unconditional (i.e. a receivable), before it transfers a good or service to the customer.

In these cases, the supplier presents the contract as a contract liability when the payment is made or the payment is due (whichever is earlier).

The contract liability is a supplier's obligation to transfer goods or services to a customer for which it has received consideration (an amount of consideration is due) from the customer.

Example: Double entry – Recognition of a contract liability

1 January 20X8

X Ltd enters into a contract to transfer Products A and B to Y Plc in exchange for ₦1,000.

X Ltd can invoice this full amount on 31 January.

Product A is to be delivered on 28 February.

Product B is to be delivered on 31 March.

The promises to transfer Products A and B are identified as separate performance obligations. ₦400 is allocated to Product A and ₦600 to Product B.

Revenue is recognised when control of each product transfers to Y Plc.

The following entries would be required to reflect the progress of the contract

Contract progress

The following accounting entries would be necessary:

At 31 January	Dr (₦)	Cr (₦)
Receivable	1,000	
Contract liability		1,000

28 February: X Ltd transfers Product A to Y plc

At 28 February	Dr (₦)	Cr (₦)
Contract liability	400	
Revenue		400

31 March: X Ltd transfers Product B to Y plc

31 March	Dr (₦)	Cr (₦)
Contract liability	600	
Revenue		600

5 SPECIFIC EXAMPLES

Section overview

- Principal versus agent considerations
- Sale with a right to return
- Repurchase agreements
- Bill and hold sales
- Consignment sales

5.1 Principal versus agent considerations

A person or company might act for another company. In this case the first company is said to be an agent of the second company and the second company is described as the principal.

Principal

An entity is a principal if it controls a promised good or service before it is transferred to a customer. However, an entity is not necessarily acting as a principal if it obtains legal title of a product just before legal title is transferred to a customer.

A principal is responsible for satisfying a performance obligation. It may do this by itself or it may engage another party (for example, a subcontractor) to help do this.

A principal recognises the gross amount of revenue to which it is entitled for goods and services transferred.

Agent

An agent's performance obligation is to arrange for the provision of goods or services by another party (the principal).

The agent is providing a selling service to the principal. The agent should not recognise the whole sale price of the goods but only the fee for selling them.

When an agent satisfies a performance obligation, it recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the principal to provide its goods or services.

An agent might sell goods for a principal and collect the cash from the sale. The agent then hands the cash to the principal after deducting an agency fee.

Example: Agency

X Ltd distributes goods for Y plc under an agreement with the following terms.

1. X Ltd is given legal title to the goods by Y plc and sells them to the retailers.
2. Y plc sets the selling price and X Ltd is given a fixed margin on all sales.
3. Y plc retains all product liability and is responsible for any manufacturing defects.
4. X Ltd has the right to return inventory to Y plc without penalty.
5. X Ltd is not responsible for credit risk on sales made.

During the year ended 31 December 20X3 Y plc transferred legal title of goods to X Ltd which cost Y plc ₦1,000,000. These are to be sold at a mark-up of 20%. X Ltd is entitled to 5% of the selling price of all goods sold.

As at 31 December X Ltd had sold 90% of the goods and held the balance of the inventory in its warehouse. All amounts had been collected by X Ltd but the company has not yet remitted any cash to Y plc.

Analysis:

In substance X Ltd is acting as an agent for Y plc. Y plc retains all significant risks and rewards of ownership of the goods transferred to X Ltd.

X Ltd would recognise:	**Dr**	**Cr**
Cash (90% × (₦1,000,000 × 120%))	1,080,000	
Revenue (5% × 90% × (₦1,000,000 × 120%))		54,000
Liability		1,026,000

Y plc would recognise:	**Dr**	**Cr**
Receivable	1,026,000	
Revenue		1,026,000

Y plc would also recognise the unsold inventory as part of its closing inventory.

It is usually straightforward to decide if an entity is an agent or a principal.

The determination is based on the nature of the promise of a party in a contract. Indicators that an entity is an agent (and therefore does not control the good or service before it is provided to a customer) include the following:

- another party is primarily responsible for fulfilling the contract;
- the entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return;
- the entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited;
- the entity's consideration is in the form of a commission; and
- the entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

5.2 Sale with a right to return

Some contracts result in the transfer of control of a product to a customer but also grant the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

- a full or partial refund of any consideration paid;
- a credit that can be applied against amounts owed, or that will be owed, to the entity; and
- another product in exchange.

All of the following must be recognised when a product is sold with a right of return:

- revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (i.e. revenue would not be recognised for the products expected to be returned);
- a refund liability; and
- an asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

5.3 Repurchase agreements

A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset.

A customer does not obtain control of the asset when the selling entity has an obligation or a right to repurchase the asset.

Even though the customer may have physical possession of the asset, the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from the asset.

If the repurchase agreement is a financing arrangement, the entity must continue to recognise the asset and also recognise a financial liability for any consideration received from the customer.

The difference between the amount of consideration received from the customer and the amount of consideration to be paid to the customer is recognised as interest.

Example: Sale and repurchase agreement (forward)

X Ltd is in the forestry business. It cuts wood and seasons it for 3 to 4 years before selling it to furniture manufacturers.

X Ltd sells 1,000 tonnes of wood to a bank for ₦1,000,000.

X Ltd has a contract under which it will buy the wood back from the bank in one year's time for ₦1,100,000.

The wood will never leave X Ltd's premises.

Analysis:

X Ltd has a contract under which it will buy the wood back at the sale proceeds plus a lender's return.

X Ltd has borrowed cash using its inventory as security.

X Ltd must recognise the "sale proceeds" as a liability (Dr Cash / Cr Liability).

The double entry is as follows:

1 January	Dr	Cr
Cash	1,000,000	
Liability		1,000,000
Year to 31 December		
Interest expense (statement of profit or loss)	100,000	
Liability		100,000
Being: Recognition of interest on loan		
Liability	1,100,000	
Cash		1,100,000
Being: Repayment of loan		

5.4 Bill and hold sales

A bill-and-hold arrangement is a contract under which goods are sold to a customer but held at the selling entity's premises until the customer requests delivery. For example, a customer may request an entity to enter into such a contract because of the customer's lack of available space for the product.

Revenue for a bill-and-hold sale is recognised in the usual way, according to whether the customer has obtained control of the asset.

The selling entity needs to determine when it satisfies its performance obligation to transfer a product by evaluating when a customer obtains control of that product.

For some contracts, this could occur (and revenue be recognised) when the product is shipped from the selling entity's site or delivered to the customer's site depending on the terms of the contract.

However, a customer might have the ability to direct the use of, and obtain substantially all of the remaining benefits from, the product even though it has decided not to exercise its right to take physical possession of that product. In this case the selling entity does not control the product. In this case, revenue would be recognised when the goods were originally sold.

For a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

- the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);
- the product must be identified separately as belonging to the customer;
- the product currently must be ready for physical transfer to the customer; and
- the selling entity cannot have the ability to use the product or to direct it to another customer.

If the selling entity recognises revenue for the sale of a product on a bill-and-hold basis, it should also consider whether it has remaining performance obligations. For example, it might consider that it is providing a warehousing service to the customer. In such cases, the transaction price must be allocated between the goods sold and that service in the usual way.

Example: Bill and hold arrangement

X Ltd enters into a contract with Y Plc for the sale of a machine and spare parts.

Y Plc pays for the machine and spare parts on 31 December 20X9, but only takes physical possession of the machine, requesting that the spare parts be stored at X Ltd's warehouse because of its close proximity to Y Plc's factory.

Further information

Y Plc has legal title to the spare parts and the parts can be identified as belonging to Y Plc.

X Ltd stores the spare parts in a separate section of its warehouse and the parts are ready for immediate shipment at Y Plc's request.

X Ltd does not have the ability to use the spare parts or direct them to another customer.

X Ltd expects to hold the spare parts for three years.

Analysis:

The promises to transfer the machine and spare parts are distinct and result in two performance obligations that each will be satisfied at a point in time.

The promise to provide custodial services is a service provided to Y Plc, distinct from the machine and spare parts. It is a performance obligation.

X Ltd should account for three performance obligations in the contract (the promises to provide the machine, the spare parts and the custodial services).

The transaction price is allocated to the three performance obligations and revenue is recognised when (or as) control transfers to Y Plc.

Revenue recognition

Control of the machine transfers to Y Plc on 31 December 20X9 when Y Plc takes physical possession.

X Ltd assesses the indicators in IFRS 15 to determine the point in time at which control of the spare parts transfers to Y Plc.

X Ltd concludes that all of the necessary criteria are met for X Ltd to recognise revenue in a bill-and-hold arrangement. X Ltd recognises revenue for the spare parts on 31 December 20X9 when control transfers to Y Plc.

The performance obligation to provide custodial services is satisfied over time as the services are provided. Revenue is recognised over time as the warehousing service is provided.

Note: X Ltd would also need to consider whether the payment terms include a significant financing component and account for it accordingly.

5.5 Consignment sales

An entity might deliver a product to another party (such as a dealer or a distributor) for sale to end customers under a consignment arrangement.

Indicators that an arrangement is a consignment arrangement include (but are not limited to) the following:

- the product is controlled by the entity until a specified event occurs, such as the sale of the product to a customer of the dealer or until a specified period expires;
- the entity is able to require the return of the product or transfer the product to a third party (such as another dealer); and
- the dealer does not have an unconditional obligation to pay for the product (although it might be required to pay a deposit).

These arrangements are common in the car industry where manufacturers deliver cars to showrooms on consignment.

Control of a product held in a consignment arrangement has not passed.

Revenue is not recognised upon delivery of a product held on consignment but at a later point in time (depending on terms in the contract).

Example: Consignment arrangement

X Ltd manufactures cars and supplies them to dealers on a consignment basis.

Either party can require the return of a car to the manufacturer within a period of six months from delivery.

The dealers are required to pay a monthly charge for the facility to display the car.

X Ltd uses this monthly charge to pay for insurance cover and carriage costs.

Legal title to cars held on consignment pass to the dealer when the car is sold to an end customer (so that title can be passed to the customer).

At the end of six months the dealer must pay X Ltd the trade price as at the date of delivery or return the car.

Revenue recognition

Control of a car passes at the end of six months (unless it is returned by the dealer) or when the car is sold.

Revenue is recognised accordingly.

6 CHAPTER REVIEW

Chapter review

- Before moving on to the next chapter check that you now know how to:
- Explain the core principle and the five step approach to revenue recognition;
- Apply the five step approach to revenue recognition;
- Explain and apply the rules on variable consideration;
- Explain how the existence of a significant financing components affects revenue recognition;
- Account for contract costs; and
- Explain the required accounting treatment in a series of specific areas.

CHAPTER 9

Non-current assets and non-financial liabilities

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	2	Non- financial assets	
		a	Assess the effects of different recognition and measurement methods and timing of recognition of non-financial assets on reported financial position.
		b	Discuss and appraise accounting treatments of non-current assets such as: **Property, Plant And Equipment - IAS 16**; Intangible Assets - IAS 38; **Investment Properties - IAS 40**; Leases - IFRS 16; Non-Current Assets Held For Sale - IFRS 5; Inventories – IAS 2; Agriculture – IAS 41; Accounting for Government Grant and Disclosure of Government Assistance– IAS 20 and Borrowing Costs – IAS 23.
	3	Non-financial liabilities	
		a	Evaluate how different methods and timing of recognition and measurement of non-financial liabilities affect reported financial position.
		b	Appraise accounting treatments of non-financial liabilities such as Employees' Benefits – IAS 19; Share Based Payment – IFRS 2; Income Tax – IAS 12; **Provisions, Contingent Liabilities and Contigent Assets – IAS 37**; and Leases - IFRS 16.

IAS 16, IAS 40, IAS 38 and IAS 37 are examinable documents.

Exam context

This chapter explains rules on accounting for property, plant and equipment, investment property, intangible assets and provisions and contingent assets and liabilities

These standards were examinable in earlier papers. They are covered here in summary from to remind you of their main features.

At the end of this chapter, you should remember how to:

- Measure property, plant and equipment on initial recognition;
- Measure property, plant and equipment on subsequent recognition using the cost model and the revaluation model;
- Account for disposals of property plant and equipment;
- Define investment property;
- Account for investment property using one of the two permitted methods;
- Explain and apply the recognition rules to intangible assets acquired in different ways;
- Measure intangible assets on initial recognition;
- Measure intangible assets after initial recognition using the cost model and the revaluation model;
- Define liability, provision, contingent liability and contingent asset;
- Distinguish between provisions, contingent liabilities or contingent assets;
- Understand and apply the recognition criteria for provisions under IFRS;
- Calculate/ measure provisions; and
- Account for changes in provisions.

1 IAS 16: PROPERTY, PLANT AND EQUIPMENT

Section overview

- Definition
- Initial recognition
- Initial measurement
- Subsequent expenditure
- Measurement after initial recognition
- Judgements

1.1 Definition

Definition: Property, plant and equipment

Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than one period.

Definitions

A **bearer plant** is a living plant that:

a. is used in the production or supply of agricultural produce;

b. is expected to bear produce for more than one period; and

c. has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

Bearer plants meet the definition of property, plant and equipment in IAS 16 and their operation is similar to that of manufacturing.

1.2 Initial recognition

The cost of an item of property, plant and equipment must be recognised as an asset if, and only if:

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

Each part of an asset that has a cost that is significant in relation to the total cost of the item must be depreciated separately. This means that the cost of an asset might be split into several different assets and each depreciated separately.

1.3 Initial measurement

Property, plant and equipment are initially recorded in the accounts of a business at their cost.

Definition: Property, plant and equipment

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs. (For example right of use assets accounted for according to rules in IFRS 16: Leases).

Elements of cost

The cost of an item of property, plant and machinery consists of:

- its purchase price after any trade discount has been deducted, plus any import taxes or non-refundable sales tax; plus
- the directly attributable costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and
- When the entity has an obligation to dismantle and remove the asset at the end of its life, its initial cost should also include an estimate of the costs of dismantling and removing the asset and restoring the site where it is located.

The recognition of costs ceases when the asset is ready for use. This is when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Exchange transactions

An asset may be acquired in exchange for another asset. The cost of such asset is measured at its fair value unless:

- the exchange transaction lacks commercial substance; or
- the fair value of neither the asset received nor the asset given up is reliably measurable.

If the new asset is measured at fair value, the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

If the new asset is not measured at fair value, its cost is measured at the carrying amount of the asset given in exchange for it. This would be the case when the exchange lacked commercial substance or when the fair value of either asset cannot be measured.

1.4 Subsequent expenditure

Expenditure relating to non-current assets, after their initial acquisition, should be capitalised if it meets the criteria for recognising an asset.

In practice, this means that expenditure is capitalised if it:

- improves the asset (for example, by enhancing its performance or extending its useful life); or

- is for a replacement part (provided that the part that it replaces is treated as an item that has been disposed of).

Repairs and maintenance expenditure is revenue expenditure. It is recognised as an expense as it is incurred, because no additional future economic benefits will arise from the expenditure.

Major inspections

A company might only be allowed to operate some assets if those assets are subject to regular major inspections for faults.

The cost of such major inspections is recognised in the carrying amount of the asset as a replacement if the recognition criteria are satisfied.

When a major inspection is carried out any remaining carrying amount of the cost of the previous inspection is derecognised.

1.5 Measurement after initial recognition

All items of property, plant and equipment in a class can be accounted for using one of two models:

- Cost model - Property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses.
- Revaluation model - Property, plant and equipment is carried at a revalued amount. This is the fair value at the date of the revaluation less any subsequent accumulated depreciation and any accumulated impairment losses.

The same model should be applied to all assets in the same class. For example, a company's policy might be to value all its motor vehicles at cost, but to apply the revaluation model to all its land and buildings.

Depreciation

Definitions

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

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

The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses. (Net book value (NBV) is a term that is often used instead of carrying amount).

Depreciation of an asset begins when that asset is available for use. This means when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Depreciation ends at the earlier of when an asset is classified as held for sale in accordance with *IFRS 5: Non-current assets held for sale and discontinued operations* and when it is derecognised.

Depreciation does not cease when an asset becomes idle or is withdrawn or retired from active use.

Review of useful life

IAS 16 requires useful lives and residual values to be reviewed at each year-end. Any change is a change in accounting estimate. The carrying amount (cost minus accumulated depreciation) of the asset at the date of change is written off over the (revised) remaining useful life of the asset.

Residual value

The residual value of an item of property, plant and equipment must be reviewed at least at each financial year end and if expectations differ from previous estimates the depreciation rate for the current and future periods is adjusted.

A change in the asset's residual value is accounted for prospectively as an adjustment to future depreciation.

Review of depreciation method

The depreciation method applied to property, plant and equipment must be reviewed periodically and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method is changed to reflect the changed pattern.

Where there is a change in the depreciation method used, this is a change in accounting estimate. A change of accounting estimate is applied from the time of the change, and is not applied retrospectively. The carrying amount (cost minus accumulated depreciation) of the asset at the date of the change is written off over the remaining useful life of the asset.

Revaluation

When a non-current asset is revalued, its 'carrying amount' in the statement of financial position is adjusted to its fair value at the date of the revaluation.

- An increase in value is credited to other comprehensive income and accumulated in equity under the heading of revaluation surplus. (However, an increase is recognised in profit or loss if it reverses a revaluation decrease on the same asset that was previously recognised in profit or loss).
- A decrease in value is recognised in profit or loss. However, a decrease is recognised in other comprehensive income if it reverses a revaluation increase on the same asset that was previously recognised in other comprehensive income.

After a non-current asset has been revalued, depreciation charges are based on the new valuation.

Realisation of the revaluation surplus

IAS 16 allows (but does not require) the transfer of a revaluation surplus to retained earnings when the asset to which it relates is derecognised (realised).

This might happen over several years as the asset is depreciated or at a point in time when the asset is sold.

1.6 Judgements – IAS 16

IAS 16: Areas of judgement and estimate

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:

- Which costs should be capitalised;
- Whether subsequent expenditure is satisfying the recognition criteria or should be expensed;
- How to split assets into components for depreciation purposes?
- Depreciation methods;
- Estimates of useful lives and residual values;
- Accounting policy (cost or revaluation); and
- Allocation of assets into classes.

2 IAS 40: INVESTMENT PROPERTY

Section overview

- Definitions
- Accounting treatment
- Judgements – IAS 40

2.1 Definitions

IAS 40: Investment Property, defines and sets out the rules on accounting for investment properties.

Definition

An investment property is property (land or a building, part of a building or both) held to earn rentals or for capital appreciation or both.

2.2 Accounting treatment

The **recognition criteria** for investment property are the same as for property, plant and equipment under IAS 16. An investment property should be recognised as an asset only when:

- ❑ it is probable that future economic benefits associated with the property will flow to the entity; and
- ❑ the cost of the property can be measured reliably.

Measurement at recognition

Investment property should be measured initially at cost plus the transaction costs incurred to acquire the property.

A property held under a lease may be classified as an investment property. The initial cost of such a property is found by capitalising the lease in accordance with *IFRS 16: Leases*.

Measurement after recognition

After initial recognition an entity may choose as its accounting policy:

- ❑ the fair value model; or
- ❑ the cost model.

The chosen policy must be applied to all the investment property of the entity.

Once a policy has been chosen it cannot be changed unless the change will result in a more appropriate presentation. IAS 40 states that a change from the fair value model to the cost model is unlikely to result in a more appropriate presentation.

Examples of investment property

The following are some examples (refer to IAS 40.8):

(a) Land held as an investment for long-term capital appreciation;
(b) Land held for future undetermined use (i.e. future purpose unknown);

(c) A building owned by an entity and leased out under one or more operating leases. This includes a building that is still vacant, but planned to be leased out; and
(d) Any property that is constructed or developed for future use as investment property.

2.3 Transfer

2.3.1 Reclassification

An entity shall transfer a property to, or from, investment property when, and only when, there is a change in use. A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is evidence of the change in use. In isolation, a change in management's intentions for the use of a property does not provide evidence of a change in use. Examples of evidence of a change in use include:

(a) Commencement of owner-occupation, or of development with a view to owner-occupation, for a transfer from investment property to owner-occupied property;
(b) Commencement of development with a view to sale, for a transfer from investment property to inventories;
(c) End of owner-occupation, for a transfer from owner-occupied property to investment property; and
(d) Inception of an operating lease to another party, for a transfer from inventories to investment property.

2.3.2 Accounting treatment

Under the fair value model, the entity should:

(a) Revalue all its investment property to 'fair value' at the end of each financial year; and
(b) Recognise any resulting gain/loss in profit or loss for the period.
(c) The property would not be depreciated.

2.3.3 Cost model for investment property

The cost model follows the provisions of IAS 16. The property is measured at cost less accumulated depreciation and less impairment loss if any.

2.4 Judgements – IAS 40

IAS 40: Areas of judgement and estimate

The basic accounting policy choice will affect the recognition of profits and losses, and could introduce extreme volatility to the statement of profit or loss.

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements. These include the following:

- Identification of investment property;
- Issues arise in respect of the assets that "come with" the property (consider a vineyard);
- Choosing the appropriate accounting policy;
- It is 'highly unlikely' that a change from fair value to the cost model would provide a more appropriate presentation; and
- Obtaining reliable measures of fair value.

3 IAS 38: INTANGIBLE ASSETS

Section overview

- Introduction
- Recognition guidance for internally-generated intangible assets
- Extra guidance for intangible assets acquired in a business combination
- Measurement after initial recognition
- Amortisation of intangible assets
- Judgements – IAS 38

3.1 Introduction

Definitions

Intangible asset: An identifiable, non-monetary asset without physical substance'

An asset: A resource controlled by the company as a result of past events and from which future economic benefits are expected to flow.

Recognition and initial measurement

An intangible asset must be measure at cost when first recognised.

An intangible asset is recognised when it:

- ❑ complies with the definition of an intangible asset; and,
- ❑ meets the recognition criteria set out in the standard.

An intangible asset must be recognised if (and only if):

- ❑ it is probable that future economic benefits specifically attributable to the asset will flow to the company;
- ❑ the cost of the asset can be measured reliably;
- ❑ If it can be identified separately; and
- ❑ If organization currently control the Intangible Non-Current Asset.

Subsequent expenditure on intangible assets

Subsequent expenditure is only capitalised if it can be measured and attributed to an asset and enhances the value of the asset. This would rarely be the case:

Means of acquiring intangible assets

A company might obtain control over an intangible resource in a number of ways. Intangible assets might be:

- ❑ purchased separately;
- ❑ acquired in exchange for another asset;
- ❑ given to a company by way of a government grant.
- ❑ internally generated; or
- ❑ acquired in a business combination.

IAS 38 provides extra guidance on how the recognition criteria are to be applied and/or how the asset is to be measured in each circumstance.

Recognition guidance for intangibles purchased separately

The probability recognition criterion is always satisfied for separately acquired intangible assets.

Also the cost of a separately acquired intangible asset can usually be measured reliably especially when the purchase consideration is in the form of cash or other monetary assets.

Recognition guidance for intangibles acquired in exchange transactions

An intangible asset may be acquired in exchange or part exchange for another intangible asset or another asset.

The cost of such items is measured at fair value unless:

- the exchange transaction lacks commercial substance; or,
- the fair value of neither the asset received nor the asset given up is reliably measurable.

If the acquired item is not measured at fair value it is measured at the carrying amount of the asset given up.

3.2 Recognition guidance for internally-generated intangible assets

IAS 38 prohibits the recognition of the following internally-generated intangible items:

- goodwill;
- brands;
- mastheads (Note: a masthead is a recognisable title, usually in a distinctive typographical form, appearing at the top of an item. An example is a newspaper masthead on the front page of a daily newspaper);
- publishing titles; and
- customer lists.

Other internally generated intangibles

Assessment of whether an internally generated intangible asset meets the criteria for recognition requires a company to classify the generation of the asset into:

- a research phase; and
- a development phase.

Definitions: Research

Research: Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development: The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Accounting treatment of development costs

Development costs must be recognised as an intangible asset, but only if all the following conditions can be demonstrated.

- It is technically feasible to complete the development project.
- The company intends to complete the development of the asset and then use or sell it.
- The asset that is being developed is capable of being used or sold.
- Future economic benefits can be generated. This might be proved by the existence of a market for the asset's output or the usefulness of the asset within the company itself.
- Resources are available to complete the development project.
- The development expenditure can be measured reliably (for example, via costing records).

Only expenditure incurred after all the conditions have been met can be capitalised.

Once such expenditure has been written off as an expense, it cannot subsequently be reinstated as an intangible asset.

3.3 Extra guidance for intangible assets acquired in a business combination

Any intangible asset identified in a business combination will be recognised as both recognition criteria are deemed to be recognised.

If an intangible asset is acquired in a business combination, its cost is the fair value at the acquisition date.

If cost cannot be measured reliably then the asset will be subsumed within goodwill.

In-process research and development

The acquiree might have a research and development project in process. Furthermore, it might not recognise an asset for the project because the recognition criteria for internally generated intangible assets have not been met.

However, the acquirer would recognise the in-process research and development as an asset in the consolidated financial statements as long as it:

- meets the definition of an asset; and
- is identifiable, i.e. is separable or arises from contractual or other legal rights.

In other words, expenditure incurred on an in-process research or development project acquired separately or in a business combination and recognised as an intangible asset is accounted for in the usual way by applying the IAS 38 recognition criteria.

Illustration: In-process research and development

Company X buys 100% of Company Y.

Company Y has spent ₦600,000 on a research and development project. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met. Company Y has knowhow as the result of the project.

Company X estimates the fair value of Company Y's know how which has arisen as a result of this project to be ₦500,000.

Analysis

The in-process research and development is not recognised in Company Y's financial statements because the recognition criteria have not been met.

From the Company X group viewpoint the in-process research and development is a purchased asset. Part of the consideration paid by Company X to buy Company Y was to buy the knowhow resulting from the project and it should be recognised in the consolidated financial statements at its fair value of ₦500,000.

Further expenditure on such a project would not be capitalised unless the criteria for the recognition of internally generated intangible assets were met.

Illustration: Subsequent expenditure on acquired in-process R and D

Continuing the previous example.

Company X owns 100% of Company Y and has recognised an intangible asset of ₦500,000 as a result of the acquisition of the company.

Company Y has spent a further ₦150,000 on the research and development project since the date of acquisition. This amount has all been expensed as the IAS 38 criteria for capitalising costs incurred in the development phase of a project have not been met.

Analysis

The ₦150,000 expenditure is not recognised in Company Y's financial statements (IAS 38 prohibits the recognition of internally generated brands).

From the Company X group viewpoint, further work on the in-process research and development project is research and the expenditure of ₦150,000 must be expensed.

3.4 Measurement after initial recognition

Intangible assets are recognised at cost when first acquired.

The two measurement models for intangible assets after acquisition are:

- cost model (i.e. cost less accumulated depreciation); and
- revaluation model (i.e. revalued amount less accumulated depreciation since the most recent revaluation).

The same model should be applied to all assets in the same class

Revaluation of an intangible asset is only allowed if the fair value can be determined by reference to an active market in that type of intangible asset.

Definition: Active market

An active market is a market in which all the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

Active markets for intangible assets are rare. Very few companies revalue intangible assets in practice.

3.5 Amortisation of intangible assets

The depreciable amount of an intangible asset with a finite useful life is allocated on a systematic basis over its useful life.

Where the useful life is assessed as indefinite:

- the intangible asset should not be amortised; but
- impairment reviews should be carried out annually (and even more frequently if there are any indications of impairment).

The useful life of an intangible asset that is not being amortised must be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset.

3.6 Judgements – IAS 38

IAS 38: Areas of judgement and estimate

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:

- Whether an internally generated asset meets the recognition criteria;
- Allocation of consideration in a business combination (i.e. the recognition of intangibles acquired);
- Future cash flows and discount rates for impairment tests; and
- Amortisation periods.

4 IAS 37: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Section overview

- Introduction
- Measurement
- Using provisions
- Guidance on specific provisions
- Contingent liabilities and contingent assets
- Summary
- Judgements – IAS 37

4.1 Introduction

Definitions

Provisions: Liabilities of uncertain timing or amount.

Liability: A present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

Obligating event: An event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation.

Provisions differ from other liabilities because there is uncertainty about the timing or amount of the future cash flows required to settle the liability.

Recognition criteria for provisions

A provision should be recognised when:

- a company has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

If one of these conditions is not met, then a provision cannot be recognised.

4.2 Measurement

The amount recognised as a provision must be the best estimate, as at the end of the reporting period, of the future expenditure required to settle the obligation. (This is amount that the company would have to pay a third party to take the obligation off its hands).

Where the effect of the time value of money is material, a provision is measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.

Each provision must be reviewed at the end of each reporting period. This might result in derecognition of a provision that no longer meets the recognition criteria

or in the re-measurement of a provision. An increase in a provision would result in the recognition of a further expense or a reduction in expense as the previously recognised provision is reduced through a credit to profit or loss.

Reimbursements

An asset for an amount recoverable from a third party in respect of an obligation (e.g. insurance) is only recognised when receipt is virtually certain. Any such asset is recognised separately from the provision (no netting off) at an amount no greater than that of the provision.

4.3 Using provisions

A provision is set up to recognise an expense (usually) that exists at the reporting date. (A provision for a liability to decommission an asset might be recognised as part of the coat of that asset).

A provision may be used only for expenditures for which the provision was originally recognised.

- If the provision is more than the amount needed to settle the liability the balance is released as a credit back through the income statement.
- If the provision is insufficient to settle the liability an extra expense is recognised.

4.4 Guidance on specific provisions

Onerous contracts

Definition

An onerous contract is a contract where the unavoidable costs of fulfilling/completing the contract now exceed the benefits to be received (the contract revenue).

A provision should be made for the additional unavoidable costs of an onerous contract. (The 'additional unavoidable costs' are the amount by which costs that cannot be avoided are expected to exceed the benefits).

Future operating losses

Provisions cannot be made for future operating losses. This is because they arise from future events, not past events.

Restructuring

A provision is recognised for the future restructuring costs only if a present obligation exists.

A constructive obligation to restructure arises only when a company:

- has a detailed formal plan for the restructuring (IAS 37 specifies certain minimum content); and
- has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

Future repairs and major overhauls

A provision cannot be recognised for the cost of future repairs or replacement parts unless the company has an obligation to incur the expenditure.

A company should capitalise expenditure incurred on replacement of an asset and depreciate this cost over its useful life.

Normal repair costs are expenses that should be included in profit or loss as incurred.

4.5 Contingent liabilities and contingent assets

Contingent liability

Definition: Contingent liability

A contingent liability is either of the following:

A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

OR

A contingent liability is a present obligation that arises from past events but is not recognised because it is not probable that an outflow of economic benefits will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

Contingent asset

Definition: Contingent asset

A contingent asset is a possible asset that arises from past events whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Contingent liabilities and contingent assets **are not recognised** in the financial statements.

In some circumstances, information about the existence of a contingent asset or a contingent liability should be **disclosed** in the notes to the financial statements.

4.6 Summary

The following table provides a summary of the rules about whether items should be treated as provisions, contingent liabilities or contingent assets.

Criteria	Provision	Contingent liability		Contingent asset
Present obligation/ asset arising from past events?	Yes	Yes	No (but may come into existance in the future)	Only a possible asset
Will settlement result in outflow/ inflow of economic benefits?	Probable outflow – and a reliable estimate **can** be made of the obligation	Not probable outflow – or a reliable estimate **cannot** be made of the obligation	Outflow to be confirmed by Uncertain future events	Inflow to be confirmed by uncertain future events
Treatment in the financial statements	Recognise a provision	Disclose as a contingent liability (unless the possibility of outflow is remote)	Disclose as a contingent liability (unless the possibility of outflow is remote)	Only disclose if inflow is probable

4.7 Judgements – IAS 37

IAS 37: Areas of judgement and estimate

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:

- Whether a present obligation exists as a result of a past event;
- Whether it is probable that an outflow of resources will be required to settle it;
- Whether a reliable estimate can be made of the amount of the obligation;
- Whether criteria have been satisfied to trigger the recognition of a restructuring provision;
- Whether a circumstance indicates future losses (no provision) or an onerous contract (provision); and
- How to measure provisions.

CRITERIA	CONTIGENT LIABILITY	CONTIGENT ASSET
liability	Asset	
If certain (100%)	Provision	Recognised
If Probable more than 50%	Provision	Disclose
If Possible (50% or less)	Disclose	Do Nothing
Remote (1-100%)	Do nothing	Do Nothing

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you remember how to:

- Measure property, plant and equipment on initial recognition;
- Measure property, plant and equipment on subsequent recognition using the cost model and the revaluation model;
- Account for disposals of property plant and equipment;
- Define investment property;
- Account for investment property using one of the two permitted methods;
- Explain and apply the recognition rules to intangible assets acquired in different ways;
- Measure intangible assets on initial recognition;
- Measure intangible assets after initial recognition using the cost model and the revaluation model;
- Define liability, provision, contingent liability and contingent asset;
- Distinguish between provisions, contingent liabilities or contingent assets;
- Understand and apply the recognition criteria for provisions under IFRS;
- Calculate/ measure provisions; and
- Account for changes in provisions.

Professional level
Corporate

CHAPTER 10

IAS 36: Impairment of assets

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	**1**	**Performance reporting**		
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.	

IAS 36 is an examinable document.

Exam context

This chapter explains rules on impairment set out in IAS 36. Note that the rules on accounting for impairment of goodwill are covered in more detail in a later chapter (Chapter 23).

This standard was examinable in a previous paper. It is covered here again in detail for your convenience

At the end of this chapter, you should be able to:

- Explain the objective of IAS 36;
- Explain the IAS 36 impairment review process;
- Estimate recoverable amount and hence impairment loss (if any);
- Account for impairment loss on assets carried under a cost model;
- Account for impairment loss on re-valued assets;
- Define a cash generating unit;
- Allocate impairment loss to assets within a cash generating unit; and
- Describe when reversal of impairment loss is permitted.

1 IMPAIRMENT OF ASSETS

Section overview

- Objective and scope of IAS 36
- Identifying impairment or possible impairment
- Measuring recoverable amount
- Accounting for impairment
- Summary of approach

1.1 Objective and scope of IAS 36

An asset is said to be impaired when it carrying amount in the statement of financial position is above the recoverable of the asset or its cash generating unit.

From time to time an asset may have a carrying value that is greater than its fair value but this is not necessarily impairment as the situation might change in the future. Impairment means that the asset has suffered a permanent loss in value.

The objective of ***IAS 36 Impairment of assets*** is to ensure that assets are 'carried' (valued) in the financial statements at no more than their recoverable amount.

Scope of IAS 36

IAS 36 applies to all assets, with the following exceptions that are covered by other accounting standards:

- inventories (IAS 2);
- deferred tax assets (IAS 12);
- financial assets (IFRS 9);
- investment property held at fair value (IAS 40);
- non-current assets classified as held for sale (IFRS 5).

Recoverable amount of assets

Definition

The ***recoverable amount*** of an asset is defined as the higher of its fair value minus costs of disposal, and its value in use.

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

Value in use is the present value of future cash flows from using an asset, including its eventual disposal.

Impairment loss is the amount by which the carrying amount of an asset (or a cash-generating unit) exceeds its recoverable amount.

Cash-generating units will be explained later.

Stages in accounting for an impairment loss

There are various stages in accounting for an impairment loss:

Stage 1: Establish whether there is an indication of impairment.

Stage 2: If so, assess the recoverable amount.

Stage 3: Write down the affected asset (by the amount of the impairment) to its recoverable amount.

Each of these stages will be considered in turn.

1.2 Identifying impairment or possible impairment

An entity must carry out an impairment review when there is evidence or an indication that impairment may have occurred. At the end of each reporting period, an entity should assess whether there is any indication that impairment might have occurred. If such an indication exists, the entity must estimate the recoverable amount of the asset, in order to establish whether impairment has occurred and if so, the amount of the impairment.

Indicators of impairment

The following are given by IAS 36 as possible **indicators of impairment**. These may be indicators outside the entity itself (external indicators), such as market factors and changes in the market. Alternatively, they may be internal indicators relating to the actual condition of the asset or the conditions of the entity's business operations.

When assessing whether there is an indication of impairment, IAS 36 requires that, as a minimum, the following sources are considered:

External sources	Internal sources
An unexpected decline in the asset's market value.	Evidence that the asset is damaged or no longer of use to the entity.
Significant changes in technology, markets, economic factors or laws and regulations that have an adverse effect on the company.	There are plans to discontinue or restructure the operation for which the asset is currently used.
An increase in interest rates, affecting the value in use of the asset.	There is a reduction in the asset's expected remaining useful life.
The company's net assets have a higher carrying value than the company's market capitalisation (which suggests that the assets are over-valued in the statement of financial position).	There is evidence that the entity's expected performance is worse than expected.

If there is an indication that an asset (or cash-generating unit) is impaired then it is tested for impairment. This involves the calculating the recoverable amount of the item in question and comparing this to its carrying amount.

Additional requirements for testing for impairment

The following assets must be reviewed for impairment at least annually, even when there is no evidence of impairment:

- an intangible asset with an indefinite useful life; and
- goodwill acquired in a business combination.

1.3 Measuring recoverable amount

It has been explained that recoverable amount is the higher of an asset's:

- fair value less costs of disposal; and
- its value in use.

If either of these amounts is higher than the carrying value of the asset, there has been no impairment.

IAS 36 sets out the requirements for measuring 'fair value less costs of disposal' and 'value in use'.

Measuring fair value less costs of disposal

Fair value is normally market value. If no active market exists, it may be possible to estimate the amount that the entity could obtain from the disposal.

Direct selling costs normally include legal costs, taxes and costs necessary to bring the asset into a condition to be sold. However, redundancy and similar costs (for example, where a business is reorganised following the disposal of an asset) are not direct selling costs.

Calculating value in use

Value in use is a value that represents the present value of the expected future cash flows from use of the asset, discounted at a suitable discount rate or cost of capital. Value in use is therefore calculated by:

- estimating future cash flows from the use of the asset (including those from ultimate disposal).
- discounting them to present value.

Estimates of future cash flows should be based on reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset.

The discount rate used should be the rate of return that the market would expect from an equally risky investment.

However, both the expected future cash flows and the discount rate might be adjusted to allow for uncertainty about the future – such as the business risk associated with the asset and expectations of possible variations in the amount or timing of expected future cash benefits from using the asset.

Example: Measurement of recoverable amount

A company has a machine in its statement of financial position at a carrying amount of ₦300,000.

The machine is used to manufacture the company's best-selling product range, but the entry of a new competitor to the market has severely affected sales.

As a result, the company believes that the future sales of the product over the next three years will be only ₦150,000, ₦100,000 and ₦50,000. The asset will then be sold for ₦25,000.

An offer has been received to buy the machine immediately for ₦240,000, but the company would have to pay shipping costs of ₦5,000.The risk-free market rate of interest is 10%.

Market changes indicate that the asset may be impaired and so the recoverable amount for the asset must be calculated.

Fair value less costs of disposal	₦000
Fair value	240,000
Costs of disposal	(5,000)
	235,000

Year	Cash flow (₦000)	Discount factor	Present value
1	150,000	1/1.1	136,364
2	100,000	$1/1.1^2$	82,645
3	50,000 + 25,000	$1/1.1^3$	56,349
			275,358

The recoverable amount is the higher of ₦235,000 and ₦275,358, i.e. ₦275,358.

The asset must be valued at the lower of carrying value and recoverable amount.

The asset has a carrying value of ₦300,000, which is higher than the recoverable amount from using the asset.

It must therefore be written down to the recoverable amount, and an impairment of ₦24,642 (₦300,000 – ₦275,358) must be recognised.

1.4 Accounting for impairment

The impairment loss is normally recognised immediately in profit or loss.

Example: Measurement of recoverable amount

A company has a machine in its statement of financial position at a carrying amount of ₦300,000.

The machine has been tested for impairment and found to have recoverable amount of ₦275,358 meaning that the company must recognise an impairment loss of ₦24,642.

This is accounted for as follows:

	Debit	Credit
Statement of profit or loss	24,642	
Property, plant and equipment		24,642

Practice question **1**

On 1 January Year 1 Entity Q purchased for ₦240,000 a machine with an estimated useful life of 20 years and an estimated zero residual value.

Depreciation is on a straight-line basis.

On 1 January Year 4 an impairment review showed the machine's recoverable amount to be ₦100,000 and its remaining useful life to be 10 years.

Calculate:

a) The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).

b) The impairment loss recognised in the year to 31 December Year 4.

c) The depreciation charge in the year to 31 December Year 4.

However, an impairment loss recognised in respect of an asset carried at a previously recognised revaluation surplus is recognised in other comprehensive income to the extent that it is covered by that surplus. Thus it is treated in the same way as a downward revaluation, reducing the revaluation reserve balance relating to that asset in the statement of changes in equity.

Impairment not covered by a previously recognised surplus on the same asset is recognised in profit or loss.

Example: Measurement of recoverable amount

A company has a machine in its statement of financial position at a carrying amount of ₦300,000 including a previously recognised surplus of ₦20,000.

The machine has been tested for impairment and found to have recoverable amount of ₦275,358 meaning that the company must recognise an impairment loss of ₦24,642.

This is accounted for as follows:

	Debit	Credit
Statement of profit or loss	4,642	
Other comprehensive income	20,000	
Property, plant and equipment		24,642

Following the recognition of the impairment, the future depreciation of the asset must be based on the revised carrying amount, minus the residual value, over the remaining useful life.

Practice question **2**

On 1 January Year 1 Entity Q purchased for ₦240,000 a machine with an estimated useful life of 20 years and an estimated zero residual value.

Depreciation is on a straight-line basis.

The asset had been re-valued on 1 January Year 3 to ₦250,000, but with no change in useful life at that date.

On 1 January Year 4 an impairment review showed the machine's recoverable amount to be ₦100,000 and its remaining useful life to be 10 years.

Calculate:

a) The carrying amount of the machine on 31 December Year 2 and hence the revaluation surplus arising on 1 January Year 3.

b) The carrying amount of the machine on 31 December Year 3 (immediately before the impairment).

c) The impairment loss recognised in the year to 31 December Year 4.

d) The depreciation charge in the year to 31 December Year 4.

1.5 Summary of the approach

Impairment of an asset should be identified and accounted for as follows:

(1) At the end of each reporting period, the entity should assess whether there are any indications that an asset may be impaired.

(2) If there are such indications, the entity should estimate the asset's recoverable amount.

(3) When the recoverable amount is less than the carrying value of the asset, the entity should reduce the asset's carrying value to its recoverable amount. The amount by which the value of the asset is written down is an impairment loss.

(4) This impairment loss is recognised as a loss for the period.

(5) However, if the impairment loss relates to an asset that has previously been re-valued upwards, it is first offset against any remaining revaluation surplus for that asset. When this happens it is reported as other comprehensive income for the period (a negative value) and not charged against profit.

(6) Depreciation charges for the impaired asset in future periods should be adjusted to allocate the asset's revised carrying amount, minus any residual value, over its remaining useful life (revised if necessary).

2 CASH GENERATING UNITS

Section overview

- Cash-generating units
- Allocating an impairment loss to the assets of a cash generating unit

2.1 Cash-generating units

It is not always possible to calculate the recoverable amount of individual assets. Value in use often has to be calculated for groups of assets, because assets may not generate cash flows in isolation from each other. An asset that is potentially impaired may be part of a larger group of assets which form a cash-generating unit.

IAS 36 defines a cash-generating unit (CGU) as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Goodwill

The existence of cash-generating units may be particularly relevant to goodwill acquired in a business combination. Purchased goodwill must be reviewed for impairment annually, and the value of goodwill cannot be estimated in isolation. Often, goodwill relates to a whole business.

It may be possible to allocate purchased goodwill across several cash-generating units. If allocation is not possible, the impairment review is carried out in two stages:

1 Carry out an impairment review on each of the cash-generating units (excluding the goodwill) and recognise any impairment losses that have arisen.

2 Then carry out an impairment review for the entity as a whole, including the goodwill.

This is explained in more detail in a later chapter (Chapter 23).

2.2 Allocating an impairment loss to the assets of a cash generating unit

When an impairment loss arises on a cash-generating unit, the impairment loss is allocated across the assets of the cash-generating unit in the following order:

- In line with IAS 36 - Impairment, first to the goodwill allocated to the cash-generating unit;
- Derecognise any of the assets that caused the total loss or that are specifically impaired to the extent that it no longer meets the recognition criteria in line with IAS 16 - PPE (if there is any);
- Next, to the other assets in the cash-generating unit, on a pro-rata basis (i.e. in proportion to the carrying amount of the assets of the cash-generating unit).

NOTE: All monetary assets must not be impaired

However, the carrying amount of an asset cannot be reduced below the highest of:

- its fair value less costs of disposal (if determinable);
- its value in use (if determinable); and
- zero.

Example: Allocation of impairment loss in cash-generating unit

A cash-generating unit is made up of the following assets.

	₦m
Property, plant and equipment	90
Goodwill	10
Other assets	60
	160

The recoverable amount of the cash-generating unit has been assessed as ₦140 million.

The impairment loss would be allocated across the assets of the cash-generating unit as follows:

There is a total impairment loss of ₦20 million (= ₦160m – ₦140m). Of this, ₦10 million is allocated to goodwill, to write down the goodwill to ₦0. The remaining ₦10 million is then allocated to the other assets pro-rata.

Therefore:

₦6 million (= ₦10m × 90/150) of the impairment loss is allocated to property, plant and equipment, and

₦4 million (= ₦10m × 60/150) of the loss is allocated to the other assets in the unit.

The allocation has the following result:

	Before loss ₦m	Impairment loss ₦m	After loss ₦m
Property, plant and equipment	90	(6)	84
Goodwill	10	(10)	–
Other assets	60	(4)	56
	160	(20)	140

3 OTHER ISSUES

Section overview

- Reversal of an impairment loss
- IAS 36 disclosure requirements for the impairment of assets

3.1 Reversal of an impairment loss

A company must make an assessment at the end of each reporting period as to whether a previously recognised impairment should be increased or may no longer exist. If the loss no longer exists it is reversed subject to the following guidance.

Any reversal:

- must be justifiable, by reference to an improvement in the indicators of impairment; and
- should not lead to a carrying amount in excess of what the carrying amount of the asset would have been without the recognition of the original impairment loss.

A reversal should be:

- recognised immediately in profit or loss; unless
- the original impairment was charged to the revaluation reserve, in which case the reversal should be credited to the revaluation reserve (and reported in the same way as a revaluation in 'other comprehensive income' for the period).

Depreciation charges for future periods should be adjusted to allocate the asset's revised carrying amount, minus any residual value, over its remaining useful life.

An impairment loss that has arisen on purchased goodwill **cannot** be reversed. This is because any reversal of an impairment loss to goodwill is likely to be caused by an increase in internally-generated goodwill rather than a reversal of the impairment of purchased goodwill. Internally-generated goodwill must not be reported as an asset.

3.2 IAS 36 disclosure requirements for the impairment of assets

For all impairments, the following disclosures should be made for each class of assets:

- ❑ The amount of impairment losses recognised in profit or loss for the period and the line item in which those items are included.
- ❑ Similar information about reversals of impairment losses recognised in profit or loss for the period.
- ❑ The amount of impairment losses on revalued assets that have been recognised (or reversed) in other comprehensive income for the period (and in the revaluation reserve).
- ❑ If the recognition or reversal of an individual impairment loss is material to the financial statements, there should be additional disclosure of:
  - the events that led to the recognition or reversal of the impairment loss;
  - the amount of the impairment loss recognised or reversed;
  - the nature of the asset; and
  - whether the recoverable amount is fair value less costs of disposal or value in use, and how the figure for the recoverable amount was calculated.
- ❑ There are additional disclosures in aggregate for impairment losses (reversals) that are not individually material, and extensive disclosures for CGUs that include goodwill or intangible assets with an indefinite useful life, including estimated sensitivities for changes in assumptions used to derive a value in use or fair value less costs of disposal (“headroom” disclosures).

4 JUDGEMENTS – IAS 36

IAS 36: Areas of judgement and estimate

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:

- Whether indicators suggest that an impairment review is required;
- The determination of fair value when there is no binding sale agreement or active market;
- The input variables to a value in use estimation (expected future cash flows and discount rate);
- The identification of CGUs; and
- How to allocate goodwill to CGUs.

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the objective of IAS 36;
- Explain the IAS 36 impairment review process;
- Estimate recoverable amount and hence impairment loss (if any);
- Account for impairment loss on assets carried under a cost model;
- Account for impairment loss on revalued assets;
- Define a cash generating unit;
- Allocate impairment loss to assets within a cash generating unit; and
- Describe when reversal of impairment loss is permitted.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

On 31 December Year 3 the machine was stated at the following amount

a) Carrying amount of the machine on 31 December Year 3

Cost	240,000
Accumulated depreciation (3 × (240,000 ÷ 20 years))	(36,000)
Carrying amount	204,000

b) Impairment loss at the beginning of Year 4 of ₦104,000 (₦204,000 – ₦100,000). This is charged to profit or loss.

c) Depreciation charge in Year 4 of ₦10,000 (= ₦100,000 ÷ 10). The depreciation charge is based on the recoverable amount of the asset.

Solution **2**

a) Carrying amount on

	₦
Cost	240,000
Accumulated depreciation at 1 January Year 3 (2 years × (240,000 ÷ 20))	(24,000)
Carrying amount	216,000
Valuation at 1 January Year 3	250,000
Revaluation surplus	34,000

b) When the asset is revalued on 1 January Year 3, depreciation is charged on the revalued amount over its remaining expected useful life.
On 31 December Year 3 the machine was therefore stated at:

	₦
Valuation at 1 January (re-valued amount)	250,000
Accumulated depreciation in Year 3 (= ₦250,000 ÷ 18))	(13,889)
Carrying amount	236,111

c) On 1 January Year 4 the impairment review shows an impairment loss of ₦136,111 (₦236,111 – ₦100,000).

An impairment loss of ₦34,000 will be taken to other comprehensive income (reducing the revaluation surplus for the asset to zero).

The remaining impairment loss of ₦102,111 (₦136,111 – ₦34,000) is recognised in the statement of profit or loss for Year 4.

d) Year 4 depreciation charge is ₦10,000 (₦100,000 ÷ 10 years).

Professional level
Corporate Reporting

CHAPTER 11

IFRS 5: Non-current assets held for sale and discontinued operations

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	2	Non- financial assets	
		a	Assess the effects of different recognition and measurement methods and timing of recognition of non-financial assets on reported financial position.
		b	Discuss and appraise accounting treatments of non-current assets such as: Property, Plant and Equipment - IAS 16; Intangible Assets - IAS 38; Investment Properties - IAS 40; Leases - IFRS 16; Non-Current Assets Held for Sale - IFRS 5; Inventories – IAS 2; Agriculture – IAS 41; Accounting for Government Grants and Disclosure of Government Assistance – IAS 20; and Borrowing Costs – IAS 23.

IFRS 5 is an examinable document

Exam context

This chapter explains the IFRS 5 rules on the measurement and presentation of non-current assets held for sale and discontinued operations.

This standard was examinable in a previous paper. It is covered here again in detail for your convenience. Note that disposal of an interest in a subsidiary is a new topic at this level. IFRS 5 could be examined in that context.

At the end of this chapter, you should be able to:

- Apply the held for sale criteria and identify if an assets is held for sale;
- Measure assets classified as held for sale at the lower of carrying amount and fair value less costs to sell;
- Account for any loss arising on classification of an asset as held for sale;
- Allocated any loss arising to assets within a disposal group classified as held for sale;
- Explain and apply the presentation rules on assets held for sale;
- Explain and apply the presentation rules on disposal groups held for sale; and
- Define and explain the accounting treatment for discontinued operations.

1 SALE OF NON-CURRENT ASSETS

Section overview

- General rules on derecognition
- Assets that are held for sale

1.1 General rules on derecognition

When an asset is derecognised, its carrying amount is removed from the statement of financial position. IAS 16 states that the carrying amount of an item of property, plant and equipment should be derecognised in the following circumstances:

- on disposal of the asset; or
- when no future economic benefits are expected to arise from its use or from its disposal.

If a non-current asset is disposed of, the gain or loss on the disposal should be included in profit or loss in the period in which the disposal occurs. The gain or loss should **not** be included in sales revenue.

The gain or loss on the disposal is calculated as:

Illustration: Gain or loss on disposal

		₦
Sale proceeds on disposal		X
Less disposal costs		(X)
Net disposal value		X
Asset at cost/revalued amount	X	
Less: Accumulated depreciation	(X)	
Carrying amount at date of disposal		(X)
Gain /loss on disposal		X

1.2 Assets that are held for sale

Sometimes, a company might hold an asset at the year-end that it has the intention of selling.

IFRS 5 Non-current assets held for sale and discontinued operations contain rules which impact the measurement and presentation of such assets.

In summary:

Non-current assets (and groups of non-current assets) that meet certain strict criteria are classified as being held for sale.

Non-current assets that are held for sale are:

- subject to an impairment test;
- presented on a separate category on the face of the statement of financial position; and
- are no longer depreciated.

Any loss recognised on a non-current asset carried at cost as a result of the impairment test at the date of its classification as 'held for sale' is recognised in the statement of profit or loss.

Any loss recognised on a non-current asset carried at a revalued amount as a result of the impairment test at the date of its classification as 'held for sale' is recognised in other comprehensive income (to the extent that it is covered by the previously recognised surplus on the same asset) with the balance recognised in the statement of profit or loss.

The above rules will be explained in more detail in the following sections.

2 INTRODUCTION TO IFRS 5

Section overview

- Objective of IFRS 5
- Scope of IFRS 5

2.1 Objective of IFRS 5

IFRS 5 sets out requirements that specify the accounting treatment for assets held for sale, and the presentation and disclosure of discontinued operations.

IFRS 5 requires assets that meet the criteria to be classified as held for sale are:

- measured at the lower of carrying amount and fair value less costs to sell;
- not depreciated; and
- presented separately on the face of the statement of financial position.

Additionally, the results of discontinued operations must be presented separately in the statement of profit or loss.

IFRS 5 identifies three classes of item that might be described as held for sale. These classes are of an increasing level of sophistication:

- non-current assets;
- disposal groups; and
- discontinued operations.

Disposal group

Definition

Disposal group – a group of assets to be disposed of in a single transaction, and any liabilities directly associated with those assets that will be transferred in the transaction.

A disposal group may be a group of cash-generating units, a single cash-generating unit, or part of a cash-generating unit.

Some disposal groups might fall into the definition of a discontinued operation.

2.2 Scope of IFRS 5

Classification and presentation

The classification and presentation requirements of IFRS 5 apply to all recognised non-current assets and to all disposal groups.

Measurement

The measurement requirements of IFRS 5 apply to all recognised non-current assets and disposal groups except for:

- deferred tax assets (*IAS 12: Income Taxes*).
- assets arising from employee benefits (*IAS 19: Employee Benefits*).
- financial assets within the scope of *IFRS 9: Financial Instruments*.
- non-current assets that are accounted for in accordance with the fair value model in *IAS 40: Investment Property*.
- non-current assets that are measured at fair value less estimated point-of-sale costs in accordance with *IAS 41: Agriculture*.
- contractual rights under insurance contracts as defined in *IFRS 17: Insurance Contracts*.

Comment on the scope of IFRS 5

The scope of IFRS 5 is a little complicated.

A non-current asset that is scoped out of IFRS 5 for measurement purposes may fall within the classification and presentation rules.

Such a non-current asset might be part of a disposal group. In this case the measurement rules of IFRS 5 apply to the disposal group as a whole but not to the scoped out assets within the group which are measured individually according to the rules set out in their own standards.

Abandonment of non-current assets

Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be:

- used to the end of their economic life; or
- closed rather than sold.

A non-current asset (or disposal group) that is to be abandoned must not be classified as held for sale.

3 CLASSIFICATION OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) AS HELD FOR SALE

Section overview

- Rule
- Criteria
- Sale expected in over 1 year

3.1 Rule

A non-current asset (or disposal group) must be classified as held for sale when its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

3.2 Criteria

The following conditions must apply at the reporting date for an asset (or disposal group) to be classified as held for sale:

- it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups);
- the sale must be highly probable, that is:
  - the appropriate level of management must be committed to a plan to sell the asset (or disposal group);
  - an active programme to locate a buyer and complete the plan must have been initiated; and
  - the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value;
- the sale must be expected to be completed within one year from the date of classification (except in limited circumstances) and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If the criteria are met for a non-current asset (or disposal group) after the reporting date but before the authorisation of the financial statements for issue, that asset must not be classified as held for sale as at the reporting date.

However, the entity is required to make certain disclosures in respect of the non- current asset (or disposal group).

Example: Classification of asset as held for sale

Entity R had the following asset at 31 March Year 4.

A property that it offered for sale for ₦5 million during June Year 3.

The market for this type of property has deteriorated and at 31 March Year 4 a buyer had not yet been found.

Management does not wish to reduce the price because it hopes that the market will improve.

Shortly after the year end (after 31 March Year 4) the entity received an offer of ₦4 million and the property was eventually sold for ₦3.5 million during May Year 4, before the financial statements were authorised for issue.

Analysis as at 31 March Year 4

The property cannot be classified as 'held for sale'.

A non-current asset qualifies as 'held for sale' if it is available for immediate sale in its present condition and actively marketed for sale at a price that is reasonable in relation to its current fair value.

The property had not been sold at the year-end although it had been on the market for some time. It appears that the reason for this was that management were asking too high a price; therefore the price is not reasonable in relation to its current fair value.

Example: Classification of asset as held for sale

Entity R had the following asset at 31 March Year 4.

Plant with a carrying value of ₦2.5 million.

At 31 March Year 4 the entity had ceased to use the plant but was still maintaining it in working condition so that it could still be used if needed.

Entity R sold the plant on 14 May Year 4.

Analysis as at 31 March Year 4

The plant cannot be classified as 'held for sale'.

At the year-end management had not made a firm commitment to sell the plant. Even though the plant was sold just after the year-end, IFRS 5 prohibits the classification of non-current assets as 'held for sale' if the criteria are met after the end of the reporting period and before the financial statements are signed.

3.3 Sale expected in over 1 year

Sometimes circumstances might extend the period to complete the sale beyond a year. This does not preclude an asset (or disposal group) from being classified as held for sale as long as:

- the delay is caused by events or circumstances beyond the entity's control; and
- there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group).

IFRS 5 sets out detailed guidance on when this is deemed to be the case.

4 MEASUREMENT OF NON-CURRENT ASSETS (OR DISPOSAL GROUPS) CLASSIFIED AS HELD FOR SALE

Section overview

- Measurement of non-current assets and disposal groups held for sale
- Allocation of an impairment loss on a disposal group
- Subsequent remeasurement
- Changes to a plan of sale

4.1 Measurement of non-current assets and disposal groups held for sale

Assets held for sale and disposal groups should be measured at the lower of:

- their carrying amount (i.e. current values in the statement of financial position, as established in accordance with accounting standards and principles), and
- fair value less costs to sell.

If the value of the 'held for sale' asset is adjusted from carrying amount to fair value less costs to sell, any impairment should be recognised as a loss in the statement of profit or loss for the period unless the asset to which it relates is carried at a previously recognised revaluation surplus. In this case the loss is taken to other comprehensive income to the extent that it is covered by the previously recognised surplus on that asset. Any amount not covered is recognised in the statement of profit or loss.

A non-current asset must not be depreciated (or amortised) while it is classified as 'held for sale' or while it is part of a disposal group that is held for sale.

Example: Impact of classification as held for sale

An asset is reclassified as 'held for sale', when its carrying amount is ₦20 million.

Its fair value less estimated costs to sell is ₦17 million.

The asset should be revalued at ₦17 million and a loss of ₦3 million should be reported in the period.

If the carrying amount is less than the fair value less costs to sell there is no impairment. In this case there is no adjustment to the carrying amount of the asset. (A gain is not recognised on reclassification as held for sale).

Example: Impact of classification as held for sale

An asset is reclassified as 'held for sale', when its carrying amount is ₦20 million.

Its fair value less estimated costs to sell is ₦24 million.

The asset 'held for sale' should not be remeasured and should continue to be carried at ₦20 million.

A gain on disposal will be included in profit for the period when the disposal actually occurs.

Example: Accounting on reclassification and subsequent disposal

A machine was purchased on 1 January Year 1 for ₦80,000. It had a useful life of 8 years and no residual value.

On 31 December Year 4 the machine was classified as held for sale. On this date the machine's fair value was estimated at ₦50,000 and the costs to sell were estimated at ₦1,000

The machine was sold for ₦48,000 on 30 June Year 5.

The machine would be accounted for in Year 4 and Year 5 are as follows:

Year 4

The asset held for sales is carried at the lower of:

Carrying amount:	₦
Cost	80,000
Depreciation up to the point of reclassification 80,000 × 4 years/8years	(40,000)
	40,000
Fair value less costs to sell (₦50,000 – ₦1,000)	49,000

The machine therefore remains at its carrying value of ₦40,000.

Year 5

The asset is sold to give the following profit on disposal:

	₦
Proceeds	48,000
Carrying amount	(40,000)
	8,000

Example: Accounting on reclassification and subsequent disposal

A machine was purchased on 1 January Year 1 for ₦80,000. It had a useful life of 8 years and no residual value.

On 31 December Year 4 the machine was classified as held for sale. On this date the machine's fair value was estimated at ₦41,000 and the costs to sell were estimated at ₦2,000.

The machine was sold for ₦37,500 on 30 June Year 5.

The entries in the statement of profit or loss for Year 4 and Year 5 are as follows:

Year 4

The asset held for sales is carried at the lower of:

Carrying amount:	₦
Cost	80,000
Depreciation up to the point of reclassification 80,000 × 4 years/8years	(40,000)
	40,000
Fair value less costs to sell (₦41,000 – ₦2,000)	39,000

The machine is therefore written down to ₦39,000.

The statement of profit or loss for Year 4 will include an impairment loss of ₦1,000 (₦40,000 – ₦39,000).

Year 5

The asset is sold to give the following loss on disposal:

	₦
Proceeds	37,500
Carrying amount	(39,000)
	1,500

4.2 Allocation of an impairment loss on a disposal group

IFRS 5 requires that if an impairment loss is recognised for a disposal group, the loss should be allocated to reduce the carrying amounts of those non-current assets in the disposal group (that are within the scope of the IFRS 5 measurement rules) in the following order:

- goodwill; then
- other non-current assets pro-rated on the basis of their carrying values.

Example: Allocation of impairment loss in a disposal group

An entity has decided to dispose of a group of its assets.

The carrying amount of the assets immediately before the classification as held to sale were as follows:

	₦
Goodwill	20,000
Property, plant and equipment (carried at re-valued amounts)	52,000
Property, plant and equipment (carried at cost)	80,000
Inventory	21,000
Financial assets	17,000
Total	190,000

The entity estimates that the 'fair value less costs to sell' of the disposal group is ₦160,000.

This means that the entity must recognise an impairment loss of ₦30,000 (₦190,000 - ₦160,000).

Allocation of the impairment loss:

The first ₦20,000 of the impairment loss reduces the goodwill to zero.

The remaining ₦10,000 of the impairment loss should be allocated to the non-current assets in the disposal group pro rata to their carrying value.

	Carrying amount before allocation	Impairment loss	Carrying amount after allocation
	₦	₦	₦
Goodwill	20,000	20,000	–
Property, plant and equipment (carried at re-valued amounts)	52,000	3,939	48,061
Property, plant and equipment (carried at cost)	80,000	6,061	73,939
Inventory	21,000	–	21,000
Financial assets	17,000	–	17,000
Total	190,000	30,000	160,000

This impairment loss of ₦30,000 will be included in the reported profit or loss from discontinued operations.

4.3 Subsequent remeasurement

Subsequent remeasurement of the non-current asset (or disposal group) might lead to:

- a further impairment loss - which must be recognised; or
- a gain - which is recognised but only to the extent that it is covered by a previously recognised impairment loss.

4.4 Changes to a plan of sale

If an asset (or disposal group) has been classified as held for sale, but the criteria are no longer met, it must be removed from this classification.

Such an asset is measured at the lower of:

- the amount at which it would have been carried if it had never been classified as held for sale (i.e.: its carrying amount before it was classified as held for sale as adjusted for any depreciation, amortisation or revaluations that would have been recognised if it had not been so classified); and
- its recoverable amount at the date of the subsequent decision not to sell.*

Any necessary adjustment to the carrying amount is recognised in income from continuing operations, in the same statement of profit or loss caption used to present a gain or loss on assets held for sale.

5 PRESENTATION AND DISCLOSURE

Section overview

- Assets (or disposal groups) held for sale

5.1 Assets (or disposal groups) held for sale

Statement of financial position presentation

Non-current assets classified as held for sale are presented separately from other assets in the statement of financial position.

The assets and liabilities of a disposal group classified as held for sale are presented separately from other assets and liabilities in the statement of financial position. These assets and liabilities must not be offset and presented as a single amount.

The major classes of assets and liabilities classified as held for sale must be separately disclosed either on the face of the statement of financial position or in the notes.

This disclosure is not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

Comparatives are not restated to reflect the classification in the statement of financial position for the latest period presented.

Gains or losses

Any gain or loss on the remeasurement of a non-current asset (or disposal group) classified as held for sale that does not meet the definition of a discontinued operation is included in profit or loss from continuing operations.

The gain or loss recognised on measuring or remeasuring a non-current asset (or disposal group) classified as held for sale is disclosed. If it is not presented separately on the face of the statement of profit or loss, the caption that includes that gain or loss must also be disclosed.

Other disclosures

The following information must be disclosed in the notes in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

- a description of the non-current asset (or disposal group);
- a description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal;
- if applicable, the segment in which the non-current asset (or disposal group) is presented in accordance with ***IFRS 8 Operating segments***.

Changes to a plan of sale

When this occurs the following must be disclosed:

- a description of the facts and circumstances leading to the decision; and
- the effect of the decision on the results of operations for the period and any prior periods presented.

6 DISCONTINUED OPERATIONS

Section overview

- Discontinued operation
- Definition of discontinued operations
- Presentation and disclosure of discontinued operations
- Other disclosures

6.1 Discontinued operation

IFRS 5 Non-current assets held for sale and discontinued operations sets out requirements for disclosure of financial information relating to discontinued operations.

The reason for requiring disclosure of information about discontinued operations is as follows:

- Closing down some operations will affect the future financial prospects of the entity.
- It is therefore appropriate that users of the financial statements should be provided with relevant information about the discontinuation. This will help them to make a more reliable prediction of the future performance of the entity.

This information can be produced by providing information about discontinued operations separately from information about continuing operations.

6.2 Definition of discontinued operations

A discontinued operation is a disposal group that satisfies extra criteria. (IFRS 5 does not say as much but this is a helpful way to think of it).

Definition

Discontinued operation - A component of an entity that either has been disposed of or is classified as held for sale and:

1. represents a separate major line of business or geographical area of operations,
2. is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or
3. is a subsidiary acquired exclusively with a view to resale.

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for Financial Reporting purposes, from the rest of the entity.

If an entity disposes of an individual non-current asset, or plans to dispose of an individual asset in the immediate future, this is not classified as a discontinued operation unless the asset meets the definition of a 'component of an entity'. The asset disposal should simply be accounted for in the 'normal' way, with the gain or loss on disposal included in the operating profit for the year.

An operation cannot be classified as discontinued in the statement of financial position if the criteria for classifying it as discontinued are met after the end of the reporting period.

For example, suppose that an entity with a financial year ending 30 June shuts down a major line of business in July and puts another major line of business up for sale. It cannot classify these as discontinued operations in the financial statements of the year just ended in June, even though the financial statements for this year have not yet been approved and issued.

A disposal group might be, for example, a major business division of a company.

For example a company that operates in both shipbuilding and travel and tourism might decide to put its shipbuilding division up for sale. If the circumstances meet the definition of 'held for sale' in IFRS 5, the shipbuilding division would be a disposal group held for sale.

6.3 Presentation and disclosure of discontinued operations

Presentation in the statement of profit or loss

The following must be disclosed for discontinued operations:

- a single amount on the face of the statement of profit or loss comprising the total of:
  - the post-tax profit or loss of discontinued operations; and
  - the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.
- an analysis of this single amount:
  - the revenue, expenses and pre-tax profit or loss of discontinued operations;
  - the related income tax expense;
  - the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation; and
  - the related income tax expense.
- The analysis may be presented in the notes or on the face of the statement of profit or loss. (If presented on the face of the statement of profit or loss it must be presented in a section identified as relating to discontinued operations).

The analysis is not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

- the net cash flows attributable to the operating, investing and financing activities of discontinued operations.

These disclosures may be presented in the notes or on the face of the financial statements.

These disclosures are not required for disposal groups that are newly acquired subsidiaries that are classified as held for sale on acquisition.

Comparatives

Comparatives must be restated for these disclosures so that the disclosures relate to all operations that have been discontinued by the reporting date for the latest period presented.

Example: Presentation of discontinued operations in the statement of profit or loss

Information relating to discontinued operations might be presented as follows.

Statement of profit or loss

X Limited: Statement of profit or loss for the year ended 31 December 20X9

	20X9	20X8
	₦000	₦000
Continuing operations		
Revenue	9,000	8,500
Cost of sales	(5,100)	(4,700)
Gross profit	3,900	3,800
Other income	50	100
Distribution costs	(1,200)	(1,000)
Administrative expenses	(1,400)	(1,200)
Other expenses	(150)	(200)
Finance costs	(300)	(300)
Profit before tax	900	1,200
Income tax expense	(300)	(400)
Profit for the period from continuing operations	600	800
Discontinued operations		
Profit for the period from discontinued operations	250	180
Profit for the period	850	980

Note

The single figure of ₦250,000 for after-tax profit or loss from discontinued operations should be analysed in a note to the accounts. Alternatively, the analysis could be given on the face of the statement of profit or loss.

Presentation in the statement of financial position

Non-current assets classified as held for sale must be disclosed separately from other assets in the statement of financial position.

Similarly, assets and liabilities that are part of a **disposal group held for sale** must be disclosed separately from other assets and liabilities in the statement of financial position.

This also applies to the assets and liabilities of a discontinued operation.

Example: Presentation of discontinued operations in the statement of financial position

An entity has two disposal groups held for sale:

	Disposal group Group 1	Group 2	Total
	₦000	₦000	₦000
Property, plant and equipment	600	300	900
Liabilities	(50)	(20)	(70)

Information relating to discontinued operations might be presented as follows.

Statement of financial position

	₦000
Assets	
Non-current assets	2,000
Current assets	720
Non-current assets classified as held for sale (see above)	900
Total assets	3,620
Equity and liabilities	
Share capital	1,000
Reserves	1,950
Total equity	2,950
Non-current liabilities	400
Current liabilities	200
Liabilities directly associated with non-current assets classified as held for sale (see above)	70
Total liabilities	670
Total equity and liabilities	3,620

Note: In this summarised statement of financial position, the non-current assets classified as 'held for sale' are the sum of the non-current assets of disposal groups 1 and 2 (₦600,000 + ₦300,000).

Similarly the 'liabilities directly associated with non-current assets classified as held for sale' are the sum of the liabilities for disposal groups 1 and 2.

In the statement of financial position, the comparative figures for the previous year are not restated. The amount for discontinued operations in the previous year does not include discontinued items for the current year. The presentation in the statement of financial position therefore differs from the presentation in the statement of profit or loss.

6.4 Other disclosures

Adjustments to carrying amounts of discontinued operations

Sometimes there is a need to adjust amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period. For example, circumstances in which these adjustments may arise include the resolution of uncertainties relating to:

- the disposal (e.g. purchase price adjustments; or
- obligations retained by the seller (e.g. environmental and product warranty obligations).

Such adjustments are classified separately in discontinued operations and the nature and amount of the adjustments are disclosed.

Note on discontinued operations and the statement of cash flows

IFRS 5 states that in the **statement of cash flows**, there should be separate disclosure of the net cash flows in the period attributable to operating activities, investing activities and financing activities of the discontinued operations.

These disclosures may be presented either on the face of the statement of cash flows or in the notes to the financial statements.

Additional disclosures

Additional disclosures about discontinued operations must be included in the notes to the financial statements. These include:

- a description of the non-current asset or disposal group;
- a description of the facts and circumstances of the sale; and
- in the case of operations and non-current assets 'held for sale', a description of the facts and circumstances leading to the expected disposal and the expected manner and timing of the disposal.

7 JUDGEMENTS – IFRS 5

IFRS 5: Areas of judgement and estimate

Disclosure about assets held for sale and discontinued operations, is intended to help users understand the implications for future results and cash flows. The classification is based on actions taken by management at or before the reporting date and expectation that a sale will be achieved.

Application of this standard requires different judgements and estimates to be made which would have an impact on figures reported in the financial statements.

These include the following:

- Whether the held for sale criteria are satisfied (several judgements); and
- Whether a disposal is a discontinued operation.

8 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Apply the held for sale criteria and identify if an assets is held for sale;
- Measure assets classified as held for sale at the lower of carrying amount and fair value less costs to sell;
- Account for any loss arising on classification of an asset as held for sale;
- Allocated any loss arising to assets within a disposal group classified as held for sale;
- Explain and apply the presentation rules on assets held for sale;
- Explain and apply the presentation rules on disposal groups held for sale; and
- Define and explain the accounting treatment for discontinued operations.

CHAPTER 12

IFRS 16: Leases

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	2	Non- financial assets	
		b	Discuss and appraise accounting treatments of non-current assets such as: Property, Plant and Equipment - IAS 16; Intangible Assets - IAS 38; Investment Properties - IAS 40; Leases - IFRS 16; Non-Current Assets Held for Sale - IFRS 5; Inventories – IAS 2; Agriculture – IAS 41; Accounting for Government Grants and Disclosure of Government Assistance – IAS 20; and Borrowing Costs – IAS 23.
	3	Non-financial liabilities	
		b	Appraise accounting treatments of non-financial liabilities such as Employees' Benefits – IAS 19; Share Based Payment – IFRS 2; Income Tax – IAS 12; Provisions, Contingent Liabilities and Contingent Assets – IAS 37; and Leases - IFRS 16.

IFRS 16 is an examinable document

Exam context

This chapter explains the accounting treatment for leases from the point of view of the lessee and the lessor.

This standard was published in 2016 as a replacement for IAS 17. It changes lessee accounting but lessor accounting is the same as under the previous standard.

At the end of this chapter, you should be able to:

- Prepare and present extracts of financial statements in respect of lessee accounting
- Prepare and present extracts of financial statements in respect of lessor accounting
- Prepare and present extracts of financial statements in respect of sale and lease back arrangements.

1 INTRODUCTION AND DEFINITIONS

Section overview

- Leases
- Background to IFRS 16
- Scope of IFRS 16
- Inception and commencement
- Identifying a lease
- Lease term
- Lease payments
- Residual values
- Interest rate implicit in the lease

1.1 Leases

IFRS 16 prescribes the accounting treatment of leased assets in the financial statements of lessees and lessors.

Definition: Lease

Lease: A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

A lease is a way of obtaining a use of an asset, such as a machine, without purchasing it outright. The company that owns the asset (the lessor) allows another party (the lessee) to use the asset for a specified period of time in return for a series of rental payments.

1.2 Background to IFRS 16

Leases give lessees the right to use assets in return for the lessees accepting an obligation to make a series of payments to the owner of the asset, the lessor.

The previous accounting rules set out in *IAS 17: Leases* focused on identifying leases that were economically similar to purchasing the asset being leased.

When this was the case, the lease was classified as a finance lease and reported on the lessee's statement of financial position. All other leases were classified as operating leases and were not reported on the lessee's statement of financial position.

The problem

Operating leases gave lessees the right to use assets and impose obligations on the lessee to pay fort his right in the same way as finance leases. The rights and obligations under operating leases often satisfied the definitions of assets and liabilities set out in the conceptual framework yet these were not recognised on the statement of financial position. Consequently, a lessee's statement of financial position provided a misleading picture about leverage and the assets that the lessee uses in its operations.

The 2013 World Leasing Yearbook reported that new leases entered into worldwide in 2011 amounted to almost ₦800 billion but under the previous rules the majority

of those leases were not reported on a lessee's statement of financial position.

Illustration:

The US Securities and Exchange Commission (SEC) estimated that US public companies had approximately ₦1.25 trillion of off-balance-sheet undiscounted operating lease commitments in 2005.

Conclusion

The distinction between operating and financial leases is arbitrary and unsatisfactory. IAS 17 did not provide for the recognition in lessees' balance sheets of material assets and liabilities arising from operating leases.

Comparability (and hence usefulness) of financial statements will be enhanced by replacing the old treatment with an approach that applied the same requirements to all leases. IFRS 16 removes the finance lease, operating lease distinction for lessees. The new rules require a lessee to recognise all leases on its statement of financial position (with certain exceptions).

IFRS 16 does not change how lessors should account for leases. Lessors still must classify leases as either finance leases or operating leases and account for them accordingly in the same way as before.

1.3 Scope of IFRS 16

IFRS 16 applies to all leases except for:

- leases to explore for or use minerals, oil etc.;
- leases of biological assets (IAS 41);
- service concession arrangements (IFRIC 12);
- licences of intellectual property granted by a lessor (within the scope of IFRS 15); and
- rights held under licensing agreements within the scope of IAS 38 e.g. patents and copyrights (a lessee can, but is not required to, apply IFRS 16 to leases of other intangible assets).

IFRS 16 specifies the accounting for an individual lease. However, as a practical expedient the rules can be applied to a portfolio of leases with similar characteristics as long as there is a reasonable expectation that the effects on the financial statements would not differ materially from applying the rules to the individual leases of the portfolio.

A lease might cover the use of several assets. Such a lease might be split into separate lease components. The right to use an asset is a separate lease component if both:

- the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to it; and
- the asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

1.4 Inception and commencement

Definitions: Inception date of the lease

The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

This is where the parties to the lease contract commit to the terms of the contract.

- Contracts must be assessed at the inception date to find out if they are a lease or if they contain a lease.
- A lessor must identify the type of lease in a contract (finance or operating) at the date of inception.

Definition: Commencement date of a lease

The date on which a lessor makes an underlying asset available for use by a lessee.

This is the date that a lessee starts to use the asset or, at least, is entitled to start to use the asset.

The accounting treatment required is applied to a lease at the commencement date.

1.5 identifying a lease

It is usually straightforward to identify a leasing contract. However, some contracts might not have the legal form of a lease but still might convey a right to use an asset in return for a payment or series of payments. Such contracts (either in whole or in part) are subject to the rules in IFRS 16.

Examples of such contracts might include:

- certain outsourcing arrangements;
- arrangements in the telecommunications industry where suppliers of network capacity sell rights to capacity.

Example: identifying a lease

X Plc manufactures cement and employs drivers who own their own vehicles to transport the cement.

The issue that IFRS 16 would address in this circumstance is whether X Plc is paying the drivers for a delivery service or was leasing the lorries and paying the owners to drive them.

Y Plc pays another company to store chemicals in a refrigerated facility.

The issue that IFRS 16 would address in this circumstance is whether Y Plc is paying for a storage service or is leasing the warehouse in which the chemicals are stored.

The issues addressed by IFRS 16 are as follows:

- how to determine whether an arrangement is (or contains) a lease as defined; and
- if an arrangement is (or contains) a lease, how the payments for the lease should be separated from payments for any other elements in the arrangement.

Existence of a lease

A contract that gives the lessee the right to control the use of an identified asset for a period of time in exchange for consideration is (or contains) a lease.

A period of time may be described in terms of usage. For example, a contract might allow for the use of a vehicle for 20,000 km.

A contract conveys the ***right to control*** the use of an ***identified asset*** when a customer has both of the following:

- the right to obtain substantially all of the economic benefits from use of the identified asset; and
- the right to direct the use of the identified asset.

This assessment of whether the contract is (or contains a lease is made at the made at the inception of the contract and this is only reassessed if the terms and conditions of the contract are changed.

Identified asset

The determination of whether a contract is (or contains) a lease is based on the substance of the arrangement. This requires an assessment of whether:

- fulfilment of the contract depends on the use of a specific asset(s); and
- whether the supplier could use another asset to fulfil his obligation the arrangement does not contain a lease.

An asset might be specified explicitly in a contract or specified implicitly at the time that it is made available for use by the customer.

If a supplier has a substantive right to substitute the asset throughout the period of use, the customer does not have the right to use an identified asset.

Such a right is substantive when the supplier:

- has the practical ability to substitute alternative assets throughout the period of use; and
- would benefit economically from the exercise this right.

The evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract. The evaluation must exclude consideration of future events are not considered likely to occur.

A right to substitute an asset after a particular event or date is not a substantive right as the lessee would have the use of an identified asset up until that event or date.

If a contract allows the supplier to provide a substitute asset in the event of the original asset needing to be repaired, the supplier does not have a substantive right of substitution.

Example: Existence of a lease

X Plc is a catering company.

It enters into a contract with a railway operator (Y Plc) to use a space in a major railway station to provide a catering outlet for a five-year period.

The contract specifies the amount of space and that the space may be located at any one of several platforms in the station.

Y Plc has the right to change the location of the space allocated to X Plc at any time during the period of use.

There would be minimal costs to Y Plc associated with changing the space for the X Plc and there are many areas in the station that could meet the specifications for the space in the contract.

Analysis

Is there an identified asset?	No. The contract specifies the amount of space but the location of the outlet can be changed at Y Plc's discretion.

Conclusion: The contract does not contain a lease.

Right to control

The right to control the use of an identified asset means that the customer has both the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset.

The right to obtain substantially all of the economic benefits from use of an asset must be assessed within the defined scope of a customer's right to use the asset. For example, if a contract for the use of an airplane prohibits the use of the pane for transporting passengers the customer shall consider only the economic benefits from use of the airplane for transporting cargo. The restriction does not affect the ability of the customer to obtain all of the economic benefits from use of an asset.

The right to direct the use of an identified asset throughout the period of use implies that the customer can either:

- direct how and for what purpose the asset is used throughout the period of use; or
- the relevant decisions about how and for what purpose the asset is used are predetermined and cannot be changed by the supplier.

Example: Existence of a lease

X Plc has a contract for the use of 5 articulated lorries for 10 years provided by Y Plc.

X Plc can use the lorries to transport most sort of goods to destinations of its choice and is allowed to split the cabs from the trailers and could put either to alternate use.

If a particular lorry needs to be serviced or repaired the Y Plc must provide a substitute lorry.

Analysis

Is there an identified asset?	Yes. The contract has identified 5 lorries. (These could either be explicitly specified in the contract or implicity identified when Y Plc delivered 5 lorries to X Plc)
Right to obtain right to obtain substantially all of the economic benefits from use of assets?	Yes. X Plc has exclusive use of the lorries over the period of the contract X Plc can direct the use of the lorries over the period of the contract.

Conclusion: The contract is a lease.

Separating payments – lessee

Lease components in a contract are accounted for separately from non-lease components (unless the allowed practical expedient is used – see later). This involves separating payments under the contract into those that relate to the lease and those that relate to other elements.

A lessee must allocate the consideration to the components of a contract on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

The relative stand-alone prices are determined on the basis of the price that a supplier would charge for a similar component.

If an observable stand-alone price is not readily available, one is estimated maximising the use of observable information.

Practical expedient

A lessee can elect (by class of asset) not to separate non-lease components from lease components, in which case the entire contract is accounted for as a lease.

Separating payments – lessor

A lessor must apply the rules in IFRS 15 when allocating consideration to different components of a contract.

1.6 Lease term

IFRS 16 refers to different periods when describing its rules.

Definition: Lease term

The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

A lease may be split into a primary period followed by an option to extend the lease for a further period (a secondary period).

In some cases, the lessee might be able to exercise such an option with a small rental or even for no rental at all. If such an option exists and it is reasonably certain that the lessee will exercise the option, the second period is part of the lease term.

A lease may allow a lessee to terminate the lease before its end. The period covered by the termination option is included in lease term if it is reasonably certain that the lessee will not exercise that option.

Example: Lease term

X plc signed a contract for the lease of an asset

Terms include:

Non-cancellable term = 5 years at an annual rental of ₦100,000

Option to extend for a further 5 years at an annual rental of ₦1

Analysis

X plc is likely to exercise the option

Lease term = 10 years

Example: Lease term

X plc signed a contract for the lease of an asset

Terms include:

Non-cancellable term = 5 years at an annual rental of ₦100,000

Option to extend for a further 5 years at an annual rental of ₦200,000

Analysis

X plc is unlikely to exercise the option

Lease term = 5 years

1.7 Lease payments

In essence, the term ***lease payments*** refer to the payments that a lessee expects to make over a lease term or to the receipts that a lessor expects over the economic life of the asset.

In a straight forward example, the lease payments that a lessee expects to make and a lessor expects to receive are same. However, this is not always the case. The definition of lease payments takes that into account.

Definition: Lease payments

Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) fixed payments (including in-substance fixed payments), less any lease incentives;

(b) variable lease payments that depend on an index or a rate;

(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.

Lease payments as defined are included in the accounting treatment for leases described later in this chapter.

Variable lease payments that do not depend on an index or a rate are not lease payments as defined. For example, a lease term that required the payment of a percentage of lessee's sales revenue to the lessor is not a lease payment. Such amounts would be recognised in profit or loss and would be part of lease accounting.

1.8 Residual values

When a company that owns an asset leases it to another party they have two interests in that asset:

- ❑ It gives them a right to receive a series of rentals over the lease term; and
- ❑ They own the asset at the end of the lease.

The value of the asset at the end of the lease is called its residual value. This figure might be guaranteed by the lessee. This means that if the asset is not worth the amount guaranteed, the lessee must pay the lessor the shortfall.

On the other hand the residual value might not be guaranteed.

Definition: Residual value guarantee and unguaranteed residual value

Residual value guarantee: A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.

Unguaranteed residual value: That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

The guaranteed and unguaranteed residual values might influence the lessor's classification of a lease and therefore how it is accounted for.

1.9 Interest rate implicit in the lease

Definition: Interest rate implicit in the lease

Interest rate implicit in the lease: The rate of interest that causes:

(a) the present value of the lease payments and the unguaranteed residual value; to equal

(b) the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

The interest rate implicit in the lease is the IRR of the cash flows from the lessor's viewpoint. It is the rate that equates the future cash inflows for the lessor to the amount that the lessor invested in the asset.

Example: Interest rate inherent in the lease

Y Plc leases an asset to X plc.

The asset cost Y Plc ₦426,494.

X Plc must pay five annual rentals of ₦100,000 in arrears.

X Plc must also guarantee the residual value of the asset at the end of the lease term to be ₦40,000.

The interest rate implicit in the lease is calculated as follows:

Year	Cash flow	Discount factor at 7%	Present value at 7%	Discount factor at 9%	Present value at 9%
0	(426,494)	1.000	(426,494)	1,000	(426,494)
1 – 5	100,000	4.100	410,000	3.890	389,000
5	40,000	0.713	28,520	0.650	26,000
NPV			12,026		(11,494)

Using

$$IRR = A\% + \left(\frac{NPV_A}{NPV_A - NPV_B}\right) \times (B - A)\%$$

$$IRR = 7\% + \left(\frac{12,026}{12,026 + 11,494}\right) \times (9 - 7)\%$$

$$IRR = 7\% + \left(\frac{12,026}{23,520}\right) \times 2\%$$

$$IRR = 7\% + 1.02\% = 8.02\%$$

$$IRR = 8\%$$

It is unlikely that you will have to calculate the interest rate implicit in the lease in an exam question. The working has been provided here to illustrate the definition.

The impact of rentals paid in advance on the interest rate implicit in the lease

If two leases are identical except that the rentals are in arrears for one (as above) and in advance for the other, the interest rates implicit in each will be different.

The lease for which the payments are in advance will be higher than the lease for which the payments are in arrears. This is because, although the total cash flows to and from the lessor will be the same, if payment is in advance they will be received by the lessor (paid by the lessee) over a shorter period. Thus although the total interest is the same it is recognised more quickly in the lease for which the payments are in advance.

Example: Interest rate inherent in the lease

Y Plc leases an asset to X plc.

The asset cost Y Plc ₦426,494.

X Plc must pay five annual rentals of ₦100,000 in advance.

X Plc must also guarantee the residual value of the asset at the end of the lease term to be ₦40,000.

The interest rate implicit in the lease is calculated as follows:

Year	Cash flow	Discount factor at 10%	Present value at 10%	Discount factor at 13%	Present value at 13%
0	(426,494)	1.000	(426,494)	1,000	(426,494)
0	100,000	1.000	100,000	1,000	100,000
1 – 4	100,000	3.170	317,000	2.974	297,400
4	40,000	0.683	27,320	0.613	24,520
NPV			17,826		(4,574)

Using

$$IRR = A\% + \left(\frac{NPV_A}{NPV_A - NPV_B}\right) \times (B - A)\%$$

$$IRR = 10\% + \left(\frac{17,826}{17,826 + 4,574}\right) \times (13 - 10)\%$$

$$IRR = 12.4\%$$

Initial direct costs

The definition of interest rate implicit in the lease makes reference to incremental initial direct costs.

Definition: Initial direct costs

Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.

Both the lessor and the lessee might incur initial direct costs. The calculation of the interest rate implicit in the lease is from the lessor's viewpoint. Therefore, the initial direct costs that feature in this calculation are those of the lessor.

The accounting treatment for initial direct costs will be explained later.

2 LESSEE ACCOUNTING

Section overview

- Initial recognition
- Subsequent measurement of the asset
- Subsequent measurement of the liability
- Allocating the finance charge (interest)
- Current and non-current elements of the lease liability
- Lease payments made in advance
- Other issues
- Presentation
- Disclosure

2.1 Initial recognition

A lease is capitalised at the commencement of the lease term. This involves the recognition of the asset that is subject to the lease (the underlying asset or right-of-use asset) and a liability for the future lease payments.

The initial double entry is based on the lease liability but the asset might also contain other components in its initial measurement.

Illustration: Double entry (in part) on initial recognition of a lease

	Debit	Credit
Asset	X	
Lease liability		X

Initial measurement of the lease liability

The lease liability is measured at the commencement date as the present value of the lease payments not yet paid at that date.

The lease payments are discounted using the interest rate implicit in the lease or, if that rate cannot be readily determined, the lessee's incremental borrowing rate is used.

Definition: Lessee's incremental borrowing rate

Lessee's incremental borrowing rate: The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

The liability is the capital amount (the principal) that the lessee will have to pay back to the lessor over the term of the lease. It is the present value of the lessee's lease payments.

Example: Initial measurement of a lease liability

X plc enters into a lease. The following information is relevant:

X Plc must pay five annual rentals of ₦100,000 in arrears.

X Plc must also guarantee the residual value of the asset at the end of the lease term to be ₦40,000.

X Plc incurs initial direct costs of ₦5,000.

The interest rate implicit in the lease is 8%.

The lease liability is measured initially as follows:

Year	Cash flow	Discount factor at 8%	Present value at 8%
1 – 5	100,000	3.993	399,271
5	40,000	0.683	27,223
			426,494

The initial measurement of the lease liability is ₦426,494. (Note: This has been measured without rounding the discount factors).

The amount paid before the commencement date and the initial direct costs are not included in the measurement of the liability.

Initial measurement of the right-of-use asset

The right-of-use asset is measured at the commencement date as follows:

Illustration: Initial measurement of right-of-use asset

	₦
Initial measurement of the lease liability	X
Lease payments made at or before the commencement date (less lease incentives received)	X
Initial direct costs incurred (by the lessee)	X
Estimate of the costs of dismantling and removing the asset and restoring the site where it is located (when the entity has an obligation to dismantle and remove the asset at the end of its life)	X
	X

Example: Initial measurement of a lease

X plc enters into a lease. The following information is relevant: X

Plc must pay five annual rentals of ₦100,000 in arrears.

X Plc must also guarantee the residual value of the asset at the end of the lease term to be ₦40,000.

X Plc incurs initial direct costs of ₦5,000.

The interest rate implicit in the lease is 8%.

The double entries to account for this lease are as follows:

	Dr	Cr
On initial recognition		
Right-of-use asset	426,494	
Lease liability		426,494
Right-of-use asset	5,000	
Cash		5,000

The right-of-use asset is measured as follows on initial recognition:

	₦
Initial measurement of the lease liability	426,494
Initial direct costs (lessee's)	5,000
	431,494

2.2 Subsequent measurement of the asset

After the commencement date, a right-of-use asset is measured using a cost model unless it is a type of asset for which an alternative measurement model is being used.

- If a lessee uses the *IAS 40: Investment property* fair value model for its investment properties, that model **must be used** for right-of-use assets that meet the definition of investment property; and
- If a lessee applies the revaluation model in *IAS 16: Property, plant and equipment* to a class of property, plant and equipment it may elect to apply the same accounting treatment to all right-of-use assets that relate to that class.

Cost model

The cost model is used in the usual way by applying the depreciation requirements in *IAS 16: Property, plant and equipment*.

The asset is measured as follows using the cost model:

Illustration: Carrying amount of a right-of-use asset

	₦
Non-current asset at cost	X
Less accumulated depreciation and accumulated impairment loss	(X)
Adjustments arising on remeasurement of the lease liability (see later)	X/(X)
Carrying amount	X

An asset is depreciated from the commencement date to the end of its useful life when:

- the lease transfers ownership of the underlying asset to the lessee by the end of the lease term; or
- if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option.

In other cases the asset is depreciated from the commencement date to the earlier of:

- the end of its useful life; or
- the end of the lease term.

Example: Subsequent measurement of the asset

X Plc enters into a 5 year lease of a machine on 1 January Year 1.

The lease liability at the commencement of the lease was ₦426,494 and X Plc incurred initial direct costs of ₦5,000 when arranging the lease.

X Plc has guaranteed the residual value of the asset at the end of the lease term at ₦40,000.

The estimated useful life of the asset is 5 years.

The accounting policy for similar owned machines is to depreciate them over their useful life on a straight line basis.

Annual depreciation charge:

Initial cost:	₦
Lease liability on initial measurement	426,494
Initial direct costs	5,000
	431,494
Residual value	(40,000)
Depreciable amount	391,494
Useful life (shorter of the lease term and the useful life)	5 years
Annual depreciation charge	78,299

The rules in *IAS 36: Impairment of assets* apply to right-of-use assets in the usual way.

The leased asset is included in the statement of financial position at its carrying amount (cost less accumulated depreciation) in the same way as similar assets.

2.3 Subsequent measurement of the liability

During each year, the lessee makes one or more lease payments. The payment is recorded in the ledger account as follows.

Illustration: Lease payment

	Debit	Credit
Lease liability	X	
Cash/bank		X

A lease liability is measured as follows at each reporting date:

Illustration: Subsequent measurement of lease liability

	₦
Amount borrowed at the start of the lease (the amount recognised on initial recognition of the lease)	X
Plus: Interest accrued	X
Minus: Repayments (lease payments)	(X)
Repayment of loan principal	(X)
Adjustment on remeasurement of the liability (see later)	X
Amount owed now.	X

In effect, each lease payment consists of two elements:

- a finance charge (interest charge) on the liability; and
- a partial repayment of the liability.

The finance charge is treated as a finance cost in profit or loss for the period. The partial repayment of the lease obligation reduces the amount of the liability that remains unpaid.

Finance charge

The total rental payments over the life of the lease will be more than the amount initially recognised as a liability. The difference is finance charge.

The total finance charge that arises over the life term is the difference between the amount initially recognised as the lease liability and the sum of the lease payments from the standpoint of the lessee.

Illustration: Total finance charge

	₦
Lessee's lease payments (total)	X
Amount on initial recognition	(X)
Total finance charge	X

Example: Total finance charge

X Plc enters into a 5 year lease of a machine on 1 January Year 1.

The lease liability at the commencement of the lease was ₦426,494 and X Plc incurred initial direct costs of ₦5,000 when arranging the lease.

X Plc has guaranteed the residual value of the asset at the end of the lease term at ₦40,000.

Total finance charge

Lessee's lease payments:	₦
Annual rentals (5 × 100,000)	500,000
Guaranteed residual value	40,000
	540,000
Amount on initial recognition	(426,494)*
Total finance charge (interest)	113,506

* This is the amount of the liability, The asset is recognised at ₦431,494.

The finance charge (interest) is recognised over the life of the lease by adding a periodic charge to the lease liability with the other side of the entry as an expense in profit or loss for the year.

Illustration:

	Debit	Credit
Statement of profit or loss: interest expense	X	
Lease liability		X

2.4 Allocating the finance charge (interest)

The total finance charge for a leased asset is allocated "so as to provide a constant rate of charge on the outstanding obligation".

This means that as the lease liability decreases at each year-end, the interest charge for the next year will be lower than it was for the previous year.

The periodic rate of interest is the discount rate used in the initial measurement of the lease liability. Using an interest rate to allocate the interest expense is called an actuarial method. (The sum of digits method usually gives an acceptable approximation to the actuarial method).

Actuarial method

Discounting arithmetic is used to calculate the interest rate implicit in the lease and this is used to discount the lease payments to arrive at the lease liability at initial recognition. If the interest rate that is implicit in the lease is not determinable the lessee's incremental borrowing rate is used.

This interest rate used is then applied to the opening balance of the lease liability at the start of each period, in order to calculate the finance charge.

Example: Allocation of the finance charge

X Plc enters into a 5 year lease of a machine on 1 January Year 1.

The lease liability at the commencement of the lease was ₦426,494 and X Plc incurred initial direct costs of ₦5,000 when arranging the lease.

X Plc has guaranteed the residual value of the asset at the end of the lease term at ₦40,000.

The interest rate implicit in the lease is 8%.

Lease liability:

Year	Opening liability	Interest (8%)	Lease payments	Closing liability
1	426,494	34,120	(100,000)	360,614
2	360,614	28,849	(100,000)	289,463
3	289,463	23,157	(100,000)	212,620
4	212,620	17,010	(100,000)	129,630
5	129,630	10,370	(140,000)	0
		113,506		

The interest expense is calculated by multiplying the opening liability by 8% in each year (so as to provide a constant rate of charge on the outstanding obligation).

The lease liability consists of the capital balance outstanding. This can be shown as follows:

Example: Lease liability:

Year	Opening balance	Lease payments	Interest (8%)	Capital repayments	Closing balance
1	426,494	(100,000)	34,120	(65,880)	360,614
2	360,614	(100,000)	28,849	(71,151)	289,463
3	289,463	(100,000)	23,157	(76,843)	212,620
4	212,620	(100,000)	17,010	(82,990)	129,630
5	129,630	(140,000)	10,370	(89,630)	0

The final payment

In the above example the final payment by the lessee is ₦140,000. This is in fact made up of two amounts, the final rental of ₦100,000 and the guaranteed residual value of ₦40,000.

It is worth considering the payment in respect of the guaranteed residual value in a little more detail.

At the end of the lease the asset that is the subject of the lease is transferred back to the lessor. It has been depreciated down to its estimated residual value of ₦40,000.

The transfer is recorded as follows:

Example: Final payment in respect of the guaranteed residual value

	Debit	Credit
Lease liability	40,000	
Right-of-use asset		40,000

In other words the ₦40,000 part of the final year payment to the lessor of ₦140,000 Is not cash but the transfer of the asset.

If the asset is worth less than ₦40,000 the lessee must make good any shortfall. In this case the asset is written down to its value at the date of the transfer (as agreed between the lessee and the lessor) and the lessee will pay cash to the lessor to compensate for any difference.

Example (continued): Final payment in respect of the guaranteed residual value

The asset has a carrying amount of ₦40,000 at the end of the lease but is only worth ₦35,000.

The lessee would make the following double entries.

Write down the asset	**Debit**	**Credit**
Statement of profit or loss	5,000	
Asset under lease		5,000
Pay the lessor the guaranteed residual value		
Lease liability	40,000	
Asset held under lease		35,000
Cash/bank		5,000

2.5 Current and non-current elements of the lease liability

The total liability must be divided between:

- the current liability (amount payable within the next 12 months); and
- the non-current liability.

The easy way to do it is to use the tables to identify the current liability or the non-current liability and then find the other as a balancing figure.

Example: Split of current and non-current liability at the end of year 1

Year	Opening balance	Lease payments	Interest	Capital repayments	Closing balance
1	426,494	(100,000)	34,120	(65,880)	360,614
2	360,614	(100,000)	28,849	(71,151)	289,463
				↑	↑
				This is the current liability	This is the non-current liability

Liability:	**₦**
Current liability	71,151
Non-current liability	289,463
Total liability (for proof)	360,614

2.6 Lease payments made in advance

An earlier section explained that if two leases are identical except that the rentals are in arrears for one and in advance for the other, the interest rates implicit in each will be higher for the lease for which the payments are in advance. This is because although the total lease payments are the same, if payment is in advance they will be received by the lessor (paid by the lessee) over a shorter period.

The overall result should be that the initial right-of-use asset and the total finance charge is the same.

Example: Initial measurement of a lease (payments in advance)

X plc enters into a lease. The following information is relevant:

X Plc must pay five annual rentals of ₦100,000 in advance.

X Plc must also guarantee the residual value of the asset at the end of the lease term to be ₦40,000.

X Plc incurs initial direct costs of ₦5,000.

The interest rate implicit in the lease is 12.37%.

The initial measurement of the liability is as follows:

Year	Cash flow	Discount factor at 12.37%	Present value at 12.37%
1 – 4	100,000	3.014	301,404
4	40,000	0.627	25,090
			326,494

Double entry on initial recognition	**Dr**	**Cr**
Right-of-use asset (as before in section 2.3)	431,494	
Cash (first rental)		100,000
Cash (initial direct costs)		5,000
Lease liability		326,494

Finance charge	**Payments in advance**	**Payments in arrears (see section 2.3)**
Lessee's lease payments:	**₦**	**₦**
Annual rentals (4 × 100,000)	400,000	
Annual rentals (5 × 100,000)		500,000
Guaranteed residual value	40,000	40,000
	440,000	540,000
Amount on initial recognition	(326,494)	(426,494)
Total finance charge (interest)	113,506	113,506

When the lease payments are made at the start of each period instead of the end of the period and payments are discounted using the interest rate implicit in the lease, the total finance charge is the same but the interest rate used is different. (This is not the case if the lease payments are discounted using the lessee's incremental borrowing rate but this will be explained later).

Example: Finance charge allocation (payments in advance)

The finance charge allocation is as follows:

Year	Opening liability	Lease payment	Liability after day 1 payment	Interest (12.37%)	Closing liability
1	326,494	–	326,494	40,387	366,881
2	366,881	(100,000)	266,881	33,013	299,895
3	299,895	(100,000)	199,895	24,727	224,621
4	224,621	(100,000)	124,621	15,379	140,000
5	140,000	(140,000)	0	0	

In the above example, the lease payments are made at the start of each year. The first lease payment has not been included in the initial measurement of the lease liability so there is lease payment shown in year 1.

The lease payment shown in year 2 is on the first day of that year. Therefore, it is deducted from the liability to give an amount upon which interest is charged going forward.

Current and non-current liability

If payments are made annually in advance, the next payment is a current liability. Therefore in the above example the ₦100,000 paid on 1 January Year 2 is a current liability and the balance (₦266,881) is a non-current liability.

Example: Current and non-current liability

Year	Opening liability	Lease payment	Liability after day 1 payment	Interest (12.37%)	Closing liability
1	326,494	–	326,494	40,387	366,881
2	366,881	(100,000)	266,881		

Total current liability | Non-current liability | Total liability

Liability:	**₦**
Current liability	100,000
Non-current liability	266,881
Total liability (for proof)	366,881

The closing liability at the end of year 1 is made up of the interest accrued in year 1 and the capital outstanding which will be paid off in later years. The payment made one day later (at the start of the next year) therefore pays the year 1 interest (₦40,387) and the balance (₦59,613) reduces the capital outstanding.

These elements could be shown separately with the closing liability at the end of year 1 as identified on the previous page (₦366,881) being made up of three parts:

- the interest recognised in year 1 but unpaid at the year-end (₦40,387);
- the current element of the capital owed on the lease (₦59,613); and
- the non-current element of the capital owed on the lease (₦266,881).

Example: Current and non-current liability

Year	Opening liability	Lease payment	Liability after day 1 payment	Interest (12.37%)	Closing liability
1	326,494	–	326,494	40,387	366,881
2	366,881	(100,000)	266,881		

Total current liability | Non-current liability | Current liability due to interest | Total liability

Liability:	₦
Current liabilities	
Interest expense	40,387
Capital element of lease liability	59,613
	100,000
Non-current liability	266,881
Total liability (for proof)	366,881

Practice question **1**

The fair value of an asset, leased under a lease commencing on 1 January Year 1 is ₦10,000.

The lease is for three years with payments of ₦4,021 annually on 1 January Year 1, Year 2 and Year 3.

The interest rate implicit in the lease is 22.25%.

Required

Complete the lease payment table for all three years 1 to 3, and calculate the current liability and the non-current liability at 31 December Year 1 under the actuarial method.

Impact of using the lessee's incremental borrowing rate

The above section illustrated that the initial right-of-use asset and the total finance charge is the same for two leases whose only difference is that payments are made in advance for one and in arrears for the other provided the interest rate implicit in the lease is used to measure the lease liability.

This is not the case if the lessee's incremental borrowing rate is used (because the interest rate implicit in the lease is not readily determinable). This is because the same discount rate would be used for payments in advance and for payments in arrears.

2.7 Other issues

Recognition exemption

A company can elect not to apply the lessee accounting rules to short-term leases (lease with a lease term of 12 months or less) and leases for assets of low value (e.g. lap-tops and mobile phones).

The election must be made by class of short term leases but may be made on an asset by asset basis for low value assets.

If such an election is made, the rental costs of the assets are recognised in profit or loss on a straight line basis or some other systematic basis if that gives a better reflection of the benefit arising from the asset.

Portfolio application

The rules in IFRS 16 set out the accounting rules for individual leases.

However, the rules may be applied to a portfolio of leases similar characteristics. In other words, and entity can account for a number of separate leases as a single lease.

This is only allowed if there is a reasonable expectation that this would not cause the financial statements to differ materially from applying the rules to the individual leases within that portfolio.

2.8 Presentation

Statement of financial position

Right-of-use assets must either be presented separately in the statement of financial position or disclosed in the notes.

If not presented separately, right-of-use assets are included in the same line item as the corresponding underlying assets would be if they were owned and this must be disclosed.

This does not apply to right-of-use assets that meet the definition of investment property, which must be presented in the statement of financial position as investment property.

Lease liabilities must either be presented separately in the statement of financial position or disclosed in the notes. If not presented separately, the line item in which they are included must be disclosed.

Statement of profit or loss

Interest expense on the lease liability must be presented separately (as a component of finance costs) from the depreciation charge for the right-of-use asset.

Statement of cash flows

Cash payments for the principal portion of the lease liability must be classified within financing activities.

Cash payments for the interest portion of the lease liability are classified by applying the requirements in *IAS 7: Statement of Cash Flows* for interest paid.

Short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability are classified within operating activities.

2.9 Disclosure

Information is provided that, together with the information provided in main financial statements gives users a basis to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

Information is disclosed in a single note (or separate section of the financial statements). However, information already presented elsewhere in the financial statements, does not need to be duplicated as long as the information is incorporated by cross-reference in the single note or separate section about leases.

The following must be disclosed:

- ❑ depreciation charge for right-of-use assets by class of underlying asset;
- ❑ interest expense on lease liabilities;
- ❑ expense relating to:
  - short-term leases accounted for by applying the recognition exemption (but not that relating to leases with a lease term of one month or less);
  - leases of low-value assets accounted for by applying the recognition exemption (but not that relating to short-term leases of low-value assets included above);
  - variable lease payments not included in the measurement of lease liabilities;
- ❑ income from subleasing right-of-use assets;
- ❑ total cash outflow for leases;
- ❑ additions to right-of-use assets;
- ❑ gains or losses arising from sale and leaseback transactions; and
- ❑ the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

These disclosures should be given in a tabular format, unless another format is more appropriate. Amounts disclosed must include costs that are included in the carrying amount of another asset during the reporting period.

The *IAS 40: Investment property* disclosures apply to right-of-use assets that meet the definition of investment property.

Disclosure requirements of *IAS 16: Property, plant and equipment* apply to right-of-use assets at revalued in accordance with that standard.

IFRS 7; Financial Instruments: Disclosures requires a maturity analysis for non-derivative financial liabilities. The requirement is to provide information on the contracted undiscounted future cash. A similar disclosure must be provided for lease liabilities separately from the maturity analyses of other financial liabilities. As this is a disclosure of undiscounted cash flows it will not agree with the balance of the liabilities in the statement of financial position which represent discounted amounts. However, the two can be reconciled be deducting future finance charges from the undiscounted amount.

Example: Lease liability maturity analysis

Using the example used in section 2.6 to show the disclosures as at the end of the first year.

lease payments	**Gross**
	₦
No later than 1 year	100,000
Later than 1 year and no later than 5 year (4× 18,000 + 8,000)	340,000
Later than 5 years	nil
	440,000
Less finance charge that relates to future periods (113,506 – 34,120[1]	(79,386)
Present value of lease liabilities (the total lease liability)	360,614

[1] The finance charge that relates to future periods is the total finance charge less the finance charge already expensed.

3 LESSEE ACCOUNTING: REASSESSMENT AND MODIFICATION

Section overview

- Remeasuring the lease liability
- Lease modifications
- Accounting for lease modifications

3.1 Remeasuring the lease liability

Lease liabilities must be remeasured to reflect changes in circumstances.

Circumstances might change over the life of the lease leading to a change in the lease payments. This could be because the lease term changes, perhaps due to a reassessment of whether an option to extend or terminate a lease is made.

Other changes might occur due to a rent review. A review of rentals would be provided in the contract but any revision to the rentals following the review might not have been anticipated in the original forecast of rentals.

A lease liability is remeasured by discounting the revised lease payments:

- using a revised discount rate when there is a change in the lease term or in the assessment of an option to purchase the underlying asset; or
- by discounting the revised lease payments at the original rate when there is a change in the amounts expected to be payable under a residual value guarantee or in future lease payments resulting from a change in an index or a rate used to determine those payments (e.g. following a market rent review).

Example: Remeasuring the lease liability (change in lease term)

X Plc enters into a 5 year lease of a machine on 1 January Year 1.

The lease liability at the commencement of the lease was ₦426,494.

X Plc incurred initial direct costs of ₦5,000 when arranging the lease.

X Plc recognised a right-of-use asset at the commencement of the lease in the amount of ₦431,494 (₦426,494 + ₦5,000).

X Plc has guaranteed the residual value of the asset at the end of the lease term at ₦40,000.

Further information

X Plc has an option to extend the lease term for a further three years at an annual rental of ₦110,000.

At the commencement date, X Plc concluded that it was not reasonably certain to exercise the option so the lease term was determined to be 5 years.

X Plc would not have to guarantee a residual value if it were to exercise the option to extend the lease term.

End of Year 4

X plc's circumstances have changed and it is now reasonably certain that it will exercise the option to extend the lease (meeting the conditions in IFRS 16).

X Plc is unable to determine a revised interest rate implicit in the lease but its incremental borrowing rate is 9%.

Example (continued): Remeasuring the lease liability

The balances in X Plc's at the end of year 4 before the remeasurement of the liability are as follows:

Lease liability at year 4:

Year	Opening liability	Interest (8%)	Lease payments	Closing liability
1	426,494	34,120	(100,000)	360,614
2	360,614	28,849	(100,000)	289,463
3	289,463	23,157	(100,000)	212,620
4	212,620	17,010	(100,000)	129,630

Right-of-use asset at year 4

	₦
Balance on initial recognition	431,494
Less: 4 years depreciation	
(4 × ((₦431,494 – ₦40,000) /5 years)	(313,195)
	118,299

The lease liability is remeasured as follows:

Years (from the end of year 4)	Narrative	Cash flow	Discount factor at 9%	Present value at 9%
1	Year 5 rental on the original lease term	100,000	0.917	91,743
2	Year 1 of the extension of the lease	110,000	0.842	92,585
3	Year 2 of the extension of the lease	110,000	0.772	84,940
4	Year 3 of the extension of the lease	110,000	0.708	77,927
				347,195

Remeasurement at end of year 4

	₦
Remeasured liability	347,195
Liability before adjustment	(129,630)
Remeasurement adjustment	217,565

Example (continued): Remeasuring the lease liability

This is achieved with the following double entry:

	Dr	Cr
Right-of-use asset	217,565	
Lease liability		217,565

The right-of-use asset after this adjustment is as follows:

	₦
Carrying amount before adjustment	118,299
Adjustment	217,565
Carrying amount after adjustment	335,864

X plc would account for the lease over the next four years (the last year of the original term plus the three years of the extension) as follows:

Lease liability over next 4 years

Year	Opening liability	Interest (9%)	Lease payments	Closing liability
1 (5)	347,195	31,248	(100,000)	278,443
2 (6)	278,443	25,060	(110,000)	193,502
3 (7)	193,502	17,415	(110,000)	100,918
4 (8)	100,918	9,083	(110,000)	0

Right-of-use asset at end of next 4 years

	₦
Carrying amount after adjustment	335,864
Depreciation in years (5 to 8)	
4 × (335,864/4 years)	(335,864)
	nil

3.2 Lease modification

Definition: Lease modification

Lease modification: A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

Lease modification is different from the situations addressed by the previous section. A lease modification involves changes to the lease that were not part of the original terms and conditions of a lease.

Example: Lease modification

X Plc leases a building for an initial period of five years with an option to extend the lease for a further three years.

At the commencement date, X Plc concluded that it was not reasonably certain to exercise the option so the lease term was determined to be 5 years.

At the end of the fourth year of the lease X plc's circumstances have changed and it is now reasonably certain that it will exercise the option to extend the lease (meeting the conditions in IFRS 16).

X Plc must remeasure the lease liability but this is **not a lease modification** as it is a change that was part of the original terms and conditions of the lease.

Example: Lease modification

Y Plc leases a building for five years.

At the end of the fourth year of the lease X plc's circumstances have changed and it has contracted with the lessor to extend the lease for a further three years beyond the original lease term.

This is a lease modification as it is a change that was **not** part of the original terms and conditions of the lease.

3.3 Accounting for lease modifications

A lease modification might be accounted for as a new lease depending on circumstances.

A lease modification is accounted for as a new lease if the modification changes the scope of the lease by adding the right to use one or more underlying assets and charges a consideration which is commensurate with the stand-alone selling price of the additional right-of-use and reflects the circumstances of the contract.

Example: Lease modification – new lease

X Plc enters into a 6 year lease for 3 floors of an office block.

At the end of Year 4, X Plc and the lessor agree to amend the original lease for the remaining 2 years to include an additional floor in the same block.

The increase in the lease payments is commensurate with the current market rate for the extra floor as adjusted for a discount to reflect costs saved by the lessor in renting to X Plc. (For example, the lessor would save the marketing costs of finding a new tenant).

Analysis

The modification grants X Plc an additional right to use an underlying asset (an extra floor in the building) and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract.

Conclusion

The modification is a separate lease from the original 6 year lease.

Accounting consequences

X Plc must recognise a right-of-use asset and a lease liability relating to the lease of the additional floor.

There are no adjustments in respect of the original lease of 3 floors as a result of this modification.

If a modification is not accounted for as a separate lease, the lease liability is remeasured by discounting the modified future cash flows using a revised discount rate.

- The lease liability would be reduced by a modification that reduces the scope of the original lease. In that case, right-of-use asset is reduced by the proportionate reduction of the asset with any balance (gain or loss recognised in profit or loss.
- The change in the lease liability for other lease modifications simply results in an adjustment to the right-of-use asset.

Example: Lease modification – reduction in scope (no separate lease)

X Plc enters into a 6 year lease for 3 floors of an office block at ₦100,000 per floor per annum payable in arrears.

The interest rate implicit in the lease could not be readily determined. X Plc's incremental borrowing rate at the commencement date was 5% per annum.

The asset is written off on a straight line basis over the life of the lease.

At the end of Year 4, X Plc and the lessor agree to amend the original lease for the remaining 2 years to reduce the space to 2 floors only.

X Plc's incremental borrowing rate at the date of the modification is 6% per annum.

Analysis

The modification does not result in a new lease as it does not the right to use one or more underlying assets.

Accounting consequences

The accounting treatment is as follows.

The lease liability was measured initially as follows:

Year	Cash flow	Discount factor at 5%	Present value at 5%
1 – 6	300,000	5.076	1,522,800

At end of year 4

The lease liability and right-of-use asset were measured as follows before the adjustment for the modification.

Carrying amount of the asset
(1,522,800 × 2 years/6 years) ₦507,600

Carrying amount of the liability:

Year	Cash flow	Discount factor at 5%	Present value at 5%
1 – 2	300,000	1.859	557,600

The future rentals fall to ₦200,000 and the right-of-use asset falls by 1/3.

The lease liability is remeasured as follows:

Year	Cash flow	Discount factor at 6%	Present value at 6%
1 – 2	200,000	1.833	366,600

The double entry is as follows:

	Dr	Cr
Lease liability 557,600 – 366,600)	191,000	
Right-of-use asset (1/3 × 507,600)		169,200
Profit or loss (balance)		21,800

4 LESS0RS: LEASE CLASSIFICATION

Section overview

- Lessors
- Finance leases and operating leases
- Identifying a finance lease
- Commentary on finance lease indicators
- Leases of land and buildings

4.1 Lessors

Companies might be lessors as a result of a variety of business models.

Finance companies (often banks and their subsidiaries)

Finance companies provide finance for the purchase of assets. In addition they might finance the use of assets through leases.

Finance companies are often associated with finance leases but they also fund large operating leases. Many airlines have use of aircraft through operating leases through finance companies.

Hire companies

These companies own a stock of capital assets which they will lease out for varying periods.

They include:

- tool hire companies;
- plant hire companies; and
- car hire companies.

Hire companies are usually involved in operating leases.

Manufacturer/dealer lessors

Some companies make or buy assets to sell. They may offer to lease the asset out as an alternative to outright sale.

Many motor vehicle manufacturers and dealers do this. Such leases would usually be finance leases (but not necessarily).

Property companies

Many companies own properties which they lease out to others. These companies might apply *IAS 40: Investment Properties* to these assets.

4.2 Finance leases and operating leases

All lessors must classify a lease as either:

- a finance lease; or
- an operating lease.

Definitions

Finance lease: A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating lease: A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Risks may be represented by the possibility of losses from:

- idle capacity;
- technological obsolescence;
- variations in return caused by changes in economic conditions.

Rewards may be represented by the expectation of;

- profitable use of the asset over its economic life;
- gains from increases in value or profits on disposal.

Substance over form

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

The legal form of a finance lease is that the lessor is the legal owner of the leased asset.

The economic substance of a finance lease is that the lessee has all the benefits and costs associated with ownership of the asset. The finance lessee is in the same position as it would have been if it had borrowed money to buy the asset itself. That is why such leases are called finance leases; they provide finance for the use of an asset.

4.3 Identifying a finance lease

The following situations (individually or in combination) would normally lead to a lease being classified as a finance lease:

- At the end of the term of the lease, the legal ownership of the asset will be transferred from the lessor to the lessee, under the terms of the lease agreement;
- The lessee has the option, at a future date, to purchase the asset from the lessor, and the agreed purchase price is substantially lower than the expected fair value of the asset at the date the option to buy can be exercised. (In this situation, it is therefore probable that the lessee will exercise the option to buy the asset);
- The term of the lease is for a major part of the expected economic life of the asset;
- At the inception of the lease, the present value of all the future lease payments amounts to substantially all of the fair value of the leased asset, or more;
- The leased asset is of such a specialised nature that it can only be used by the lessee (without the need for a major modification);
- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

In all these situations, it can normally be concluded that substantially all the risks and rewards incidental to ownership are transferred to the lessee.

These indicators are not always conclusive. Classification should always be based on the substance of the agreement taking account of all information.

Leases are classified at the inception of the lease. Sometimes a lessee and lessor agree to change the provisions of a lease and the changes might be of a sort that would have changed the lease classification if the new terms had been in effect at the inception of the lease. In these cases the revised agreement is regarded as a new agreement over its term.

However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

4.4 Commentary on finance lease indicators

It is not always obvious why the above circumstances indicate that a lease is a finance lease. This section provides an explanation on some of these.

To understand these it is useful to think of the terms from the lessor's viewpoint.

Bargain purchase option

If a lease includes a term whereby the lessee can buy the leased asset at a bargain price at the end of the lease that lease is a finance lease.

If the lessor includes this term in the lease the lessor would expect the lessee to take advantage of it. Therefore the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals and final sale price are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

- The lessee would only do this if it had access to the risks and benefits of ownership.
- In substance, this is just like borrowing the cash and buying the asset.

Therefore, the lease is a finance lease.

Lease is for a major part of the expected economic life of the asset.

If the lessor includes this term in the lease the lessor knows that when the asset is given back to it at the end of the lease, the asset will only have a small value.

Therefore the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

- The lessee would only do this if it had access to the risks and benefits of ownership.
- In substance, this is just like borrowing the cash and buying the asset.

Therefore, the lease is a finance lease.

Specialised nature of the asset

If the lessor includes this term in the lease the lessor knows that when the lease comes to an end it will be unable to lease the asset on to another party.

Therefore the lessor knows that it needs to make sure to recover the cost of the asset together with any related interest during the lease term. The rentals are set at a level which allows it to do this.

Therefore, the lessee will pay the full cash price of the asset together with related finance expense over the lease term.

- The lessee would only do this if it had access to the risks and benefits of ownership.
- In substance, this is just like borrowing the cash and buying the asset.

Therefore, the lease is a finance lease.

PV of future lease payments amounts to substantially all of the fair value of the leased asset

A lease is a finance lease if at the inception of the lease, the present value of all the future lease payments amounts to substantially all of the fair value of the leased asset, or more. (The discount rate to be used in calculating the present value of the lease payments is the interest rate implicit in the lease).

In this case the lessee is paying the full cash price of the asset together with related finance expense over the lease term.

Example: PV of future lease payments

A finance company has purchased an asset to lease out to a manufacturing company.

The asset cost for ₦500,000 and has an economic life of 10 years.

The lease is for 9 years at an annual rental (in arrears) of ₦87,000 per annum.

The interest rate implicit in the lease is 10%.

Analysis: Lessor's view

Time	Narrative	Cash flows	Discount factor (10%)	Present value
1 to 9	Lessor's lease payments	87,000	5.759	501,033

This is more than the fair value of the asset. This lease is a finance lease (also note that the lease is for the major part of the expected economic life of the asset which is another finance lease indicator).

Example: PV of future lease payments

A finance company has purchased an asset for ₦50,000 and will lease it out in a series of leases as follows:

The first lease is to Company A for a period of 4 years at an annual rental of ₦10,000.

After the end of the lease to Company A the asset will be leased to Company B for 3 years at a rental of ₦10,000. Company B is not related to Company A.

At the end of this lease the asset is expected to have an unguaranteed residual value of ₦2,573.

The Interest rate implicit in the lease is 10%.

Analysis: Lessor's view

Time	Narrative	Cash flows	Discount factor (10%)	Present value
1 to 7	Lessor's lease payments	10,000	4.868	48,680

This is 97.4% ($^{48,680}/_{50,000} \times 100$) of the fair value of the asset which most would agree that this was substantially all of the fair value of the asset (though IFRS 16 does not give a numerical benchmark).

This lease is a finance lease.

Practice question **2**

X Plc has leased a cement lorry.

The cash price of the lorry would be ₦3,000,000.

The lease is for 6 years at an annual rental (in arrears) of ₦600,000. The asset is believed to have an economic life of 7 years.

The interest rate implicit in the lease is 7%.

X Plc is responsible for maintaining and insuring the asset.

Required

State with reasons the kind of lease X Plc has entered into.

4.5 Leases of land and buildings

A property lease usually includes both land and buildings. Each element should be classified separately. In other words, a property lease is viewed as a lease of land and a different lease of the building.

Leases of land and buildings are classified as operating or finance leases in the same way as leases of other assets.

Land element

An important consideration is that land normally has an indefinite economic life. This means that the lease term will not normally be for a major part of the life of the asset and the asset will have a significant value at the end of the lease. This implies that the land element of the lease will usually be an operating lease.

This is not always the case. In some parts of the world a property lease might be very long (say 999 years). In a case like this the unguaranteed residual value might be very large but in present value terms is negligible, leading the present value of the lease payments to be substantially all of the fair value of the asset at the inception of the lease. Such a lease could be a finance lease.

Building element

The building is classified as a finance lease or as an operating lease according to the guidance set out and explained in sections 2.2 and 2.3 above.

Splitting the payments

It is necessary to split the rental payments for the land and building into the rental for the land and the rental for the building.

The lease payments are allocated between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception of the lease.

The relative fair value of the leasehold interests is from the point of view of the lessee. This means that the relative fair value of the leasehold interests is not the same as the relative fair value of the land and the building.

Example: Land and buildings

A company leases a property for ₦450,000 per annum (in arrears).

The lease is for 10 years and the useful life of the building is 5 years.

	Land (₦)	Building (₦)
Fair value	2,000,000	500,000
Fair value of leasehold interest	1,000,000	500,000

The rentals are allocated between the land and buildings in the ratio of 1,000,000 to 500,000 or 2 to 1

	₦
Rental for land ($^2/_3 \times$ 450,000)	300,000
Rental for building ($^1/_3 \times$ 450,000)	150,000

If this cannot be done the entire lease must be classified as a finance lease unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

If the land element is immaterial, the land and buildings may be treated as a single unit for the purpose of lease classification. In such a case, the economic life of the building is regarded as the economic life of the entire leased asset.

5 LESSOR ACCOUNTING

Section overview

- Finance lease accounting
- Manufacturer/dealer leases
- Operating lease accounting
- Disclosure

5.1 Finance lease accounting

The lessor does not record the leased asset in his own financial statements because he has transferred the risks and rewards of ownership of the leased asset to the lessee. Instead, he records the amount due to him under the terms of the finance lease as a receivable.

The receivable is described as the net investment in the lease.

Definitions: Net and gross investment in the lease

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Gross investment in the lease is the aggregate of:

(a) the lease payments receivable by the lessor under a finance lease, and

(b) any unguaranteed residual value accruing to the lessor.

An earlier section explained that the interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes:

- the aggregate present value of the lease payments and the unguaranteed residual value; to be equal to;
- the sum of the fair value of the leased asset and any initial direct costs of the lessor.

Therefore the net investment in the lease is the sum of the fair value of the asset plus the initial direct costs.

Initial recognition

The lessor records a receivable for the capital amount owed by the lessee. This should be stated at the amount of the 'net investment in the lease'.

Illustration: Double entry on Initial recognition of a finance lease

	Debit	Credit
Net investment in the lease	X	
Cash/bank		X

For finance leases other than those involving manufacturer or dealer lessors, initial direct costs are included in the initial measurement of the finance lease receivable thus reducing the amount of income recognised over the lease term to below what it would have been had the costs not been treated in this way. The result of this is that the initial direct costs are recognised over the lease term as part of the income recognition process.

Initial direct costs of manufacturer or dealer lessors in connection with negotiating and arranging a lease are excluded from the definition of initial direct costs. As a result, they are excluded from the net investment in the lease.

The treatment of similar costs incurred by manufacturers and dealers is explained later.

Subsequent measurement of the receivable

During each year, the lessor receives payments from the lessor. Each receipt is recorded in the ledger account as follows.

Illustration: Lessor receipts

	Debit	Credit
Cash/bank	X	
Net investment in the lease		X

A finance lease receivable (net investment in the lease) is measured in the same way as any other financial asset. The balance at any point in time is as follows:

Illustration: Net investment in the lease

	₦
Amount loaned at the start of the lease (the amount recognised on initial recognition of the lease)	X
Plus: Interest accrued	X
Minus: Repayments (lease payments or rentals)	(X)
Repayment of loan principal	(X)
Amount owed to the lessor now.	X

In effect, each lease receipt consists of two elements:

- finance income on the receivable; and
- a partial repayment of the receivable (net investment in the lease).

The finance charge is recognised as income in profit or loss for the period. The partial repayment of the lease receivable reduces the amount owed to the lessor.

Finance income

The total rental receipts over the life of the lease will be more than the amount initially recognised as a receivable. The difference is finance income.

The total finance income that arises over the life of the lease is the difference between the amount invested in the lease (the amount loaned plus the initial direct costs) and the sum of all receipts.

Illustration: Total finance income

	₦
Lessor's lease payments	X
Initial direct costs	X
	X
Amount on initial recognition	(X)
Total finance income	X

Example: Total finance income

Ready Finance Plc agreed to lease a machine to X Plc commencing on 1 January Year 1.

The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of ₦18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was ₦80,000 and Ready Finance incurred initial direct costs of ₦2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is ₦10,000. The lessee has guaranteed an amount of ₦8,000.

The interest rate implicit in the lease is 10.798%.

Total finance income

Lessor's lease payments:	₦
Annual rentals (6 × 18,000)	108,000
Guaranteed residual value	8,000
Unguaranteed residual value	2,000
	118,000
Amount on initial recognition	(80,000)
Initial direct costs	(2,000)
	(82,000)
Total finance income	36,000

The finance income is recognised over the life of the lease by adding a periodic return to the net investment in the lease with the other side of the entry as income in profit or loss for the year.

Illustration:

	Debit	Credit
Net investment in the lease	X	
Statement of profit or loss: finance income		X

Calculating and allocating finance income

Finance income is recognised so as to give a constant periodic rate of return on the lessor's net investment in the finance lease.

Example: Calculating and allocating finance income

Ready Finance Plc agreed to lease a machine to X Plc commencing on 1 January Year 1.

The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of ₦18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was ₦80,000 and Ready Finance Plc incurred initial direct costs of ₦2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is ₦10,000. The lessee has guaranteed an amount of ₦8,000.

The interest rate implicit in the lease is 10.798%.

Proof that interest rate implicit in the lease is 10.798%

Year	Narrative	Cash flow	Discount factor (10.798%)	Present value
	lease payments			
1 to 6	Annual rentals	18,000	4.2553	76,595
6	Guaranteed residual value	8,000	0.54052	4,324
6	Unguaranteed residual value	2,000	0.54052	1,081
				82,000
	Fair value of the asset			80,000
	Initial direct costs			2,000
				82,000

Example: Calculating and allocating finance income

Ready Finance Plc agreed to lease a machine to X Plc commencing on 1 January Year 1.

The lease was a 6 year finance lease of a machine on 1 January Year 1 with annual lease payments of ₦18,000, payable in arrears.

The fair value of the machine at the commencement of the lease was ₦80,000 and Ready Finance Plc incurred initial direct costs of ₦2,000 when arranging the lease.

The estimated residual value of the asset at the end of the lease is ₦ 10,000 and the lessee has guaranteed ₦8,000 of this amount.

The interest rate implicit in the lease is 10.798%.

Net investment in the lease

Year	Opening net investment	Interest (10.798%)	Lease receipts	Closing net investment
1	82,000	8,854	(18,000)	72,854
2	72,854	7,867	(18,000)	62,721
3	62,721	6,773	(18,000)	51,494
4	51,494	5,560	(18,000)	39,054
5	39,054	4,217	(18,000)	25,271
6	25,271	2,729	(26,000)	2,000
		36,000		

The interest income is calculated by multiplying the opening receivable by 10.798% in each year (so as to provide a constant rate of return on the net investment in the lease).

The final balance on the account is the unguaranteed residual value.

5.2 Manufacturer/dealer leases

Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

- profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and
- finance income over the lease term.

Revenue

The sales revenue recognised at the commencement of the lease term is the lower of:

- the fair value of the asset; and
- the present value of the lessor's lease payments at a market rate of interest.

Cost of sale

The cost of sale recognised at the commencement of the lease term is the carrying amount of the leased asset less the present value of the unguaranteed residual value.

The deduction of the present value of the unguaranteed residual value recognises that this part of the asset is not being sold. This amount is transferred to the lease receivable. The balance on the lease receivable is then the present value of the amounts which the lessor will collect off the lessee plus the present value of the unguaranteed residual value. This is the net investment in the lease as defined earlier.

Costs incurred by manufacturer or dealer lessors in connection with negotiating and arranging a lease must be recognised as an expense when the selling profit is recognised.

Profit or loss on the sale

The difference between the sales revenue and the cost of sale is the selling profit or loss. Profit or loss on these transactions is recognised in accordance with the policy followed for recognising profit on outright sales.

The manufacturer or dealer might offer artificially low rates of interest on the finance transaction. In such cases the selling profit is restricted to that which would apply if a market rate of interest were charged.

Example: Manufacturer or dealer leases

Best Cars Plc is a car dealer.

It sells expensive cars and offers a certain model for sale by lease.

The following information is relevant:

Price of the car in a cash sale	₦200,000
Cost of the car	₦150,000
Finance option: Annual rental	₦80,423
Lease term	3 years
Interest rate	10%
Estimated residual value	nil
Lessor's cost of setting up the lease	₦2,000
Discount factor t1 to t3 @ 10%	2.486852 (written as 2.487)

Working: Revenue – lower of:	₦
Fair value of the asset	200,000
Present value of the lease payments 80,423 × 2.487	200,000

Initial double entry:

Revenue	**Debit**	**Credit**
Lease receivable (Net investment in the lease)	200,000	
Statement of profit or loss		200,000
Cost of sale		
Statement of profit or loss	150,000	
Asset (Inventory)		150,000
Cost of setting up the lease		
Statement of profit or loss	2,000	
Cash/bank		2,000

Example: Manufacturer or dealer lease (continued)

Net investment in the lease (over its life):

Year	Opening net investment	Interest (10%)	Lease receipts	Closing net investment
1	200,000	20,000	(80,423)	139,577
2	139,577	13,958	(80,423)	73,112
3	73,112	7,311	(80,423)	nil

The interest income is calculated by multiplying the opening receivable by 10% in each year (so as to provide a constant rate of return on the net investment in the lease).

Summary of double entry in year 1:

	Bank	Inventory	Net investment in the lease	Profit or loss
B/f		150,000Dr		
Revenue			200,000Dr	200,000Cr
Cost of sales		(150,000)Cr		(150,000)Dr
Set up cost	(2,000)Cr			(2,000)Dr
Profit on sale				48,000Cr
Finance income			20,000Dr	20,000Cr
Lease rental	80,423Dr		(80,423)Cr	
			139,577Dr	68,000Cr

Example: Manufacturer or dealer leases with unguaranteed residual value

The following information is relevant:

Price of the car in a cash sale	₦200,000
Cost of the car	₦150,000
Finance option:	
Annual rental	₦76,402
Lease term	3 years
Interest rate	10%
Estimated residual value	₦13,310
Lessor's cost of setting up the lease	₦2,000

Discount factors:	
t3 @ 10%	0.7513148 (written as 0.751)
t1 to t3 @ 10%	2.486852 (written as 2.487)

Workings

W1: Revenue – lower of:	₦
Fair value of the asset	200,000
Present value of the lease payments	
76,402× 2.487	190,000

W2: Present value of the unguaranteed residual value	₦
Present value of the lease payments	
13,310 × 0.751	10,000

Initial double entry:

Revenue	**Debit**	**Credit**
Lease receivable (Net investment in the lease)	190,000	
Statement of profit or loss		190,000
Cost of sale		
Statement of profit or loss	140,000	
Asset (Inventory)		140,000
Transfer		
Lease receivable (Net investment in the lease)	10,000	
Asset (Inventory)		10,000
Cost of setting up the lease		
Statement of profit or loss	2,000	
Cash/bank		2,000

Example: Manufacturer or dealer lease (continued)

Net investment in the lease (over its life):

Year	Opening net investment	Interest (10%)	Lease receipts	Closing net investment
1	190,000			
	10,000			
	200,000	20,000	(76,402)	143,598
2	143,598	14,360	(76,402)	81,556
3	81,556	8,156	(76,402)	13,310

The interest income is calculated by multiplying the opening receivable by 10% in each year (so as to provide a constant rate of return on the net investment in the lease).

The balance on the account at the end of the lease term is the unguranteed residual value.

Summary of double entry in year 1:

	Bank	Inventory	Net investment in the lease	Profit or loss
B/f		150,000Dr		
Revenue			190,000Dr	190,000Cr
Cost of sales		(140,000)Cr		(140,000)Dr
Set up cost	(2,000)Cr			(2,000)Dr
Profit on sale				48,000Cr
Transfer		(10,000)Cr	10,000Dr	
Finance income			20,000Dr	20,000Cr
Lease rental	76,402Dr		(76,402)Cr	
			143,598Dr	68,000Cr

5.3 Operating lease accounting

The lessor has **not** transferred the risks and rewards of ownership of the physical asset to the lessee. Therefore, the lessor shows the leased asset as a non-current asset in its statement of financial position.

It will be shown in an appropriate category of **property, plant and equipment as an investment property** at its carrying value (cost/valuation minus accumulated depreciation).

In respect of the leased asset, the lessor's annual statement of profit or loss will include:

- depreciation on the asset as an expense, and
- rental income (as for the lessee, this is usually calculated on a straight-line basis).

Lease income from operating leases is recognised in income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which use benefit derived from the leased asset is diminished.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease are added to the carrying amount of the leased asset and recognised as an expense over the lease term on the same basis as the lease income.

The depreciation policy for depreciable leased assets must be consistent with the lessor's normal depreciation policy for similar assets, and calculated in accordance with IAS 16 and IAS 38.

Manufacturer/dealer leases

A manufacturer or dealer lessor must not recognise any selling profit on entering into an operating lease. It is not the equivalent of a sale as the risks and benefits of ownership do not pass.

Operating lease incentives Error! Bookmark not defined.

Lessors often give incentives to induce a potential lessee to sign up for a lease.

Incentives include:

- rent-free periods;
- up-front cash payments; or
- contributions to the lessee's relocation costs.

Lease incentives (for new or renewed operating lease) are an integral part of the net consideration and should be recognised on a straight-line basis unless another systematic basis is more appropriate.

Example: Operating lease incentives

X Limited signed a contract to lease an asset to a customer on 1 January 2016.

The lease was for 20 years.

The first year is rent free with rentals of ₦30,000 per annum payable in arrears thereafter.

Analysis

The lease incentive must be recognised as an expense over 20 years. This means that the total rentals for 20 years are 19 payments of ₦30,000).

Therefore, the annual income net of the lease incentive given would be:

$$\frac{19 \times ₦30{,}000}{20 \text{years}} = \text{Rs.}28{,}500$$

The double entries would be as follows:

Year 1	**Debit**	**Credit**
Lease incentive	₦28,500	
Statement of profit or loss		₦28,500

The deferred debit represents an amount "paid" by the lessor in order to receive future rentals over the lease term.

This asset is written off to profit or loss over the lease term. This means that even though the future annual cash receipts will be ₦30,000 the company will only recognise income of ₦28,500.

Years 2 to 20	**Debit**	**Credit**
Cash	₦30,000	
Statement of profit or loss		₦28,500
Deferred credit		₦1,500

5.4 Disclosure

Information is provided that, together with the information provided in main financial statements gives users a basis to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

Information is disclosed in a single note (or separate section of the financial statements). However, information already presented elsewhere in the financial statements, does not need to be duplicated as long as the information is incorporated by cross-reference in the single note or separate section about leases.

Finance lease disclosures

A lessor must disclose the following amounts for the period:

- ❑ finance income on the net investment in the lease;
- ❑ selling profit or loss (if any); and
- ❑ income relating to variable lease payments not included in the measurement of the net investment in the lease.

Significant changes in the carrying amount of the net investment in finance leases must be explained (in both qualitative and quantitative terms).

A lessor must provide a maturity analysis showing undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. The sum of the undiscounted lease payments must be reconciled to the net investment in the lease by deducting unearned finance income from the total.

Definitions: Unearned finance income

Unearned finance income is the difference between:

(a) the gross investment in the lease, and

(b) the net investment in the lease.

Operating leases

A lessor must disclose the lease income (separately disclosing income relating to variable lease payments that do not depend on an index or a rate).

IAS 16 disclosure requirements apply to items of property, plant and equipment subject to an operating lease. Each class of property, plant and equipment must be disaggregated into assets subject to operating leases and assets not subject to operating leases. Therefore, the IAS 16 disclosures are given separately for assets subject to an operating lease (by class of underlying asset) and other assets.

The disclosure requirements in IAS 36, IAS 38, IAS 40 and IAS 41 for assets subject to operating leases are applied as appropriate.

A lessor must provide a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

A lessor must disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective of IFRS 16. This additional information includes, but is not limited to, information that helps users of financial statements to assess:

- the nature of the lessor's leasing activities; and
- how the lessor manages the risk associated with any rights it retains in underlying assets.

6 SALE AND LEASEBACK TRANSACTIONS

Section overview

- Sale and leaseback transactions
- Seller/lessee accounting for transfers that are a sale
- Seller/lessee accounting for transfers that are a sale at above market terms
- Seller/lessee accounting for transfers that are a sale at below market terms
- Buyer/lessor accounting for transfers that are a sale
- Accounting for transfers that are not a sale

6.1 Sale and leaseback transactions

Sale and leaseback transactions involve one entity (seller/lessee) transferring an to another entity (the buyer/lessor) and then immediately leasing it back.

The buyer/lessor is normally a bank or finance company. The purpose of the transaction is to allow the seller/lessee to raise cash whilst retaining use of the asset.

Illustration: Sale and leaseback transactions

X Plc owns an office building that it uses for its administrative operations.

It may decide to sell and lease back the building, to raise cash. By selling the building, it raises cash. By leasing back the building, it retains the use of the building for its operational activities.

The accounting treatment for such a transaction depends on whether the initial transfer of the asset from the seller/lessee to the buyer/lessor is a sale or not. This in turn depends on whether the transfer involves the seller/lessee incurs and satisfies a performance obligation in accordance with rules in IFRS 15.

6.2 Seller/lessee accounting for transfers that are a sale

The seller/lessee must account for the sale of the asset and the subsequent leaseback of the asset.

Accounting for the sale involves:

- ❑ recognising the sale proceeds; and
- ❑ derecognising the original asset.

Accounting for the lease involves:

- ❑ recognising a lease liability; and
- ❑ recognising a right-of-use asset.

These different amounts interact and result in a change in net assets. This results in the recognition of a gain/(loss) on the rights to the asset that have been transferred by the seller/lessee.

Another way of thinking about the gain/(loss) is that although the seller/lessee has sold an asset, it has also retained a right to continue using it. Any gain or loss should relate only to the rights sold and not those retained.

The gain of loss is easily calculated as a balancing figure as follows:

Illustration: Sale and lease back double entry

	Debit	Credit
Sale proceeds	X	
Original asset (carrying amount)		X
Right-of-use asset	X	
Lease liability		X
Gain on transfer (as a balancing figure)		X

Lease liability

The lease liability at the inception of the lease is measured in the usual way as the present value of the lease payments discounted at the interest rate inherent in the lease (if available) or the lessee's incremental borrowing rate.

Right-of-use asset

The seller/lessee has sold an asset but retained a right to use it. The right-of-use asset is a portion of the asset that has been sold.

The fair value of the asset is a measure of all rights inherent in the asset. The lease liability is a measure of the fair value of those rights reacquired through the lease. Therefore, the relationship between the two figures can be used to show the proportion of the rights retained.

This proportion is applied to the original carrying amount as follows to arrive at the right-of-use asset.

Illustration: Measuring the right-of-use asset

$$\text{Carrying amount of the asset (before the transfer)} \times \frac{\text{Lease liability}}{\text{Fair value of the asset}}$$

Note that the right-of-use asset is not measured at its fair value but as a proportion of its original carrying amount.

Example: Sale and leaseback (at fair value)

X plc sells an asset and leases it back.

The transfer qualifies as a sale according to IFRS 15 criteria.

Details of the asset:

Carrying amount = ₦1,000,000

Sale proceeds = ₦1,300,000

Fair value = ₦1,300,000

Terms of the lease:

20 annual payments of ₦83,951.48

Interest rate implicit in the lease = 5%

(The 20 period, 5% annuity factor is 12.16)

The transaction is accounted for as follows:

Step 1: Measure the lease liability as the present value of the lease payments.

Years	Cash flow	Discount factor	Present value
1 to 20	83,951.48	12.4622	1,046,221

Step 2: Measure the right-of-use asset

$$\text{Right-of-use asset} = 1{,}000{,}000 \times \frac{1{,}046{,}221}{1{,}300{,}000}$$

Right-of-use asset = 804,785

Step 3: Complete the double entry identifying the gain/(loss) on disposal as a balancing figure

	Debit	Credit
	₦	₦
Cash	1,300,000	
Asset		1,000,000
Lease liability		1,046,221
Right-of-use asset	804,785	
Gain on disposal (balance)		58,564
	2,104,785	2,104,785

6.3 Seller/lessee accounting for transfers that are a sale at above market terms

A sale and leaseback transaction may be at above market terms. This is where either:

- the fair value of the consideration for the sale of the asset is greater than its fair value; or
- the lease payments are above market rates (implying that they do more than simply pay for the right-of-use asset).

In such cases an adjustment is made to recognise additional financing. In effect, the sale proceeds received are treated as being made up of two amounts (being actual sale proceeds plus a loan). The lease payments pay for the right-of-use asset and the loan. Therefore, the present value of the lease payments is a total made up of the lease liability proper plus the loan.

The adjustment for additional finance is made on the basis of the more readily determinable of:

- the difference between the fair value of the consideration for the sale and the fair value of the asset; and
- the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

Example: Sale (not at fair value) and leaseback

X plc sells an asset and leases it back.

The transfer qualifies as a sale according to IFRS 15 criteria.

Details of the asset:

Carrying amount of = ₦1,000,000

Sale proceeds = ₦1,500,000

Fair value = ₦1,300,000

Terms of the lease:

20 annual payments of ₦100,000

Interest rate implicit in the lease = 5%

(The 20 period, 5% annuity factor is 12.4622)

Notes: The sale proceeds of ₦1,500,000 comprise ₦1,300,000 for the asset and additional finance of ₦200,000.

The present value of the annual payments discounted at the interest rate implicit results in a total liability which is made up of the lease liability proper plus this additional finance. The lease liability proper is calculated by subtracting the additional finance from the total liability.

Example (continued): Sale (not at fair value) and lease back

The transaction is accounted for as follows:

Step 1: Measure the total liability as the present value of the annual payments.

Years	Cash flow	Discount factor	Present value
1 to 20	100,000	12.4622	1,246,220

Step 2: Identify the lease liability.

	₦
Extra finance	200,000
Lease liability	1,046,220
PV of payments (12.4622 × 100,000)	1,246,220

Step 3: Measure the right-of-use asset (as before)

Right-of-use asset =	1,000,000 ×	1,046,221
		1,300,000
Right-of-use asset =		804,785

Step 4: Complete the double entry

The double entry can be completed as follows:

	Debit	Credit
	₦	₦
Cash	1,500,000	
Asset		1,000,000
Right-of-use asset	804,785	
Liability (extra finance)		200,000
Lease liability		1,046,221
PV of lease payments		1,046,221
Net gain		58,564
	2,304,785	2,304,785

Tutorial notes:

1 The existence of the extra finance component does not affect the other aspects of the transaction.
The difference between the solution in this example and the previous example is a simple double entry of ₦200,000 between cash and a liability for the extra finance.

2 The payments in this example are higher than those in the previous example in order to pay off the extra ₦200,000.

3 It is not needed to solve the above example but the annual payments of ₦100,000 can be prorated between the two components of the liabiity as follows:

	₦
Extra finance (₦100,000 × 200,000/1,246,221)	16,049
Lease liability (₦100,000 × 1,046,221/1,246,221)	83,951
	100,000

6.4 Seller/lessee accounting for transfers that are a sale at below market terms

A sale and leaseback transaction may be at below market terms. This is where either:

- the fair value of the consideration for the sale of the asset is less than its fair value; or
- the lease payments are lower than market rates.

In such cases an adjustment is made to recognise that the seller/lessee made a prepayment of lease rentals. In effect, the sale proceeds received is not the only asset arising as a result of the initial sale; there is a prepayment to recognise also.

The present value of the lease payments is made up of the lease payment proper less the prepayment made. Therefore, in order to calculate the lease liability proper, the prepayment must be added to the present value of the lease rentals.

This is a little tricky to think of but it is exactly the same as recognising additional finance for transactions at above market terms but using a negative figure instead.

Example: Sale (not at fair value) and lease back

X plc sells an asset and leases it back.

The transfer qualifies as a sale according to IFRS 15 criteria.

Details of the asset:

Carrying amount of = ₦1,000,000

Sale proceeds = ₦1,200,000 (₦100,000 less than fair value)

Fair value = ₦1,300,000

Terms of the lease:

20 annual payments of ₦75,927

Interest rate implicit in the lease = 5%

(The 20 period, 5% annuity factor is 12.4622)

The present value of lease payments is ₦946,221

Notes: The sale proceeds of ₦1,200,000 are ₦100,000 less than the fair value of the asset. In effect, this is an extra amount being paid by X Plc in addition to the annual payments in order to obtain the right-of-use asset. The lease liability proper is made up of the present value of the lease payments plus the shortfall.

Example (continued): Sale (not at fair value) and lease back

The transaction is accounted for as follows:

Step 1: Measure the total liability as the present value of the annual payments.

Years	Cash flow	Discount factor	Present value
1 to 20	75,927	12.4622	946,221

Step 2: Identify the lease liability.

	₦
Lease liability (balancing figure)	1,046,220
Lease prepayment	(100,000)
PV of payments (as above)	946,221

Step 3: Measure the right-of-use asset (as before)

Right-of-use asset = 1,000,000 × 1,046,221 / 1,300,000

Right-of-use asset = 804,785

Step 4: Complete the double entry

The double entry can be completed as follows:

	Debit	Credit
	₦	₦
Cash	1,200,000	
Asset		1,000,000
Right-of-use asset	804,785	
Lease prepayment	100,000	
Lease liability		1,046,221
PV of the lease payments		946,221
Net gain		58,564
	2,004,785	2,004,785

Tutorial Notes:

1 The existence of the lease prepayment does not affect the other aspects of the transaction. The difference between the solution in this example and the example at market terms is a simple double entry of ₦100,000 between cash and a a lease prepayment.

2 The payments in this example are lower than those in the first example as ₦100,000 has already been repaid.

6.5 Buyer/lessor accounting for transfers that are a sale

The lessor must account for the purchase of the asset by applying applicable accounting standards.

The lease back is accounted for using lessor accounting as previously described.

6.6 Accounting for transfers that are not a sale

This is accounted for using loan accounting by both parties. IFRS 9 applies to the financial liability recognised by the seller and the financial asset recognised by the buyer.

7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Prepare and present extracts of financial statements in respect of lessee accounting;
- Prepare and present extracts of financial statements in respect of lessor accounting; and
- Prepare and present extracts of financial statements in respect of sale and lease back arrangements.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

	₦
Total lease payments (3 × ₦4,021)	12,063
Minus: Cash price of the asset	(10,000)
Total finance charge	2,063

Actuarial method

Year ended 31 December	Opening balance	Lease payment	Capital outstanding	Interest at 22.25%	Closing balance
	₦	₦	₦	₦	₦
Year 1	10,000	(4,021)	5,979	1,330	7,309
Year 2	7,309	(4,021)	3,288	733	4,021
Year 3	4,021	(4,021)	–	–	–

The year-end liability at the end of Year 1 is ₦7,309 in total.

- The non-current liability is the liability at the start of the next year after deducting the first payment (₦3,288).
- The current liability is the payment in year 2 less any interest contained in it that has not yet accrued.

	₦
Current liability, end of Year 1	4,021*
Non-current liability, end of Year 1	3,288
Total liability, end of Year 1	7,309

* 4,021 can be divided into 1,330 of interest payable and 2691 of principal payable

Solution **2**

The lease is a finance lease.

Reasons

The lease is for a major part of the life of the asset (6 out of 7 years).

X Plc must ensure the asset. It is exposed to one of the major risks of ownership of the asset (its loss).

The present value of the lease payments is 95.3% ($^{4.767 \times 600,000}/_{3,000,000}$) of the fair value of the asset at the inception of the lease.

Professional level
Corporate

CHAPTER 13

IAS 12: Income taxes

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	3	Non-financial liabilities	
		a	Evaluate how different methods and timing of recognition and measurement of non-financial liabilities affect reported financial position.
		b	Appraise accounting treatments of non-financial liabilities, such as Employees' Benefits – IAS 19; Share Based Payment – IFRS 2; Income Tax – IAS 12; Provisions, Contingent Liabilities and Contigent Assets – IAS 37; and Leases - IFRS 16.

IAS 12 is an examinable document.

Exam context

This chapter explains the accounting treatments for current tax and deferred tax.

This standard was examinable in a previous paper. It is covered here again in detail for your convenience.

Note that at this level you also need to know how to account for deferred taxation issues arising in business combinations which was not covered previously.

At the end of this chapter, readers should be able to:

- Account for current tax;
- Define temporary differences;
- Identify temporary differences that cause deferred tax liabilities and deferred tax assets;
- Determine the amount of deferred tax to be recognised in respect of temporary differences identified; and
- Apply the disclosure requirements of IAS 12.

1 ACCOUNTING FOR TAXATION

Section overview

- Taxation of profits
- Over-estimate or under-estimate of tax from the previous year
- Taxation in the statement of financial position

1.1 Taxation of profits

Companies pay tax on their profits. The tax charge is based on their accounting profit as adjusted according to the tax law of Nigeria.

Definitions

Accounting profit is profit or loss for a period before deducting tax expense.

Taxable profit (tax loss) is the profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Tax computation

A series of adjustments is made against a company's accounting profit to arrive at its taxable profit. These adjustments involve:

- ❑ Adding back inadmissible deductions (accounting expenses which are not allowed as a deduction against taxable profit).
- ❑ Deducting admissible deductions which include:
  - expenses that are allowable as a deduction against taxable profit but which have not been recognised in the financial statements; and
  - income recognised in the financial statements but which is exempted from company income tax.

The tax rate is applied to the taxable profit to calculate how much a company owes in tax for the period. IFRS describes this as ***current tax***.

An exam question might require you to perform a basic taxation computation from information given in the question.

Illustration: Tax computation format

	₦
Accounting profit before tax	X
Add back: Inadmissible deductions	X
Less: Admissible deductions	(X)
Taxable profit	X
Tax rate	x%
Tax payable (current tax)	X

Example: Tax computation

Enugu Traders had an accounting profit of ₦789,000 for the year ended 31 December 20X8.

The accounting profit was after depreciation of ₦70,000 and included a profit on disposal (capital gain) of ₦97,000.

The company had incurred borrowing costs of ₦70,000 in the year of which ₦10,000 had been capitalised in accordance with IAS 23.

The company holds right-of-use assets (IFRS 16). During the year the lease finance charge was ₦15,000 and rentals paid were ₦80,000.

At 1 January 20X8 the tax written down value of machinery was ₦120,000 and for buildings was ₦600,000.

Tax regime

All borrowing costs are deductible for tax purposes.

Capital gains are not taxable.

Fines are not tax deductible.

Lease rentals are deductible in full for tax purposes.

Accounting depreciation is not allowable for tax purposes.

Capital allowances are claimable at 10% per annum for buildings and 15% per annum for machinery applied to tax written down value at the start of the year.

Tax is paid at 30%

The tax computation is as follows:

	₦
Accounting profit	789,000
Add back inadmissible deductions:	
Accounting depreciation	70,000
Fine paid	125,000
Lease finance charge	15,000
	210,000
Less: Admissible deductions	
Lease payments	80,000
Capital gain	97,000
Borrowing cost capitalised	10,000
	(187,000)
Assessable profit	812,000
Less: Capital allowances	
(15% × 120,000 + 10% × 600,000)	(78,000)
Taxable profit	734,000
Income tax (30% of taxable profit)	220,200
Education tax (2% of assessable profit (812,000))	16,240
Tax payable to FIRS	236,440

Tax base

The above example referred to the tax written down value of the machinery and buildings. This is the tax authority's view of the carrying amount of the asset measured as cost less capital allowances calculated according to the tax legislation.

IFRS uses the term tax base to refer to an asset or liability measured according to the tax rules.

Definition

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

The tax base of an asset is the amount that the tax authorities will allow as a deduction in the future.

Measurement

Current tax liabilities (assets) for the current and prior periods must be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

1.2 Over-estimate or under-estimate of tax from the previous year

Current tax for current and prior periods must be recognised as a liability until paid. If the amount already paid exceeds the amount due the excess must be recognised as an asset.

When the financial statements are prepared, the tax charge on the profits for the year is likely to be an estimate. The figure for tax on profits in the statement of comprehensive income is therefore not the amount of tax that will eventually be payable, because it is only an estimate. The actual tax charge, agreed with the tax authorities some time later, is likely to be different.

In these circumstances, the tax charge for the year is adjusted for any under-estimate or over-estimate of tax in the previous year.

- an under-estimate of tax on the previous year's profits is added to the tax charge for the current year.
- an over-estimate of tax on the previous year's profits is deducted from the tax charge for the current year.

Example: Over-estimate or under-estimate of tax

	₦	₦
Profit from operations		460,000
Interest		(60,000)
Profit before tax		400,000
Tax:		
Adjustment for under-estimate of tax in the previous year	3,000	
Tax on current year profits	100,000	
Tax charge for the year		(103,000)
Profit after tax		297,000

1.3 Taxation in the statement of financial position

The taxation charge for the year is the liability that the company expects to pay. The timing of tax payments on profits varies from one country to another, depending on the tax rules in each country. The actual amount of tax payable, and reported in the statement of financial position as a current liability (taxation payable), is calculated as follows:

Illustration: Taxation in the statement of financial position

	₦
Tax payable at the beginning of the year	X
Tax charge for the year	X
	X
Tax payments made during the year	(X)
Tax payable at the end of the year	X

Example: Taxation in the financial statements

Fresh Company has a financial year ending on 31 December.

At 31 December 20X7 it had a liability for income tax of ₦77,000.

The tax on profits for the year to 31 December 20X8 was ₦114,000.

The tax charge for the year to 31 December 20X7 was over-estimated by ₦6,000.

During the year to 31 December 20X8, the company made payments of ₦123,000 in income tax.

This would result in the following accounting treatment:

Tax charge in the statement of comprehensive income	₦
Tax on current year profits	114,000
Adjustment for over-estimate of tax in the previous year	(6,000)
Taxation charge for the year	108,000

Tax liability in the statement of financial position	₦
Tax payable at the beginning of the year	77,000
Tax charge for the year	108,000
	185,000
Tax payments made during the year	(123,000)
Tax payable at the end of the year	62,000

2 DEFERRED TAX: INTRODUCTION

Section overview

- Deferred taxation – Underlying problem
- Identifying deferred tax balances
- IAS 12 approach to the problem

2.1 Deferred taxation – Underlying problem

As explained in the last section, in most jurisdictions the rules for the recognition and measurement of certain assets, liabilities, income and expenses for tax purposes differ from the equivalent rules under IFRSs. This results in different figures in the financial statements and in the tax computations/tax working papers.

It is convenient to envisage two separate sets of accounts:

- one set constructed following IFRS rules; and
- a second set following the tax rules (tax computations).

This results in a breakdown in the tax rate percentage relationship between the profit before tax figure and the taxation figure. In other words the tax charge is not the tax rate applied to the profit before tax.

Example: Deferred taxation - Underlying problem

X Limited made accounting profit before tax of ₦50,000 in each of the years, 20X1, 20X2 and 20X3 and pays tax at 30%.

X Limited bought an item of plant on 1 January 20X1 for ₦9,000. This asset is to be depreciated on a straight line basis over 3 years.

Accounting depreciation is not allowed as a taxable deduction in the jurisdiction in which the company operates. Instead capital allowances are available as shown in the following tax computations.

	20X1	20X2	20X3
	₦	₦	₦
Accounting profit (after depreciation)	50,000	50,000	50,000
Add back depreciation	3,000	3,000	3,000
Deduct capital allowances	(4,500)	(2,500)	(2,000)
	(1,500)	500	1,000
Taxable profit	48,500	50,500	51,000
Tax @ 30%	14,550	15,150	15,300

Example continued: Deferred taxation - Underlying problem

In the absence of the recognition of deferred tax this would be reported as follows:

X Limited: Statement of comprehensive income for the years ending:

	20X1	20X2	20X3	Total
	₦	₦	₦	₦
Profit before tax	50,000	50,000	50,000	150,000
Income tax @ 30% (as above)	(14,550)	(15,150)	(15,300)	(45,000)
Profit after tax	35,450	34,850	34,700	105,000

Looking at the total column, the profit before tax is linked to the taxation figure through the tax rate (150,000 × 30% = 45,000).

This is not the case in each separate year.

This is because the current tax charge is not found by multiplying the accounting profit before tax by the tax rate. Rather, it is found by multiplying an adjusted version of this figure by the tax rate

The item of plant is written off in the calculation of both accounting profit and taxable profit but by different amounts in different periods. The differences are temporary in nature as over the three year period, the same expense is recognised for the item of plant under both the accounting rules and the tax rules.

Transactions recognised in the financial statements in one period may have their tax effect deferred to (or more rarely, accelerated from) another. Thus the tax is not matched with the underlying transaction that has given rise to it.

In the above example the tax consequences of an expense (depreciation in this case) are recognised in different periods to when the expense is recognised.

Accounting for deferred tax is based on the principle that the tax consequence of an item should be recognised in the same period as the item is recognised. It tries to match tax expenses and credits to the period in which the underlying transactions to which they relate are recognised.

In order to do this, the taxation effect that arises due to the differences between the figures recognised under IFRS and the tax rules is recognised in the financial statements.

The double entry to achieve this is between a deferred tax balance in the statement of financial position (which might be an asset or a liability) and the tax charge in the statement of comprehensive income. (More complex double entry is possible but this is outside the scope of your syllabus).

The result of this is that the overall tax expense recognised in the statement of comprehensive income is made up of the current tax and deferred tax numbers.

Definition: Tax expense

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

2.2 Identifying deferred tax balances

The differences between the two sets of rules will result in different numbers in the financial statements and in the tax computations.

Two perspectives

These differences can be viewed from:

- a statement of comprehensive income (income and expenses) perspective:
  - the differences arising in the period are identified by comparing income and expenses recognised under IFRS to the equivalent figures that are taxable or allowable under tax legislation;
  - the approach identifies the deferred tax expense or credit recognised in the statement of comprehensive income for the period (with the other side of the entry recognised as a liability or asset); or
- a statement of financial position (assets and liabilities) perspective:
  - the differences are identified on a cumulative basis by comparing the carrying amount of assets and liabilities under IFRS to the carrying amount of the same assets and liabilities according to the tax rules;
  - the approach identifies the deferred tax liability (or asset) that should be recognised (with the movement on this amount recognised as a credit or expense in the statement of comprehensive income).

IAS 12 uses the statement of financial position perspective but both will be explained here for greater understanding.

Example continued: Two perspectives

The following table identifies the differences between the accounting treatment and the taxation treatment of the item of plant from both perspectives.

	Carrying amount	Tax base	Assets and liabilities	Income and expenses
Cost at 01/01/X1	9,000	9,000		
Charge for the year	(3,000)	(4,500)		(1,500)
Cost at 31/12/X1	6,000	4,500	1,500	
Charge for the year	(3,000)	(2,500)		500
Cost at 31/12/X2	3,000	2,000	1,000	
Charge for the year	(3,000)	(2,000)		1,000
Cost at 31/12/X3	–	–	–	–

Statement of comprehensive income perspective

Example continued: Statement of comprehensive income perspective

20X1:

₦3,000 is disallowed but ₦4,500 is allowed instead.

⇒ taxable expense is ₦1,500 greater than the accounting expense.

⇒taxable profit is ₦1,500 less than accounting profit.

⇒ current tax is reduced by 30% of ₦1,500 (₦450).

⇒ deferred tax expense of ₦450 must be recognised to restore the balance (Dr: Tax expense / Cr: Deferred taxation liability).

20X2:

₦3,000 is disallowed but ₦2,500 is allowed instead.

⇒ taxable expense is ₦500 less than the accounting expense.

⇒taxable profit is ₦500 more than accounting profit.

⇒ current tax is increased by 30% of ₦500 (₦150).

⇒ deferred tax credit of ₦150 must be recognised to restore the balance (Dr: Deferred taxation liability / Cr: Tax expense).

20X3:

₦3,000 is disallowed but ₦2,000 is allowed instead.

⇒ taxable expense is ₦1,000 less than the accounting expense.

⇒taxable profit is ₦1,000 more than accounting profit.

⇒ current tax is increased by 30% of ₦1,000 (₦300).

⇒ deferred tax credit of ₦300 must be recognised to restore the balance (Dr: Deferred taxation liability / Cr: Tax expense).

The statement of comprehensive income would now be as follows:

	20X1	20X2	20X3
	₦	₦	₦
Profit before tax	50,000	50,000	50,000
Income tax @ 30% W1	14,550	15,150	15,300
Deferred tax	450	(150)	(300)
	(15,000)	(15,000)	(15,000)
Profit after tax	35,000	35,000	35,000

Statement of financial position	**20X1**	**20X2**	**20X3**
Deferred tax liability:	₦	₦	₦
Balance b/f	nil	450	300
Movement in the year	450	(150)	(300)
Balance b/f	450	300	nil

Statement of financial position perspective

Example continued: Statement of financial position perspective

This approach compares the carrying amount of assets and liabilities in the financial statements to their tax base to identify the cumulative differences to that point in time.

These differences are called temporary differences.

An asset in the financial statements compared to the taxman's view requires the recognition of a deferred tax liability which is measured by applying the tax rate to the temporary difference.

	Carrying amount	Tax base	Temporary difference	Tax @ 30%
At 31/12/X1	6,000	4,500	1,500	450
At 31/12/X2	3,000	2,000	1,000	300
At 31/12/X3	nil	nil	nil	nil

By the end of 20X1

The asset in the financial statements is ₦1,500 more than the tax base.

A deferred tax liability of ₦450 must be recognised.

	Debit	Credit
Tax expense	450	
Deferred tax liability		450

By the end of 20X2

The asset in the financial statements is ₦1,000 more than the tax base.

A deferred tax liability of ₦300 must be recognised but there was ₦450 at the start of the year so the liability must be reduced.

	Debit	Credit
Deferred tax liability	150	
Tax expense		150

By the end of 20X3

The asset in the financial statements is the same as the tax base (nil).

A deferred tax liability of nil must be recognised but there was ₦300 at the start of the year so the liability must be reduced.

	Debit	Credit
Deferred tax liability	300	
Tax expense		300

These amounts are the same as on the previous page and would have the same impact on the financial statements.

The recognition of deferred taxation has restored the relationship between profit before tax and the tax charge through the tax rate in each year (30% of ₦50,000 = ₦15,000).

Terminology

When a difference comes into existence or grows it is said to originate. When the difference reduces in size it is said to reverse.

Thus, in the above example a difference of ₦1,500 originated in 20X1. This difference then reversed in 20X2 and 20X3.

Warning

Do not think that an origination always leads to the recognition of a liability and an expense. The direction of the double entry depends on the circumstances that gave rise to the temporary difference. This is covered in section 3 of this chapter.

2.3 IAS 12 Approach to the problem

IAS 12: Income taxes, advocates a statement of financial position approach.

Business must identify a deferred tax liability (or perhaps asset) at each reporting date.

It must do this by identifying the differences between the carrying amount of assets and liabilities in the financial statements to the tax base (tax authority's view of those same items). These differences are known as temporary differences (this will be explained in more detail in the next section).

Once the temporary differences have been identified the deferred tax balance is calculated by applying the appropriate tax rate to the difference.

3 RECOGNITION OF DEFERRED TAX: BASIC APPROACH

Section overview

- Identifying the temporary difference
- Taxable and deductible temporary differences
- Accounting for deferred tax
- Sources of temporary differences

3.1 Identifying the temporary difference

Accounting for deferred tax is based on the identification of the temporary differences.

Definition: Temporary difference

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Temporary differences may be either:

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

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

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefit that will flow to an entity when it recovers the carrying amount of the asset.

Definition: Tax base

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

3.2 Taxable and deductible temporary differences

Temporary differences may be either taxable temporary differences or deductible temporary differences.

Taxable temporary differences

A taxable temporary difference is caused by a debit in the carrying amount of an asset or liability in the financial statements compared to the tax base of that item.

Taxable temporary differences lead to the recognition of deferred tax liabilities.

Example: Taxable temporary differences

Each of the following is a taxable temporary difference leading to the recognition of a deferred tax liability.

	Carrying amount	Tax base	Temporary difference	Deferred tax liability (30%)
Non-current asset	1,000	800	200	60
Inventory	650	600	50	15
Receivable	800	500	300	90
Receivable (note 1)	500	nil	500	150
Payable (note 2)	(1,000)	(1,200)	200	60

Note 1:

This implies that an item accounted for using the accruals basis in the financial statements is being taxed on a cash bases.

If an item is taxed on cash basis the tax base would be zero as no receivable would be recognised under the tax rules.

Note 2:

The credit balance in the financial statements is ₦1,000 and the tax base is a credit of ₦1,200. Therefore, the financial statements show a debit balance of 200 compared to the tax base. This leads to a deferred tax liability.

IAS 12 rationalises the approach as follows (using the non-current assets figures to illustrate)

Inherent in the recognition of an asset is that the carrying amount (₦1,000) will be recovered in the form of economic benefits that will flow to the entity in future periods.

When the carrying amount exceeds the tax base (as it does in this case at ₦800) the amount of taxable economic benefit will exceed the amount that will be allowed as a deduction for tax purposes.

This difference is a taxable temporary difference and the obligation to pay the resulting income tax in the future periods is a liability that exists at the reporting date.

The company will only be able to expense ₦800 in the tax computations against the recovery of ₦1,000.

The ₦200 that is not covered will be taxed and that tax should be recognised for now.

Definition: Deferred tax liability

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deductible temporary differences

A deductible temporary difference is caused by a credit in the carrying amount of an asset or liability in the financial statements compared to the tax base of that item.

Deductible temporary differences lead to the recognition of deferred tax assets.

Example: Deductible temporary differences

Each of the following is a deductible temporary difference leading to the recognition of a deferred tax asset.

	Carrying amount	Tax base	Temporary difference	Deferred tax asset (30%)
Non-current asset (note 1)	1,000	1,200	(200)	60
Receivable	800	900	(100)	30
Payable	(1,200)	(1,000)	(200)	60

Note 1:

There is a debit balance for the non-current asset of ₦1,000 and its tax base is a debit of ₦1,200. Therefore, the financial statements show a credit balance of 200 compared to the tax base. This leads to a deferred tax asset.

Definition: Deferred tax asset

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

(a) deductible temporary differences;

(b) the carry forward of unused tax losses; and

(c) the carry forward of unused tax credits.

(The deferred tax assets arising from the carry forward of unused tax losses and the carry forward of unused tax credits are not in your syllabus).

3.3 Accounting for deferred tax

Accounting for deferred taxation involves the recognition of a liability (or an asset) in the statement of financial position at each year end. The business must then account for the movement on the liability.

The other side of the entry that changes the balance on the deferred taxation liability (asset) is recognised in the statement of profit or loss. (Note that some differences require double entry to other comprehensive income or directly to equity).

Approach

The calculation of the balance to be recognised in the statement of financial position is quite straightforward.

- **Step 1:** Identify the temporary differences (this should always involve a columnar working as in the example below);
- **Step 2:** Multiply the temporary differences by the appropriate tax rate.
- **Step 3:** Compare this figure to the opening figure and complete the double entry.

Example: Accounting for deferred tax

X plc has non-current assets with a carrying value of ₦200,000 and a tax base of ₦140,000.

It has recognised a receivable of ₦10,000. This relates to income which is taxed on a cash basis.

It has also accrued for an expense in the amount of ₦20,000. Tax relief is only given on this expense when it is paid.

At the start of the year X plc had a deferred tax liability of ₦12,000.

Required

Show the movement on the deferred tax account and construct the journal to record this movement.

In order to answer a question like this you need to complete the following proforma:

	₦
Deferred taxation balance at the start of the year	12,000
Transfer to the income statement (as a balancing figure)	?
Deferred taxation balance at the end of the year **(working)**	?

In order to complete this you need a working to identify the temporary differences.

Example continued: Accounting for deferred tax

The temporary differences are identified and the required deferred tax balance calculated as follows:

Working:

	Carrying amount	Tax base	Temporary differences	DT balance at 30%
	₦	₦	₦	₦
Non-current assets	200,000	140,000	60,000	18,000 (liability)
Accrued income	10,000	–	10,000	3,000 (liability)
Accrued expense	(20,000)	–	(20,000)	(6,000) asset
			50,000	15,000

The answer can then be completed by filling in the missing figures and constructing the journal as follows:

	₦
Deferred taxation balance at the start of the year	12,000
Statement of profit or loss (as a balancing figure)	3,000
Deferred taxation balance at the end of the year **(working)**	15,000

Journal:	**Debit**	**Credit**
Income statement (tax expense)	3,000	
Deferred tax liability		3,000

3.4 Sources of temporary differences

Circumstances under which temporary differences arise include;

- Situations when income or expense is included in accounting profit in one period but included in the taxable profit in a different period. Examples include:
  - items which are taxed on a cash basis but which will be accounted for on an accruals basis; and
  - situations where the accounting depreciation does not equal capital allowances.
- Revaluation of assets where the tax authorities do not amend the tax base when the asset is revalued.

Examples leading to the recognition of deferred tax liabilities

Interest may be received in arrears, leading to a receivable in the statement of financial position. However, this interest may not be taxable until the cash is received.

Example: Recognition of deferred tax liabilities

A plc recognises interest receivable of ₦600,000 in its financial statements.

No cash has yet been received and interest is taxed on a cash basis. The interest receivable has a tax base of nil.

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Interest receivable	600,000	–	600,000
Deferred tax liability @ 30%			180,000

Development costs may be capitalised and amortised (in accordance with IAS 38) but tax relief may be given for the development costs as they are paid.

Example: Recognition of deferred tax liabilities

In the year ended 30 June 20X9, B Plc incurred development costs of ₦320,000.

These were capitalised in accordance with IAS 38, with an amortisation charge of ₦15,000 in 20X9.

Development costs are an allowable expense for tax purposes in the period in which they are paid. The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Development costs	305,000	–	305,000
Deferred tax liability @ 30%			91,500

Accounting depreciation is not deductible for tax purposes in most tax regimes. Instead the governments allow a deduction on statutory grounds.

Example: Recognition of deferred tax liabilities

C plc has non-current assets at 31 December 20X8 with a cost of ₦5,000,000.

Accumulated depreciation for accounting purposes is ₦2,250,000 to give a carrying amount of ₦2,750,000

Tax deductible depreciation of ₦3,000,000 has been deducted to date.

The fixed assets have a tax base of ₦2,000,000.

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Non-current asset	2,750,000	2,000,000	750,000
Deferred tax liability @ 30%			225,000

Examples leading to the recognition of deferred tax assets

Warranty costs may be recognised as a liability (in accordance with IAS 37) but tax relief may be given only when the cash is spent in the future.

Example: Recognition of deferred tax assets

D plc recognises a liability of ₦100,000 for accrued product warranty costs.

For tax purposes, the product warranty costs will not be deductible until the entity pays any warranty claims. (Therefore the tax base is nil).

The company is very profitable and does not expect this to change. (This means that they expect to pay tax in the future so should be able to recover the deferred tax asset).

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Warranty provision	100,000	–	100,000
Deferred tax asset @ 30%			30,000

This time the financial statements contain a liability when compared to the tax authority's view of the situation. Therefore deferred tax is an asset.

It is possible to have a temporary difference even if there is no asset or liability. In such cases there is a zero value for the asset (or liability). For example, research costs may be expensed as incurred (in accordance with IAS 38) but tax relief may be given for the costs at a later date.

Example: Recognition of deferred tax assets

In the year ended 31 December 20X8, E Plc incurred research costs of ₦500,000.

These were expensed accordance with IAS 38.

Research costs are not permitted as a taxable deduction until a later period.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Research costs	nil	500,000	500,000
Deferred tax asset @ 30%			150,000

4 RECOGNITION AND MEASUREMENT RULES

Section overview

- Recognition of deferred tax liabilities
- Recognition of deferred tax assets
- A recognition issue – non-taxable items
- Measurement of deferred tax balances

4.1 Recognition of deferred tax liabilities

A deferred tax liability must be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

- ❑ the initial recognition of goodwill; or
- ❑ the initial recognition of an asset or liability in a transaction which:
  - is not a business combination; and
  - at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

There is further guidance on the recognition of deferred tax liabilities in respect of taxable temporary differences arising in a business combination.

Comment on the exceptions: Goodwill

Goodwill usually exists only in group accounts. Groups are not taxed as such: it is the members of a group that are the taxable entities, i.e. the parent and each subsidiary are taxed separately. Goodwill in group accounts is not an asset recognised by the tax authorities so has a tax base of nil. This means that goodwill is a temporary difference but does not lead to the recognition of a deferred tax liability because of the exception.

Example: Goodwill

In the year ended 31 December 20X8, A Plc acquired 80% of another company and recognised goodwill of ₦100,000 in respect of this acquisition.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Goodwill	100,000	nil	100,000
Deferred tax (due to the exception)			nil

The exception refers to the initial recognition of goodwill. However, there is no deferred tax in respect of this difference at any time in the future even if the carrying amount (and hence the temporary difference) changes.

In some jurisdictions goodwill can arise in individual company financial statements. Furthermore, the goodwill might be tax deductible in those jurisdictions. In such cases goodwill is just the same as any other asset and its tax consequences would be recognised in the same way.

Example: Goodwill

In the year ended 31 December 20X8, B Plc acquired a partnership and recognised good will of ₦100,000 in respect of this acquisition.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Goodwill	100,000	100,000	nil
Deferred tax on initial recognition			nil

In the future, both the carrying amount and the tax base of the goodwill might change leading to deferred tax consequences.

Comment on the exceptions: Initial recognition of other items

A temporary difference may arise on initial recognition of an asset or liability, for example if part or all of the cost of an asset will not be deductible for tax purposes. This exception relates to the initial recognition of an asset or liability in a transaction that is not a business combination. In other words, the exception does not apply if the initial recognition is due to a business combination. There is guidance on deferred tax arising in business combinations but this is not examinable at this level.

If the transaction is not a business combination and affects either accounting profit or taxable profit the exception does not apply and deferred tax is recognised on initial recognition.

Example: Loan

In the year ended 31 December 20X8, C Plc lent ₦100,000 to another company and incurred costs of ₦5,000 in arranging the loan. The loan is recognised at ₦105,000 in the accounts.

Under the tax rules in C Plc's jurisdiction the cost of arranging the loan is deductible in the period in which the loan is made.

The relevant tax rate is 30%.

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Loan	105,000	100,000	5,000
Deferred tax on initial recognition			1,500

The exception does not apply as the transaction affects the taxable profits on initial recognition.

If the transaction is not a business combination, and affects neither accounting profit nor taxable profit, deferred tax would normally be recognised but the exception prohibits it.

Example: Initial recognition

In the year ended 31 December 20X8, D Plc acquired a non-current asset at a cost of ₦100,000. The asset is to be depreciated on a straight line basis over its useful life of 5 years.

The asset falls outside the tax system. Depreciation is not allowable for tax purposes and there is no tax deductible equivalent. Any gain on disposal is not taxable and any loss on disposal not taxable.

The relevant tax rate is 30%.

Initial recognition:

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Non-current asset	100,000	nil	100,000
Deferred tax on initial recognition (due to the exception)			nil

Subsequent measurement (1 year later)

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Non-current asset	80,000	nil	80,000
Deferred tax on initial recognition (due to the exception – this still results from the initial recognition)			nil

4.2 Recognition of deferred tax assets

A deferred tax asset must be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

- is not a business combination; and
- at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

There is further guidance on the recognition of deferred tax asset in respect of deductible temporary differences arising in a business combination but that is outside the scope of your syllabus.

A deferred tax asset must only be recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be used.

This means that IAS 12 brings a different standard to the recognition of deferred tax assets than it does to deferred tax liabilities:

- liabilities are always be recognised in full (subject to certain exemptions beyond the scope of your syllabus); but
- assets may not be recognised in full (or in some cases at all).

IAS 12 also requires that the carrying amount of a deferred tax asset must be reviewed at the end of each reporting period to check if it is still probable that sufficient taxable profit is expected to be available to allow the benefit of its use.

If this is not the case the carrying amount of the deferred tax asset must be reduced to the amount that it is expected will be used in the future. Any such reduction might be reversed in the future if circumstances change again.

4.3 A recognition issue – non - taxable items

The definition of temporary difference is repeated here for convenience:

Definition: Temporary difference

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.

Deferred tax should be recognised only in respect of those items where expense or income is recognised in both accounting profit and taxable profit but in different periods.

Unfortunately, applying the definition of temporary difference given above would result in the inclusion of items where the difference might not be temporary but permanent in nature.

Example: Permanent difference.

E Plc has recognised ₦100,000 income as a receivable in its accounting profit for the year.

This income is not taxable.

Applying the definition of temporary difference would lead to the following:

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Receivable	100,000	nil	100,000

However, this is not a temporary difference. It is not a transaction recognised in accounting profits in one period and taxable profits in another.

It is never recognised in taxable profits.

Items not taxable or tax allowable should not result in the recognition of deferred tax balances. In order to achieve this effect, IAS 12 includes the following rules:

- the tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.
- the tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

Returning to the above example:

Example: Permanent difference.

E Plc has recognised ₦100,000 income as a receivable in its accounting profit for the year.

This income is not taxable.

Applying the definition of temporary difference would lead to the following:

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Receivable	100,000	100,000	nil

The item is not taxable so its tax base is set to be the same as its carrying amount.

This results in a nil temporary difference and prevents the recognition of deferred tax on this asset.

This sounds rather complicated but just remember that it is a mechanism to exclude non-taxable items from the consideration of deferred tax (even though the definition might have included them).

Remember this: there is no deferred tax to recognise on items that are not taxed or for which no tax relief is given.

Closing comment

Accounting for deferred taxation restores the relationship that should exist between the profit before tax in the financial statements, the tax rate and the tax charge. In earlier examples we saw that after accounting for deferred tax the tax expense (current and deferred tax) was equal to the tax rate × the accounting profit before tax.

This will not be the case if there are permanent differences.

4.4 Measurement of deferred tax balances

Deferred tax assets and liabilities must not be discounted.

Deferred tax assets and liabilities must be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

5 DEFERRED TAX: BUSINESS COMBINATIONS

Section overview

- Introduction
- Revaluation of assets/liabilities in the fair value exercise
- Unremitted earnings of group companies
- Unrealised profit adjustments
- Change in recoverability of parent's deferred tax asset due to an acquisition

5.1 Introduction

Additional deferred tax items need to be considered in preparing group accounts, because new sources of temporary differences arise:

- ❑ revaluation of assets/liabilities in the fair value exercise;
- ❑ unremitted earnings of group companies;
- ❑ unrealised profit adjustments.

5.2 Revaluation of assets/liabilities in the fair value exercise

When a parent company makes an acquisition, it must perform a fair value exercise on the assets and liabilities of the entity it has acquired. This will result in a change in the carrying value of some of the assets and liabilities. However, the tax base will not be affected, as this is based on the original cost.

Temporary differences arise for all the revalued assets and liabilities

Double entry

The deferred tax is recognised automatically during the consolidation process. There is no need to make a specific double entry.

Example: Fair value exercise and deferred tax

P Ltd acquires a 100% subsidiary on 31 December 20X6 for ₦600,000.

The subsidiary's deferred taxation position at the date of acquisition was as follows:

	Book value	Tax base	Temporary differences
	₦000	₦000	₦000
Property, plant and equipment	180	150	30
Accounts receivable	210	210	-
Inventory	124	124	-
Pension liability	-	-	-
Accounts payable	(120)	(120)	-
Temporary differences			30
Deferred tax at 30%			9

P Ltd carries out a fair value exercise.

The deferred tax balance must be recomputed to take account of the fair value differences as follows:

	Fair value	Tax base	Temporary differences
	₦000	₦000	₦000
Property, plant and equipment	270	150	120
Accounts receivable	210	210	-
Inventory	174	124	50
Pension liability	(30)	-	(30)
Accounts payable	(120)	(120)	-
Fair value of net assets	504		
Temporary differences			140
Deferred tax at 30%			42

The deferred tax balance of ₦9,000 must be increased to ₦42,000 in the consolidation workings.

Goodwill is calculated as follows:

	₦000
Cost of investment	600
Fair value of net assets acquired (as in the statement of financial position)	504
Deferred tax arising on fair value exercise	(42)
	(462)
Goodwill on acquisition	138

5.3 Unremitted earnings of group companies

When a company acquires a subsidiary or associate, it acquires a right to receive dividends out of its accumulated profits. A temporary difference arises on the profits of the subsidiary or associate that have not been distributed to the parent as at the date of consolidation. For clarity, this is the parent's share of the subsidiary's post acquisition retained profit.

IAS 12 requires that a deferred tax liability be recognised for these undistributed earnings, because they will attract tax when the dividends are paid to the parent in the future.

However, deferred taxation is not recognised on such amounts when:

- the parent is able to control the timing of the reversal of the temporary difference (i.e. the timing of when the dividend is paid); and
- it is probable that the temporary difference will not reverse in the future (i.e. there is no intention to instigate the payment of a dividend).

In practice, it is unusual to see companies recognising deferred tax liability for undistributed profits of a subsidiary because of the above rule.

The situation for investments in associates is different because the parent is unlikely to control the timing of the reversal of the temporary difference.
Recognition of deferred tax liability for undistributed profits of associates is quite common.

5.4 Unrealised profit adjustments

Where inter-company trading takes place between group companies and the inventory is still held by the group at the year end, an adjustment is made in the group accounts because the profit has not been realised outside of the group.

However, tax is charged on the profits of the individual companies, not on the group as a whole. The profit on intra-group sales will therefore be subjected to tax, and this will create a temporary difference.

The issue to resolve is whose tax rate should be used when providing for the deferred tax on this temporary difference – the seller's or the buyer's? IAS 12 requires that deferred tax be provided at the buyer's rate of tax.

5.5 Change in recoverability of parent's deferred tax asset due to an acquisition

A parent company may have a deferred tax asset that it has not recognised as it does not believe it probable that taxable profits will be available against which the asset can be used.

The probability of realising a pre-acquisition deferred tax asset of the acquirer could change as a result of a business combination.

For example, the acquirer may be able to utilise the benefit of its unused tax losses against the future taxable profit of the acquiree.

In such cases, the parent company should recognise the change in the deferred tax asset in the period of the business combination. This does not affect the goodwill calculation.

6 PRESENTATION AND DISCLOSURE

Section overview

- Presentation
- Disclosure

6.1 Presentation

Offset of current tax liabilities and assets

A company must offset current tax assets and current tax liabilities if, and only if, it:

- ❑ has a legally enforceable right to set off the recognised amounts; and
- ❑ intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

These are the same rules as apply to assets and liabilities in general as described in IAS 1.

In the context of taxation balances whether a current tax liability and asset may be offset is usually specified in tax law, thus satisfying the first criterion.

In most cases, where offset is legally available the asset would then be settled on a net basis (i.e. the company would pay the net amount).

Offset of deferred tax liabilities and assets

A company must offset deferred tax assets and deferred tax liabilities if, and only if:

- ❑ the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and
- ❑ the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either:
  - the same taxable entity; or
  - different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

The existence of deferred tax liability is strong evidence that a deferred tax asset from the same tax authority will be recoverable.

Example: Offset of deferred tax liabilities and assets

The following deferred tax positions relate to the same entity:

	Situation 1	Situation 2
Deferred tax liability	12,000	5,000
Deferred tax asset	(8,000)	(8,000)
	4,000	(3,000)

In situation 1, the financial statements will report the net position as a liability of 4,000. The existence of the liability indicates that the company will be able to recover the asset, so the asset can be set off against the liability.

In situation 2, setting off the asset against the liability leaves a deferred tax asset of 3,000. This asset may only be recognised if the entity believes it is probable that it will be recovered in the foreseeable future.

6.2 Disclosure

This section does not include the IAS 12 disclosure requirements in respect of those aspects of deferred taxation which are not examinable at this level.

Components of tax expense (income)

The major components of tax expense (income) must be disclosed separately.

Components of tax expense (income) may include:

- current tax expense (income);
- any adjustments recognised in the period for current tax of prior periods;
- the amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;
- the amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;
- the amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce current tax expense;
- deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset;
- the amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

Illustration: Note to the statement of comprehensive income

Taxation expense	**₦**
Current tax	129,000
Adjustment for over estimate of tax in prior year	(5,000)
Deferred taxation	
Arising during the period	20,000
Due to change in tax rate	(5,000)
	15,000
	139,000

Example: Change in rate

31 December 20X8

Profits were taxed at 30%.

A Plc recognised a deferred tax liability of ₦30,000 (it had temporary differences of ₦100,000).

31 December 20X9

The tax rate changed to 25% during the year.

At the year- end A Plc carried out the following deferred tax calculation:

	Carrying amount	Tax base	Temporary difference
	₦	₦	₦
Non-current assets	1,000,000	820,000	180,000
Deferred tax at 25%			45,000

The movement on the deferred tax liability would be shown as follows:

	₦
Deferred taxation b/f	30,000
Statement of comprehensive income: Rate change (5/30 × 30,000)	(5,000)
Deferred taxation b/f restated	25,000
Statement of comprehensive income (balancing figure – due to the origination of temporary differences in the period)	20,000
Deferred taxation balance at the end of the year **(working)**	45,000

Journal:	**Debit**	**Credit**
Income statement (tax expense)		5,000
Income statement (tax expense)	20,000	
Deferred tax liability		15,000

Tax reconciliation

The following must also be disclosed:

- an explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:
  - a numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate(s), disclosing also the basis on which the applicable tax rate(s) is (are) computed; or
  - a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed;
- an explanation of changes in the applicable tax rate(s) compared to the previous accounting period;

A major theme in this chapter is that the different rules followed to calculate accounting profit and taxable profit lead to distortion of the relationship that exists between profit before tax in the financial statements, the tax rate and the current tax expense for the period. Accounting for deferred tax corrects this distortion so that after accounting for deferred tax the tax expense (current and deferred tax) was equal to the tax rate × the accounting profit before tax.

This is not the case if there are permanent differences. The above reconciliations show the effect of permanent differences.

Example: Tax reconciliations

B Plc had an accounting profit before tax of ₦500,000.

This contained income of ₦20,000 which is not taxable.

Accounting depreciation in the year was ₦100,000 and tax allowable depreciation was ₦150,000. This means that a temporary difference of ₦50,000 originated in the year.

B Plc's taxation computation is as follows:	**₦**
Accounting profit	500,000
Add back inadmissible deductions	
Depreciation	100,000
Deduct admissible deduction	
Income not taxable	(20,000)
Assessable profit	580,000
Tax allowable depreciation	(150,000)
Taxable profit	430,000
Tax at 30%	129,000

Tax expense	**₦**
Current tax	129,000
Deferred taxation (30% × ₦50,000)	15,000
Tax expense	144,000

Tax reconciliation (in absolute numbers)	**₦**
Accounting profit	500,000
Applicable tax rate	30%
Accounting profit × the applicable tax rate	150,000
Tax effect of untaxed income (30% of ₦20,000)	(6,000)
Tax expense	144,000

Tax reconciliation (in percentages)	
Applicable tax rate	30.0%
Tax effect of untaxed income ($^{6,000}/_{500,000}$)	(1.2%)
Effective tax rate ($^{144,000}/_{500,000}$)	28.8%

Other disclosures

An entity must disclose the amount of income tax consequences of dividends to shareholders of the entity that were proposed or declared before the financial statements were authorised for issue, but are not recognised as a liability in the financial statements;

An entity must disclose the amount of a deferred tax asset and the nature of the evidence supporting its recognition, when:

- the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences; and
- the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Account for current tax
- Define temporary differences
- Identify temporary differences that cause deferred tax liabilities and deferred tax assets
- Determine the amount of deferred tax to be recognised in respect of temporary differences identified
- Apply the disclosure requirements of IAS 12

Practice questions **1**

XYZ Limited had an accounting profit before tax of ₦90,000 for the year ended December 31, 20X8. The tax rate is 30%.

The following balances and information are relevant as at 31 December 20X8.

Non-current assets	₦	₦	
Property	63,000		1
Plant and machinery	100,000	90,000	2
Right-of-use assets (IFRS 16)	80,000		3
Receivables:			
Trade receivables	73,000		4
Interest receivable	1,000		5
Payables			
Fine	10,000		
Lease obligation	85,867		3
Interest payable	3,300		5

Note 1: The property cost the company ₦70,000 at the start of the year. It is being depreciated on a 10% straight line basis for accounting purposes.

The company's tax advisers have said that the company can claim ₦42,000 accelerated depreciation as a taxable expense in this year's tax computation.

Note 2: The balances in respect of plant and machinery are after providing for accounting depreciation of ₦12,000 and tax allowable depreciation of ₦10,000 respectively.

Note 3: The right-of-use asset was acquired at the start of the year. The right-of-use asset and lease liability at initial recognition were ₦100,000.

Rental expense for leases is tax deductible in full. The annual rental for the asset is ₦28,800 and was paid on 31st December 20X9.

The asset is depreciated on a straight-line basis over five years.

Note 4: The receivables figure is shown net of an allowance for doubtful balances of ₦7,000. This is the first year that such an allowance has been recognised. A deduction for debts is only allowed for tax purposes when the debtor enters liquidation.

Note 5: Interest income is taxed and interest expense is allowable on a cash basis. There were no opening balances on interest receivable and interest payable.

a. Prepare a tax computation and calculate the current tax expense.

b. Calculate the deferred tax liability required as at 31 December 20X8.

c. Show the movement on the deferred tax account for the year ended 31 December 20X8 given that the opening balance was ₦3,600 Cr.

d. Prepare a note showing the components of the tax expense for the period.

e. Prepare a reconciliation between the tax expense and the product of the accounting profit multiplied by the applicable rate.

SOLUTIONS TO PRACTICE QUESTIONS

Solution: Tax computation for the year ended 31 December 20X8 **1a**

	₦	₦
Accounting profit		90,000
Add back inadmissible expenses		
Depreciation on property	7,000	
Depreciation of plant and machinery	12,000	
Depreciation of right of use asset	20,000	
Lease finance charge (working)	14,667	
Increase in provision for doubtful debts	7,000	
Interest payable accrual	3,300	
Fine	10,000	73,967
Less admissible deductions		
Interest income	1,000	
Tax allowable depreciation on property	42,000	
Tax allowable depreciation on plant and machinery	10,000	
Lease rentals	28,800	(81,800)
		82,167
Tax 30%		24,650

Working: Lease finance charge	₦
Lease liability start of the year (initial recognition)	100,000
Lease payment	(28,800)
Lease finance charge (balancing figure)	14,667
Lease liability at year-end	85,867

Solution: Deferred tax liability as 31 December 20X8 **1b**

	Carrying value	Tax base	Temporary difference
	₦	₦	₦
Property	63,000	28,000	35,000
Plant and machinery	100,000	90,000	10,000
Right-of-use asset	80,000	nil	80,000
Lease obligation	(85,867)	nil	(85,867)
	(5,867)	nil	(5,867)
Trade receivables	73,000	80,000	(7,000)
Interest receivable	1,000	nil	1,000
Fine	(10,000)	(10,000)	–
Interest payable	(3,300)	nil	(3,300)
			29,833
Deferred tax @ 30%			8,950

	Temporary differences	Deferred tax @ 30%
Deferred tax liabilities	46,000	13,800
Deferred tax assets	(16,167)	(4,850)
		8,950

Solution: Movement on the deferred tax account for the year ended 31 December 20X8. **1c**

	₦
Deferred tax as at 1st January 20X9	3,600
Statement of comprehensive income (balancing figure)	5,350
Deferred tax as at 31st December 20X9	8,950

Solution: Components of tax expense for the year ended 31 December 20X8. **1d**

	₦
Current tax expense (see part a)	24,650
Deferred tax (see part c)	5,350
Tax expense	30,000

Solutions: Tax reconciliation for the year ended 31 December 20X8. **1e**

	₦
Accounting profit	90,000
Tax at the applicable rate (30%)	27,000
Tax effects of expenses that are not deductible in determining taxable profit	
Fines	3,000
Tax expense	30,000

Professional level
Corporate Reporting

CHAPTER 14

IAS 19: Employee benefits

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	3	Non-financial liabilities	
		a	Evaluate how different methods and timing of recognition and measurement of non-financial liabilities affect reported financial position.
		b	Appraise accounting treatments of non-financial liabilities such as Employees' Benefits – IAS 19; Share Based Payment – IFRS 2; Income Tax – IAS 12; Provisions, Contingent Liabilities and Contingent Assets – IAS 37; and Leases - IFRS 16.

IAS 19 is an examinable standard.

Exam context

This chapter explains the rules set out in IAS 19. The most complex area is accounting for defined benefit pension plans. Recent changes to the rules have simplified the model but it is still needs careful attention. Work through the examples carefully and make sure that you understand the process.

At the end of this chapter, you should be able to:

- Define the different types of employment benefits
- Account for defined contribution post-employment benefit plans
- Define the various cost components associated with defined benefit post-employment benefit plans
- Explain the role of an actuary
- Account for defined benefit post-employment benefit plans including the application of the asset ceiling.

1 IAS 19: EMPLOYEE BENEFITS

Section overview

- The scope and basic principles of IAS 19
- Short-term employee benefits
- Termination benefits
- Other long term benefits

1.1 The scope and basic principles of IAS 19

Definition

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

A company may reward its employees in ways other than payment of a basic salary. Employers often provide entitlements to paid holidays, or pay an annual cash bonus to some employees, or provide employees with a company car, medical insurance and pension benefits. (Some employees also receive share options under company pension schemes: these are classified as share-based payments.)

IAS 19 provides guidance on accounting for all forms of employee benefits, except for share-based payments. Share-based payments are dealt with by IFRS 2.

IAS 19 sets out rules of accounting and disclosure for:

- short term employee benefits;
  - wages, salaries and social security contributions;
  - paid annual leave and paid sick leave;
  - profit-sharing and bonuses; and
  - non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;
- post-employment benefits, such as the following:
  - retirement benefits (e.g. pensions and lump sum payments on retirement); and
  - other post-employment benefits, such as post-employment life insurance and post-employment medical care;
- other long-term employee benefits, such as the following:
  - long-term paid absences such as long-service leave or sabbatical leave;
  - jubilee or other long-service benefits; and
  - long-term disability benefits; and
- termination benefits.

Accounting principle

The basic principle in IAS 19 is that the cost of providing benefits to employees should be matched with the period during which the employees work to earn the benefits. This principle applies even when the benefits are payable in the future, such as pension benefits.

IAS 19 requires an entity:

- to recognise a liability when an employee has provided a service in exchange for a benefit that will be paid in the future, and
- to recognise an expense when the entity makes use of the service provided by the employee.

The basic double entry may therefore be (depending on the nature of the employee benefits):

- Debit: Employment cost (charged as an expense in the statement of profit or loss)
- Credit: Liability for employee benefits

1.2 Short-term employee benefits

Definition

Short-term employee benefits are employee benefits that expected to be settled wholly within twelve months after the end of the period in which the employee provides the service.

Short-term employee benefits include:

- wages, salaries and social security contributions
- paid annual holiday and paid absences due to sickness
- profit-sharing payments and bonuses
- other benefits not in a monetary form, such as medical insurance, free accommodation in a house or flat owned by the entity and company cars.

The expense must be accounted for on an accruals basis and any unpaid entitlement should be recognised as a short-term liability. Discounting the liability to a present value is not required, because it is payable within 12 months.

Short-term paid absences

Sometimes an entity may pay employees for absence for various reasons. These include holidays, sickness and maternity leave.

Entitlement to paid absences falls into two categories:

- accumulating
  - carried forward for use in future periods if the current period's entitlement is not used in full;
  - expense and liability is recognised when employees render service that increases their entitlement to future paid absences

- measured at the additional amount expected to be paid as a result of the unused entitlement that has accumulated at the end of the reporting period.

❑ non-accumulating.

- unused amounts cannot be carried forward;
- expense and liability is recognised when the absences occur.

Profit-sharing and bonus plans

The expected cost of profit-sharing and bonus payments must be recognised when, and only when:

❑ the entity has a present legal or constructive obligation to make such payments as a result of past events; and

❑ a reliable estimate of the obligation can be made.

A reliable estimate of its legal or constructive obligation under a profit-sharing or bonus plan can be made when, and only when:

❑ the formal terms of the plan contain a formula for determining the amount of the benefit;

❑ the entity determines the amounts to be paid before the financial statements are authorised for issue; or

❑ past practice gives clear evidence of the amount of the entity's constructive obligation.

A present obligation exists when, and only when, the entity has no realistic alternative but to make the payments.

1.3 Termination benefits

Definition

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

a. an entity's decision to terminate an employee's employment before the normal retirement date; or

b. an employee's decision to accept an offer of benefits in exchange for the termination of employment.

Recognition

An entity must recognise a liability and expense for termination benefits at the earlier of the following dates:

❑ when the entity can no longer withdraw the offer of those benefits; and

❑ when the entity recognises costs for a restructuring within the scope of IAS 37 that involves the payment of termination benefits.

Measurement

Termination benefits are measured in accordance with the nature of the employee benefit, that is to say short term benefits, other long term benefits or post-employment benefits.

1.4 Other long term benefits

Definition

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

An entity must recognise a net liability (asset) for any other long term benefit. This is measured as:

- the present value of the obligation for the benefit; less
- the fair value of assets set aside to meet the obligation (if any).

Movements in the amount from one year to the next are recognised in P&L.

2 POST-EMPLOYMENT BENEFITS

Section overview

- Post-employment benefits
- Defined contribution pension plans
- Defined benefit pension plans
- Introduction to accounting for defined benefit pension plans
- Accounting for defined benefit pension plans
- Accounting for defined benefit pension plans – Alternative approach
- Past service cost
- Asset ceiling example
- Multi-employer plans

2.1 Post-employment benefits

Definition

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

The most significant post-employment benefit is a retirement pension, but there may also be post-employment life insurance and medical care.

Definition

Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.

There are two types of post-employment benefit plan:

- ❑ defined contribution plans; and
- ❑ defined benefit plans.

Definitions

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

2.2 Defined contribution pension plans

In a defined contribution pension plan, the employer pays an agreed amount of money ('defined contributions') at regular intervals into a pension fund for the employee. The amount of money that the employer contributes is usually a fixed percentage of the employee's wages or salary (e.g. 5% of the employee's basic salary).

The contributions to the fund are invested to earn a return and increase the value of the fund. When an employee retires, he or she is paid a pension out of the fund. The amount of pension received by the employee is not pre-determined, but depends on the size of the employee's share of the fund at retirement.

As the name 'defined contribution' implies, the company's obligation to pay a pension to the employee is limited to the agreed amounts of contribution. The company is not required to make good any shortfalls if the pension fund does not have enough assets to pay the pension benefits that the employee would like to have. In effect, the employee bears the risk of a poor-performing fund, not the employer.

Accounting treatment: contributions to defined contribution schemes

Accounting for the employer's contributions to a defined contribution scheme is straightforward. Using the accruals concept:

- the contributions payable for the reporting period are charged to profit or loss as an expense (an employee cost) in the statement of profit or loss.
- any unpaid contributions at the end of the year will be shown in the statement of financial position as an accrual/liability and any prepaid contributions will be shown as an asset (a prepayment).

2.3 Defined benefit pension plans

Under a defined benefit plan, the employer guarantees the amount of pension that its employees will receive after they retire. A company might save cash into a separate fund (just as for defined contribution plans) in order to build up an asset that can be used to pay the pensions of employees when they retire. This would be known as a funded plan. If an employer does not save up in this way the plan is described as being unfunded.

The amount that an employee will receive is usually linked to the number of years that he or she has worked for the company, and the size of his/her annual salary at retirement date (or on leaving the company). Defined benefit plans are often known as "final salary schemes"

If there are insufficient funds in the plan to provide employees with the guaranteed pensions then the employer must make up the shortfall. The risk remains with the employer.

Role of an actuary

An actuary is a highly qualified specialist in the financial impact of risk and uncertainty. They advise companies on the conduct of their pension plans.

An actuary will advise the company how much to pay in contributions into the pension plan each year, in order to ensure there are sufficient funds to cover the company's obligation to make the pension payments. This involves making a large number of estimates. For example, the actuary has to estimate the average life expectancy of retired employees, the expected number of years of service that retired employees will have given when they retire, their final salary and the expected returns on investments in the pension fund.

It is very unlikely that the actuary's estimates will be 100% accurate so whenever the value of the pension fund assets and the employer's pension obligations are measured, the company may find that there is a deficit or a surplus.

- When the amount of the employer's future pension obligations is more than the value of the investments in the pension fund, the fund is in deficit.
- When the value of the investments in the pension fund is higher than the value of the employer's obligations to make future pension payments, the fund is in surplus.

When a surplus or deficit occurs an employer might take no action. This would be the case when the company believes that the actuarial assumptions may not be true in the short term but will be true over the long term. Alternatively, the company might decide to eliminate a deficit (not necessarily immediately) by making additional contributions into the fund.

When the fund is in surplus, the employer might stop making contributions into the fund for a period of time (and 'take a pension holiday'). Alternatively the company may withdraw the surplus from the fund, for its own benefit.

2.4 Introduction to accounting for defined benefit pension plans

Pensions are paid by the defined benefit plan which is a separate legal entity from the company. However, the company has the legal obligation to pay the pensions.

The defined benefit plan is a special entity set up in order to handle a large number of complex and long term transactions for the company and to separate the plan's assets from those of the company (the pensions of the employees are protected if the company runs into difficulties).

Statement of financial position

IAS 19 requires that an entity must recognise a defined benefit item (net liability due to a deficit or net asset due to a surplus) in the statement of financial position.

The net defined benefit liability (asset) is the deficit or surplus and is measured as:

- the present value of the defined benefit obligation; less
- the fair value of plan assets (if any).

A surplus in a defined benefit plan is measured at the lower of:

- the surplus in the defined benefit plan; and
- the asset ceiling (which is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan).

Definition

The **present value of a defined benefit obligation** is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

The obligation is estimated by an actuary, and is based on actuarial estimates and assumptions. IAS 19 requires that it must be measured using the projected unit credit method (you may need to know this term but do not need to apply it) using a discount rate available on high quality corporate bonds.

Movement for the period

The movements on the defined benefit item are due to:

- cash contributions to the plan
- current service cost (to P&L);
- past service cost (to P&L);
- gains or loss on settlement (to P&L);
- net interest (expense or income); and (to P&L); and
- remeasurement (to OCI);

Note that the benefit paid has no effect as it reduces the plan assets and plan obligations by the same amount.

Definitions – Movements recognised through P& L

Definitions

Current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period;

Past service cost is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan).

Net interest on the net defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

A **settlement** is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Definitions – Movements recognised through OCI

Definitions

Remeasurements of the net defined benefit liability (asset) comprise:

a. actuarial gains and losses;

b. any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Actuarial gains and losses are changes in the present value of the defined benefit obligation resulting from:

a. experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and

b. the effects of changes in actuarial assumptions.

2.5 Accounting for defined benefit pension plans

Step 1

Construct a note to show the net liability (net asset) that is recognised on the face of the statement of financial position. This note should include both amounts for the current year and comparatives.

Illustration: Defined benefit net liability (asset)

	Opening	Closing
Present value of plan obligation	X	X
Fair value of plan assets	X	X
	X	X

This is used to identify the movement on the defined benefit liability (asset) which is journalised at step 2

Step 2

Construct the following journal and enter the movement on the defined benefit liability (asset) and the cash paid to the plan by the company (contributions).

Illustration: Journal

	Debit	Credit
Profit or loss		
Other comprehensive income (remeasurement)		
Cash (contributions)		X
Defined benefit net liability		X

The above illustration assumes an increase in the liability. This would not be the case in all examples. (In other words, the movement might be a debit or a credit, depending on circumstance).

Step 3

Identify the profit and loss entries. These comprise:

- current service cost;
- past service cost (if any); and
- interest (an interest rate applied to the opening net liability (asset).

Enter the total into the journal.

Step 4

Calculate the remeasurement as a balancing figure.

Example: Defined benefit accounting

The following information relates to the defined benefit plan of Company X for the year to 31 December 20X6.

At 1 January 20X6:	**₦000**
Fair value of the plan assets	900
Present value of the plan obligations	1,850

During 20X6:	**₦000**
Current service cost	90
Contributions paid into the plan	150
Benefits paid out by the plan	60

Actuarial assumptions:	
Discount rate	10%

New actuarial valuation at 31 December 20X6:	**₦000**
Fair value of the plan assets	850
Present value of the plan obligations	1,960

Construct a journal to show the movement on the defined benefit account.

Answer: Defined benefit accounting

Step 1: The opening position

	1 January 20X6	31 December 20X6
	₦000	₦000
Present value of plan obligation	1,850	1,960
Fair value of plan assets	(900)	(850)
	950	1,110

Note that the movement on the defined benefit liability is an increase of ₦160,000 (1,110,000 – 950,000)

Step 2: Construct the journal and fill in the blanks as far as possible

	Debit	Credit
	₦000	₦000
Profit or loss		
Other comprehensive income (remeasurement)		
Cash (contributions)		150
Defined benefit net liability		160

Answer (continued): Defined benefit accounting

Step 3: Identify amounts to be recognised in profit or loss

	₦000
Current service cost	90
Interest (10% × ₦950,000)	95
	185

Note that the movement on the defined benefit liability is an increase of ₦160,000 (1,110,000 – 950,000)

Step 4: Complete the journal by calculating the remeasurement as a balancing figure

	Debit	Credit
	₦000	₦000
Profit or loss	185	
Other comprehensive income (remeasurement as a balancing figure)	125	
Cash (contributions)		150
Defined benefit net liability		160
	310	310

2.6 Accounting for defined benefit pension plans – Alternative approach

Steps 1 and 2 are as before. The difference is in the calculation of the remeasurement.

This involves rolling the opening figures forward to the year end. The approach is to calculate what the closing defined benefit net liability (net asset) should be by adjusting the opening defined benefit net liability (asset) by what has happened in the period and by applying the actuarial assumptions.

This balance can then be compared with the actual closing balance and the remeasurement identified as a balancing figure.

This accounting treatment can best be explained using an example:

Example: Defined benefit accounting

The following information relates to the defined benefit plan of Company X for the year to 31 December 20X6.

At 1 January 20X6:	**₦000**
Fair value of the plan assets	900
Present value of the plan obligations	1,850

During 20X6:	**₦000**
Current service cost	90
Contributions paid into the plan	150
Benefits paid out by the plan	60

Actuarial assumptions:	
Discount rate	10%

New actuarial valuation at 31 December 20X6:	**₦000**
Fair value of the plan assets	850
Present value of the plan obligations	1,960

Construct a journal to show the movement on the defined benefit account.

Answer: Defined benefit accounting

Step 1: The opening position (as before)

	1 January 20X6	31 December 20X6
	₦000	₦000
Present value of plan obligation	1,850	1,960
Fair value of plan assets	(900)	(850)
	950	1,110

Step 2: Construct the journal and fill in the blanks as far as possible (as before)

	Debit	Credit
	₦000	₦000
Profit or loss		
Other comprehensive income (remeasurement)		
Cash (contributions)		150
Defined benefit net liability		160

Answer (continued): Defined benefit accounting

Step 3: Construct a working to identify the movements on the defined benefit net liability (asset)

	₦000
At start of year	(950)
1 Net interest (10% × 950,000)	(95)
2 Contributions paid (given)	150
3 Current service cost (given)	(90)
4 Benefits paid out (given)	0
Expected year end position	(985)
Remeasurement (balancing figure)	(125)
Actual year end position	(1,110)

Step 4: Complete the journal by entering in the profit and loss amounts and the remeasurement from the above working.

	Debit	Credit
	₦000	₦000
Profit or loss (₦95,000 + ₦90,000)	185	
Other comprehensive income	125	
Cash (contributions)		150
Defined benefit net liability		160
	310	310

Possible complication

In the above illustration the opening defined benefit net liability (asset) was rolled forward.

IAS 19 requires disclosure of reconciliations of the present value of the defined benefit obligation and the fair value of the defined benefit assets.

This is done by constructing a similar working to that shown in step 3 above but including further columns for both the defined benefit liability and the defined benefit asset.

Example:

Using the facts from the previous example the working would be as follows:

Step 3: Construct a working to identify the movements on the defined benefit net liability (asset)

	Fund position		Company position
	Liability	Assets	Net
	₦000	₦000	₦000
At start of year	(1,850)	900	(950)
1 Interest expense (10% × 1,850,000)	(185)		(185)
1 Interest earned (10% × 900,000)		90	90
1 Net interest (10% × 950,000)			(95)
2 Contributions paid (given)		150	150
3 Current service cost (given)	(90)		(90)
4 Benefits paid out (given)	60	(60)	0
Expected year end position	(2,065)	1,080	(985)
Remeasurement (balancing figure)	105	(230)	(125)
Actual year end position	(1,960)	850	(1,110)

Note, that this explains why the benefits paid do not figure in the double entry. When benefit is paid it reduces both the asset and the liability and in consequence has no impact on the net position.

2.7 Past service cost

Past service cost is the change in the present value of the defined benefit obligation resulting from a plan amendment or curtailment.

- A plan amendment occurs when an entity introduces, or withdraws, a defined benefit plan or changes the benefits payable under an existing defined benefit plan.
- A curtailment occurs when an entity significantly reduces the number of employees covered by a plan. A curtailment may arise from an isolated event, such as the closing of a plant, discontinuance of an operation or termination or suspension of a plan.

Past service cost may be either positive (when benefits are introduced or changed so that the present value of the defined benefit obligation increases) or negative (when benefits are withdrawn or changed so that the present value of the defined benefit obligation decreases).

Recognition

Past service cost must be recognised as an expense at the earlier of:

- when the plan amendment or curtailment occurs
- when related restructuring costs are recognised.

2.8 Asset ceiling example

IAS 19 requires that an entity must recognise a defined benefit item (net liability due to a deficit or net asset due to a surplus) in the statement of financial position.

The net defined benefit liability (asset) is the deficit or surplus and is measured as:

- the present value of the defined benefit obligation; less
- the fair value of plan assets (if any).

However, if the net item is a surplus it is subject to a test which puts a ceiling on the amount that can be recognised. This is known as the "asset ceiling" test.

A surplus in a defined benefit plan is measured at the lower of:

- the surplus in the defined benefit plan; and
- the asset ceiling (which is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan).

The approach is exactly the same as before except that net defined benefit assets recognised at step 1 must be adjusted downwards to the asset ceiling.

Example: Defined benefit accounting with asset ceiling

The following information relates to the defined benefit plan of Company X for the year to 31 December 20X6.

At 1 January 20X6:	**₦000**
Fair value of the plan assets	1,150
Present value of the plan obligations	1,100
Present value of economic benefits available due to rules in the jurisdiction	40

During 20X6:	**₦000**
Current service cost	125
Contributions paid into the plan	80
Benefits paid out by the plan	130
Actuarial assumptions:	
Discount rate	10%

New actuarial valuation at 31 December 20X6:	**₦000**
Fair value of the plan assets	1,395
Present value of the plan obligations	1,315
Present value of economic benefits available due to rules in the jurisdiction	65

Construct a journal to show the movement on the defined benefit account.

Answer: Defined benefit accounting with asset ceiling

Step 1: The opening position

	1 January 20X6	31 December 20X6
	₦000	₦000
Fair value of plan assets	1,150	1,395
Present value of plan obligation	(1,100)	(1,315)
	50	80
Asset ceiling adjustment (balancing figure)	(10)	(15)
Asset ceiling (PV of economic benefits available	40	65

Note that the movement on the defined benefit asset is an increase of ₦25,000 (65,000 – 40,000)

Step 2: Construct the journal and fill in the blanks as far as possible (as before)

	Debit	Credit
	₦000	₦000
Profit or loss		
Other comprehensive income (remeasurement)		
Cash (contributions)		80
Defined benefit net asset	25	

Step 3: Identify amounts to be recognised in profit or loss

	₦000
Current service cost	(125)
Interest credit (10% × 40,000)	4
	121

Step 4: Complete the journal by calculating the remeasurement as a balancing figure

	Debit	Credit
	₦000	₦000
Profit or loss	121	
Other comprehensive income (remeasurement as a balancing figure)		66
Cash (contributions)		80
Defined benefit net asset	25	
	146	146

2.9 Multi-employer plans

Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans that:

- ❑ pool the assets contributed by various entities that are not under common control; and
- ❑ use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees.

Any multi-employer plan must be classified as a defined contribution plan or a defined benefit plan.

If an entity participates in a multi-employer defined benefit plan it must account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan.

If sufficient information is not available to use defined benefit accounting for a multi-employer defined benefit plan, an entity must account for it as if it were a defined contribution plan.

Group plans

Defined benefit plans that share risks between entities under common control (e.g. a parent and its subsidiaries) are not multi-employer plans.

Any entity participating in a defined benefit plan that shares risks between entities under common control must disclose:

- ❑ the contractual agreement or stated policy for charging the net defined benefit cost or the fact that there is no such policy.
- ❑ the policy for determining the contribution to be paid by the entity.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define the different types of employment benefits
- Account for defined contribution post-employment benefit plans
- Define the various cost components associated with defined benefit post-employment benefit plans
- Explain the role of an actuary
- Account for defined benefit post-employment benefit plans including the application of the asset ceiling.

Professional level
Corporate

CHAPTER 15

IFRS 2: Share-based payments

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	3	Non-financial liabilities	
		a	Evaluate how different methods and timing of recognition and measurement of non-financial liabilities affect reported financial position.
		b	Appraise accounting treatments of non-financial liabilities such as Employee Benefits – IAS 19; Share Based Payment – IFRS 2; Income Tax – IAS 12; Provisions, Contingent Liabilities and Contingent Assets – IAS 37; and Leases - IFRS 16.

IFRS 2 is an examinable document.

Exam context

This chapter explains how to account for share-based payments.

At the end of this chapter, you should be able to:

- Describe the three types of share-based payment scheme
- Account for equity-settled share-based payments
- Account for cash-settled share-based payments
- Explain what happens when there is a choice of equity or cash

1 INTRODUCTION

Section overview

- Introduction
- Scope
- Types of share-based payments
- Recognition
- Grants of share options to employees: the accounting problem

1.1 Introduction

IFRS *2 Share-based payment* explains the accounting treatment for share-based payment transactions.

Definition

A share-based payment transaction is defined as a transaction in which an entity:

a. receives goods or services as consideration for equity instruments of the entity, or

b. receives goods or services from a supplier by incurring a liability to the supplier for an amount that is based on the entity's share price.

1.2 Scope

Included in scope

The IFRS applies to share-based payment transactions in which an entity acquires or receives goods or services unless the transaction is specifically excluded from its scope.

Excluded from the scope

Transfers of an entity's equity instruments by its shareholders to parties that have supplied goods or services to the entity when such a transfer is clearly for a purpose other than payment for goods or services supplied (in which case it is within the scope of IFRS 2)

Transactions with an employee (or other party) in their capacity as a shareholder.

Transactions where equity instruments are issued in exchange for control of an acquiree in a business combination.

Share-based payment transactions in which the entity receives or acquires goods or services under a "contract to buy or sell a non-financial item" that is within the scope of IFRS on financial instruments. (IAS 32 *Presentation* and IFRS 9 *Financial Instruments*).

1.3 Types of share based payments

IFRS 2 identifies three types of share based payment transaction:

- equity-settled share-based payment transactions
  - where the entity pays for goods or services by issuing equity instruments including both:
    - shares; and,
    - share options;
- cash-settled share-based payment transactions
  - where an entity incurs a liability for goods or services and the settlement amount is based on the price (or value) of the entity's shares or other equity instruments.
- transactions where an entity acquires goods or receives services and either the entity or the supplier can choose payment to be:
  - a cash amount based on the price (or value) of the entity's shares or other equity instruments, or
  - equity instruments of the entity

IFRS 2 uses the generic term ***equity instruments***. In most cases the equity instruments in question are either shares or share options.

IFRS 2 does not apply in the cases of shares issued as consideration in a business combination or to contracts for the purchase of goods within the scope of IAS 32 and 39.

IFRS 2 uses the term fair value in a way that differs in some respects from the IFRS 13 definition. When applying IFRS 2, fair value is measured in accordance with the guidance in IFRS2 not that in IFRS 13.

1.4 Recognition

Goods and services must be recognised when the goods and services are received.

This might result in the recognition of an asset or expense depending on the nature of the transaction. If the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets (determined by rules in other standards), they must be recognised as expenses.

- if the goods or services are received or acquired through an equity-settled share-based payment transaction the credit entry to match the recognition of the debit is to equity.
- if the goods or services are received or acquired through a cash-settled share-based payment transaction the credit entry to match the recognition of the debit is to a liability.

1.5 Grants of share options to employees: the accounting problem.

The nature of employee share options

Occasionally shares may be used instead of cash to pay suppliers for goods or services. These are described as share-based payments, and until IFRS 2, there was no accounting standard addressing the recognition and measurement of these transactions.

However, the main reason for the publication of IFRS 2 was to introduce rules of accounting for employee share options.

In an employee share option scheme, an employee is given the right to subscribe for new shares in the company at a future date, at a price that is usually fixed when the share options are awarded.

The accounting problem

The award of share options to an employee is a reward for services given by the employee.

- If the employee is rewarded with a cash bonus, the cost of the cash bonus would be included in total employment costs and charged as an expense in the relevant accounting period.
- A problem in the past with accounting for share options was that although share options are a similar type of reward for service, the cost of the options were not charged as an expense in the statement of profit or loss.

An award of share options to an employee is consideration given by the entity to the employee in return for the employee's services. Before IFRS 2 was published this was not accounted for.

As the following sections explain in detail, the IFRS 2 rules on share based payment result in the recognition of an expense in profit or loss.

Controversy

When the standard was in its development phase, many argued that there was no expense because no cash passes hands. However, IFRS 2 is based on the concept that the expenses represent a consumption of benefit that usually happens to be measured in terms of a cash cost but need not be in all cases.

The IFRS 2 expense represents the consumption of the benefit of the employees' service.

2 MEASUREMENT OF EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS

Section overview

- Introduction
- Direct or indirect measurement
- Measurement data
- Measurement of fair value of equity instruments granted
- Recognition
- Modifications to the terms and conditions on which equity instruments were granted
- After equity instruments have vested

2.1 Introduction

When an entity acquires goods or receives services it must measure them at fair value with a corresponding increase in equity.

This raises several issues:

- how should the fair value be measured?
- when should the fair value be measured?
- when should the transaction be recognised?

In answering these questions IFRS 2 distinguishes between:

- transactions with employees (and others providing similar services); and
- transactions with other parties.

The IFRS 2 approach is summarised in the following table:

	Transactions with other parties	Transactions with employees
How is the fair value of the transaction measured?	With reference to the fair value of the goods and services received	With reference to the fair value of the equity instrument granted
When is the transaction measured?	At the date when the goods and services are received	At the date when the equity instruments are granted
When is the transaction recognised?		
No vesting conditions	At date the goods and services are received	At grant date (there is a presumption that the services have been received in full)
Vesting conditions	As the service is rendered over the vesting period	As the service is rendered over the vesting period

2.2 Direct or indirect measurement

There are two possible approaches which could be followed to measure the fair value of the transaction:

- ❑ estimate the fair value of the debit:
  - this is known as direct measurement;
  - this uses the fair value of the goods and services themselves;
  - there is a rebuttable presumption that this can be estimated reliably;
  - it must be used except for:
    - those rare cases in which the fair value of goods and services received cannot be estimated reliably; and,
    - transactions with employees.
- ❑ estimate the fair value of the equity instrument credit:
  - this is known as indirect measurement;
  - this uses the fair value of the equity instruments themselves;
  - it must be used:
    - when the fair value of goods and services received cannot be estimated reliably; or
    - for transactions with employees.

2.3 Measurement date

The measurement date is the date at which the fair value of the equity instruments granted is measured for the purposes of this IFRS.

The measurement date is:

- ❑ the grant date for transactions with employees (and others providing similar services);
- ❑ the date on which goods are obtained or services received for transactions with parties other than employees (and those providing similar services).

2.4 Measurement of fair value of equity instruments granted

This is needed when the indirect method is being used (i.e. when options are granted to employees).

Fair value is measured taking into account all relevant terms and conditions upon which the equity instruments are granted.

Grant of shares

The market price of the shares is used.

If the shares are not publicly traded an estimated market price should be used adjusted to take into account the terms and conditions upon which those shares were granted.

Options

The fair value of options granted is measured at the market price of traded options with similar terms and conditions.

In most cases there will not be a traded option with similar terms and conditions because the options granted are subject to terms and conditions that do not apply to traded options. For example, typically, employee share options are:

- non-transferable and
- subject to vesting conditions.

Fair value is then estimated by applying an option pricing model, for example:

- the Black-Scholes-Merton model; or,
- a binomial model.

In applying the model the entity must take into account all relevant factors. These include:

- the exercise price of the option;
- the life of the option;
- the current price of the underlying shares;
- the expected volatility of the share price;
- the dividends expected on the shares;
- the risk-free interest rate for the life of the option;
- vesting conditions that are market conditions.

2.5 Recognition

Often, when equity instruments are granted they are subject to conditions that must be satisfied before the counterparty becomes unconditionally entitled to the instrument.

No vesting conditions

If the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to the equity instruments they are said to vest immediately.

In the absence of evidence to the contrary, the entity must presume that services rendered by the counterparty as consideration for the equity instruments have been received.

In this case the entity must recognise the services received in full on the grant date.

Recognition – vesting conditions

IFRS 2 distinguishes different categories of "vesting condition". These are:

- service conditions require the counterparty to complete a specified period of service before the option vests; and
- performance conditions require the counterparty to complete a specified period of service and specified performance targets to be met.

Recognition over a period

A grant of equity instruments is often conditional upon satisfying specified vesting conditions. In this case the services received are recognised over the vesting period (with corresponding increases in equity).

- At each year end an entity must make the best available estimate of the number of equity instruments expected to vest taking account of non-market vesting conditions. These might include:
  - service conditions; and
  - non-market performance conditions.
- The number of shares is then valued using the fair value at the grant date.
- The charge for the year is then calculated by comparing the opening and closing estimates.
- At the vesting date the actual number of equity instruments that vest (or that would have vested except for the failure of a market condition) is the basis for the overall cumulative charge (and the corresponding balance in equity).

Estimates of the outcome of vesting conditions may change from year to year. The estimate at any particular date, of the number of equity instruments granted, takes such changes into account

Ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted is based on the number of equity instruments that eventually vest (or that would have vested except for the failure of a market condition – see below)

No amount is recognised on a cumulative basis for goods or services received if the equity instruments granted do not vest because of failure to satisfy non-market vesting conditions.

Market conditions

A performance target may involve a market condition. This is any condition that relates to share price.

For example, a performance condition might be that the shares will vest as long as an employee stays with the company for three years from the grant date and the share price increases by 20% in this period.

The probability of achieving a market condition is taken into account when estimating the fair value of the equity instrument granted. Subsequent changes in this probability play no part in the recognition.

When people meet this for the first time they often find it a little difficult to accept. For clarity, this means that an option may not vest due to failure to meet the market condition but an expenses is recognised as if the condition had been met.

Another way of saying this is that a market condition is a measurement attribute rather than a recognition attribute.

Service condition

If a grant of share options is conditional upon the completion of three years' service, recognition is based on the assumption that the services rendered by the employee in consideration for these share options will be received over that three-year vesting period.

Example: Equity settled share-based payment

X plc is a company with a 31 December year end.

On 1st January Year 1 grants 100 options to each of its 500 employees.

Each grant is conditional upon the employee working for X plc over the next three years.

At the grant date X plc estimates:

a. The fair value of each option is ₦15.

b. 20% of employees will leave over the vesting period.

Required

Calculate the income statement expense for each year of the vesting period if everything turns out exactly as expected.

Answer

31 December Year 1	**₦**	**Equity**
Expected outcome (at grant date value)		
500 × 80% × 100 × ₦15	600,000	
	×1/3	
Year 1 charge	200,000	
Accumulated in equity by end of year 1		200,000

31 December Year 2	**₦**	
Expected outcome (at grant date value)		
500 × 80% × 100 × ₦15	600,000	
	×2/3	
Recognised by the year end	400,000	
Less expense previously recognised	(200,000)	
Year 2 charge	200,000	
Accumulated in equity by end of year 2		400,000

31st December Year 3	**₦**	
Actual outcome (at grant date value)		
500 × 80% × 100 × ₦15	600,000	
Less expense previously recognised	(400,000)	
Year 3 charge	200,000	
Accumulated in equity by end of year 3		600,000

Changes in estimate of the outcome of the service conditions are taken into account in the calculation of the number of equity instruments that are expected to vest at the end of the vesting period.

Practice question **1**

X plc is a company with a 31st December year end.

On 1st January Year 1 X plc grants 100 options to each of its 500 employees.

Each grant is conditional upon the employee working for X plc over the next three years.

At the grant date X plc estimates that the fair value of each option is ₦15.

Required:

Calculate the income statement charge for the year ended:

1. 31st December Year 1 if at that date, X plc expects 85% of employees to still be with the company at the end of the vesting period.
2. 31st December Year 2 if at that date, X plc expects 88% of employees to still be with the company at the end of the vesting period.
3. 31st December Year 3 if at that date 44,300 share options vest.

Service condition – non- market performance condition

If a grant of share options is conditional on staying with an entity until a performance condition is achieved the length of the vesting period will vary.

The length of the expected vesting period is estimated at grant date an revised if subsequent information indicates that the length of the vesting period differs from previous estimates (but not if the performance condition is a *market condition*).

Example: Equity settled share-based payment with performance condition

X plc is a company with a 31st December year end.

On 1st January Year 1 X plc grants 100 shares to each of its 500 employees on condition that the employees remain with the company in the vesting period.

The shares will vest at:

a. 31st December Year 1 if X plc's earnings grow by 18% or more; or

b. 31st December Year 2 if X plc's earnings grow by an average of 13% or more over the two years; or

c. 31st December Year 3 if X plc's earnings grow by an average of 10% or more over the three years.

At the grant date X plc estimates that the fair value of each share is ₦30.

31st December Year 1

Earnings have grown by 14% therefore the shares do not vest at this date.

X plc makes the following estimates:

a. earnings will increase at 14% in the next year with the result that the shares are expected to vest at the next year end.

b. 88% of employees are expected to still be with the company at that time.

31st December Year 1

	₦	Equity
Expected outcome (at grant date value)		
500 × 88% × 100 × ₦30	1,320,000	
	×1/2	
Year 1 charge	660,000	
Accumulated in equity by end of year 1		660,000

Example (continued): Equity settled share-based payment with performance condition

31st December Year 2

Earnings have grown by 10% therefore the shares do not vest at this date. The growth rate over the two years is less than an average of 13%. Therefore the shares do not vest at this date.

X plc makes the following estimates:

a. earnings will increase at 6% in the next year with the result that the shares are expected to vest at the next year end.

b. 84% of employees are expected to still be with the company at that time.

31st December Year 2

	₦	Equity
Expected outcome (at grant date value)		
500 × 84% × 100 × ₦30	1,260,000	
Less expense previously recognised	(660,000)	
Year 2 charge	600,000	
Accumulated in equity by end of year 2		1,260,000

31st December Year 3

Earnings have grown by 8%. This gives an average growth rate of 10.67% so the shares vest.

There are 419 employees who receive shares.

31st December Year 3

	₦	Equity
Expected outcome (at grant date value)		
419 × 100 × ₦30	1,257,000	
Less expense previously recognised	(1,260,000)	
Year 3 credit	(3,000)	
Accumulated in equity by end of year 3		1,257,000

2.6 Modifications to the terms and conditions on which equity instruments were granted

The terms and conditions upon which an option was granted may be modified subsequently. For example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options.

Any changes to the terms and conditions on which the options were granted must be taken into account when measuring the services received.

Background

As a minimum an entity must recognise services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a non-market vesting condition.

In addition, the entity must recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

Modifications that increase the fair value of the equity instruments granted

The entity must calculate the incremental fair value of the equity instruments brought about by the modification.

This incremental fair value is included in the measurement of the amount recognised for services received as consideration for the equity instruments granted.

The incremental fair value granted is calculated as the difference between the following as at the date of the modification:

- the fair value of the modified equity instrument; and
- that of the original equity instrument, both estimated as at the date of the modification.

When a modification occurs during the vesting period the incremental fair value granted is included in the measurement of the amount recognised over the period from the modification date until the date when the equity instruments vest. This is in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.

Modification that increase the number of equity instruments granted

This is similar to the above.

The fair value of the additional equity instruments granted (measured at the date of the modification) is included in the measurement of the amount recognised for services received as consideration for the equity instruments granted.

When a modification occurs during the vesting period the fair value of the additional equity instruments granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the additional equity instruments vest. This is in addition to the amount based on the grant date fair value of the equity instruments originally granted, which is recognised over the remainder of the original vesting period.

Modification that decrease the total fair value of the share based arrangement

In effect such modifications are ignored. The entity must continue to account for the services received as consideration for the equity instruments granted as if that modification had not occurred.

Cancellation of share based arrangement

A cancellation is accounted for as an acceleration of vesting. The amount that would otherwise have been recognised over the vesting period is recognised immediately.

An entity may make a payment to the employee in compensation forthe cancellation. Such a payment is accounted for as the repurchase of an equity interest and deducted from equity. However if the payment exceeds the fair value of the equity instruments repurchased any excess is recognised as an expense.

An entity may grant new equity instruments to the employee and identify them as a replacement for those cancelled on the date when those new equity instruments are granted. When this happens the grant of the new instruments is accounted for in the same way as a modification.

The incremental fair value granted is calculated at the date the replacement equity instruments are granted as the difference between:

- the fair value of the replacement equity instruments; and
- the net fair value of the cancelled equity instruments which is:
  - the fair value of the cancelled instruments immediately before the cancellation, less
  - the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity.

Example: Cancellation

X plc is a company with a 31st December year end.

On 1st January Year 1 X plc grants 100 options to each of its 500 employees.

Each grant is conditional upon the employee working for X plc over the next five years.

The grant date fair value of each option is ₦10.

X plc expects 80% of employees to leave over the vesting period.

X Plc cancelled the scheme in Year 3 when 460 employees were still in the scheme.

Required:

Calculate the income statement expense for each year.

Answer

31st December Year 1

	₦	Equity
Expected outcome (at grant date value)		
500 × 80% × 100 × ₦10	400,000	
	×1/5	
Year 1 charge	80,000	
Accumulated in equity by end of year 1		80,000

31st December Year 2

	₦	
Expected outcome (at grant date value)		
500 × 80% × 100 × ₦10	400,000	
	×2/5	
Recognised by the year end	160,000	
Less expense previously recognised	(80,000)	
Year 2 charge	80,000	
Accumulated in equity by end of year 2		160,000

31st December Year 3

	₦	
Total expense		
460 × 100 × ₦10	460,000	
Less expense previously recognised	(160,000)	
Year 3 charge	300,000	
Accumulated in equity by end of year 3		460,000

2.7 After equity instruments have vested

Once goods or services have been recognised in accordance with IFRS 2 (with a corresponding increase in equity) an entity is not allowed to adjust total equity.

For example an entity is not allowed to reverse the transaction when:

- vested equity instruments are later forfeited; or
- options are not exercised.

However an entity is allowed to recognise a transfer from one component of equity to another.

3 MEASUREMENT OF CASH-SETTLED SHARE-BASED PAYMENT TRANSACTIONS

Section overview

- Introduction
- Share appreciation scheme – as an illustration
- Effects of vesting conditions on the measurement of a cash-settled share-based payment
- Classification of share-based payment transactions with net settlement features
- Accounting for a modification to terms and conditions that result in a cash share-based payment changing to equity-settled

3.1 Introduction

Cash-settled share-based payment transactions - This is where an entity incurs a liability for goods and services and the settlement amount is based on the price (or value) of the entity's shares or other equity instruments.

The basic rules are:

- ❑ The liability incurred is measured at its fair value at each reporting date until it is settled.
- ❑ Any change in the fair value of the liability is recognised in profit or loss.

3.2 Share appreciation scheme – as an illustration

An entity might grant share appreciation rights to employees as part of their pay package, whereby the employees will become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time.

Immediate recognition

An entity must recognise services received, and a liability to pay for those services, as the employees render service.

Some share appreciation rights vest immediately (the employees are not required to complete a specified period of service to become entitled to the cash payment).

- ❑ In the absence of evidence to the contrary, the entity must presume that the services rendered by the employees in exchange for the share appreciation rights have been received
- ❑ The entity must recognise immediately the services received and a liability to pay for them.

Recognition over a period

Some share appreciation schemes do not vest until the employees have completed a specified period of service.

The entity must recognise the services received, and a liability to pay for them, as the employees render service during that period.

Measurement

The liability is measured, initially and at each reporting date until settled, at the fair value of the share appreciation rights.

This is done by applying an option pricing model, taking into account:

- the terms and conditions on which the share appreciation rights were granted, and
- the extent to which the employees have rendered service to date.

If the share appreciation rights granted are conditional upon the employees' remaining in the entity's employ for the next three years and the employees have completed only one year's service at the reporting date, the entity must measure the fair value of the liability at the reporting date and multiplying the resulting amount by one-third.

Example: Cash-settled share-based payment transaction

X plc grants 100 cash share appreciation rights (SARs) to each of its 500 employees.

Each grant is conditional upon the employee working for X plc over the next three years.

Further information

	Actual leavers in the year	Estimate of further leavers in the future	Number of employees whose interest is expected to vest
Year 1	35	60	405
Year 2	40	25	400
Year 3	22	-	403 *(actually vest)*

The entity estimates the fair value of the SARs at the end of each year in which a liability exists as shown below.

Year	Fair value
1	15
2	18
3	20

The liability at the year-end and hence the expense in each year can be calculated as follows:

Expense for services received and consumed

	Year 1	Year 2	Year 5
Number of employees whose interest is expected to vest	405	400	403
Number of rights	100	100	100
Fair value of the right	15	18	20
Total expected expense	₦607,500	₦720,000	₦806,000
Fraction of the vesting period	1/3	2/3	3/3
Liability at year end **(W)**	₦202,500	₦480,000	806,000
Liability at the start	-	(₦202,500)	(₦480,000)
Charge to P&L (Movement on the liability)	₦202,500	₦277,500	₦326,000

3.3 Effects of vesting conditions on the measurement of a cash-settled share-based payment

IFRS 2 requires that the liability for a cash-settled share-based payment should be measured initially and at the end of each reporting period until settled, at its fair value taking into account the terms and conditions under which it was issued.

Accounting for the effects of vesting and non-vesting conditions on the measurement of a cash-settled share-based payment should follow the approach used for measuring equity-settled share-based payments.

3.4 Classification of share-based payment transactions with net settlement features

Some tax jurisdictions require entities to withhold an amount for an employee's tax obligation associated with share-based payments and pay that amount to the taxation authorities.

Entities in such jurisdictions might include terms and conditions in employee share-based payment arrangements which allow them to deduct equity instruments up to the monetary value of the employee's tax liability from the total number of equity instruments that would otherwise be issued on vesting. The employer would then make a cash payment on behalf of the employee to the tax authority.

In the absence of other guidance it might be difficult to identify the employee share scheme as equity-settled or cash-settled.

Such a transaction should be classified as equity-settled in its entirety as long as the entire share-based payment would otherwise be classified as equity-settled if it had not included the net settlement feature.

3.5 Accounting for a modification to terms and conditions that result in a cash share-based payment changing to equity-settled

IFRS 2 provides specific guidance on the following two situations:

- Modifications to the terms of a cash-settled share-based payment transaction that result in it changing to an equity-settled share-based payment transaction.
- The settlement of a cash-settled share-based payment and its replacement by a new equity-settled share-based payment.

At the date of the modification:

- the share-based payment transaction is measured by reference to the modification-date fair value of the equity instruments granted as a result of the modification;
- the previously recognised liability in respect of the cash-settled share-based payment is derecognised;
- the equity-settled share-based payment is recognised to the extent that the services have been rendered up to this date; and
- any difference between the carrying amount of the liability derecognised and the amount recognised in equity is recorded in profit or loss immediately.

4 MEASUREMENT OF SHARE-BASED PAYMENT TRANSACTIONS WITH CASH ALTERNATIVES

Section overview

- Introduction
- Share-based payment transactions in which the counterparty has the choice of settlement
- Share-based payment transactions in which entity has the choice of settlement

4.1 Introduction

Some employee share-based payment arrangements give the employees (or the employer) the right to choose to receive (or pay) cash instead of shares or options, or instead of exercising options.

The standard contains different accounting methods for cash-settled and equity-settled share-based payment transactions. Where there is a choice of settlement, it is necessary to determine which accounting method should be applied.

This depends on whether:

- the employee has the choice of settlement; or
- the entity has the choice of settlement.

4.2 Share-based payment transactions in which the counterparty has the choice of settlement

Background

The counterparty has been granted rights to a compound financial instrument, (i.e. a financial instrument that includes both debt and equity components). Thus the counterparty has:

- the right to be paid in cash; with,
- an option to take shares.

The entity must measure the fair value of the compound financial instrument at grant date identifying a value to both components.

Transactions where the fair value of goods and services is measured directly

This category will not include transactions with employees.

The equity component is measured as the difference between the fair value of the goods or services received and the fair value of the debt component, at the date when the goods or services are received.

Other transactions

This category includes transactions with employees.

The debt component and the equity component are measured separately.

The fair value of the compound financial instrument is the sum of the fair values of the two components.

Share-based payment transactions in which the counterparty has the choice of settlement are often structured so that the fair value of one settlement alternative is the same as the other. (For example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights).

In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. (This is because the fair value of the equity component must take into account the fact that the holder forfeits the right to receive cash in order to exercise the option).In addition the entity must account separately for the goods or services received or acquired in respect of each component of the compound financial instrument.

- for the debt component, the entity must recognise the goods or services acquired, and a liability to pay for those goods or services, as the counterparty supplies goods or renders service, in the same way as other cash-settled share-based payment transactions.
- for the equity component (if any), the entity must recognise the goods or services received, and an increase in equity, as the counterparty supplies goods or renders service, in the same way as other equity-settled share-based payment transactions.

Date of settlement

The liability is remeasured at its fair value at the date of settlement.

- If the entity issues equity instruments on settlement (instead of paying cash), the liability is transferred direct to equity, as the consideration for the equity instruments issued.
- If the entity pays cash on settlement (instead of issuing equity instruments), any equity component previously recognised remains in equity. (The entity is allowed to recognise a transfer within equity, i.e. a transfer from one component of equity to another).

4.3 Share-based payment transactions in which the entity has the choice of settlement

Where an obligation exists

The entity must determine whether it has a present obligation to settle in cash and account for the share-based payment transaction accordingly.

The entity has a present obligation to settle in cash if the choice of settlement in equity instruments

- has no commercial substance; or,
- if the entity has a past practice or a stated policy of settling in cash.

Where an obligation exists, the entity must account for the transaction according to the rules applied to cash-settled share-based payment transactions.

Where there is no obligation

Where an obligation does not exist the entity must account for the transaction according to the rules applied to equity-settled transactions.

In this case the entity may still decide to settle in cash at the settlement date.

- If the entity elects to settle in cash, the cash payment is accounted for as the repurchase of an equity interest, i.e. as a deduction from equity.
- if the entity elects to settle by issuing equity instruments, no further accounting is required (other than a transfer from one component of equity to another, if necessary).

There is a special rule to amend the above where the entity elects the settlement alternative with the higher fair value, as at the date of settlement. If this is the case the entity must recognise an additional expense for the excess value given:

- If cash is paid and the fair value of this is greater than the fair value of the shares that could have been issued in settlement the difference must be taken to profit.
- If shares are issued in settlement and they have a fair value greater than that of the cash alternative the difference must be taken to profit.

5 DISCLOSURES

Section overview

- Disclosures about nature and extent of share based payment arrangements
- Disclosures about fair value measurement
- Disclosures about effect on profit or loss for the period and financial position

5.1 Disclosures about nature and extent of share based payment arrangements

Underlying principle

An entity must disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.

To give effect to this principle an entity must disclose at least the following:

- a description of each type of share-based payment arrangement that existed at any time during the period, including the general terms and conditions of each arrangement, such as:
  - vesting requirements;
  - the maximum term of options granted; and,
  - the method of settlement (e.g. whether in cash or equity).
- the number and weighted average exercise prices of share options for each of the following groups of options:
  - outstanding at the beginning of the period;
  - granted during the period;
  - forfeited during the period;
  - exercised during the period;
  - expired during the period;
  - outstanding at the end of the period; and
  - exercisable at the end of the period.
- for share options exercised during the period, the weighted average share price at the date of exercise. If options were exercised on a regular basis throughout the period, the entity may instead disclose the weighted average share price during the period.
- for share options outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life. If the range of exercise prices is wide, the outstanding options shall be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.

5.2 Disclosures about fair value measurement

An entity must disclose information to enable users to understand how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined.

5.3 Disclosures about effect on profit or loss for the period and financial position

Underlying principle

An entity must disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

To give effect to this principle an entity must disclose at least the following:

- the total expense recognised for the period arising from share-based payment transactions in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions;
- for liabilities arising from share-based payment transactions:
  - the total carrying amount at the end of the period; and
  - the total intrinsic value at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period (e.g. vested share appreciation rights).

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe the three types of share-based payment scheme
- Account for equity-settled share-based payments
- Account for cash-settled share-based payments
- Explain what happens when there is a choice of equity or cash

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

31st December Year 1

	₦	Equity
Expected outcome (at grant date value)		
500 × 85% × 100 × ₦15	637,500	
	×1/3	
Year 1 charge	212,500	
Accumulated in equity		212,500

31st December Year 2

	₦	
Expected outcome (at grant date value)		
500 × 88% × 100 × ₦15	660,000	
	×2/3	
	440,000	
Less expense previously recognised	(212,500)	
Year 2 charge	227,500	
Accumulated in equity		440,000

31st December Year 3

	₦	
Actual outcome (at grant date value)		
44,300 × ₦15	664,500	
Less expense previously recognised	(440,000)	
Year 3 charge	224,500	
Accumulated in equity		664,500

Professional level
Corporate Reporting

CHAPTER 16

IFRS 13: Fair Value Measurement

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	**Reporting of entity's performance to stakeholders**			
	1	**Performance reporting**		
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.	

IFRS 13 is an examinable standard.

Exam context

This chapter explains the rules set out in IFRS 13.

At the end of this chapter, you should be able to:

- Define fair value
- Measure fair value in situations involving a principal or most advantageous market and situations involving the highest and best use of assets
- Explain different techniques that might be used to arrive at fair value
- Describe the fair value hierarchy set out in the standard

1 INTRODUCTION TO IFRS 13

Section overview

- Background
- Definition of fair value
- The asset or liability
- Market participants

1.1 Background

There are many instances where IFRS requires or allows entities to measure or disclose the fair value of assets, liabilities or their own equity instruments.

Examples include (but are not limited to):

IASs 16/38	Allows the use of a revaluation model for the measurement of assets after recognition. Under this model, the carrying amount of the asset is based on its fair value at the date of the revaluation.
IAS 40	Allows the use of a fair value model for the measurement of investment property. Under this model, the asset is fair valued at each reporting date.
IAS 19	Defined benefit plans are measured as the fair value of the plan assets net of the present value of the plan obligations.
IFRS 9	All financial instruments are measured at their fair value at initial recognition. Financial assets that meet certain conditions are measured at amortised cost subsequently. Any financial asset that does not meet the conditions is measured at fair value. Subsequent measurement of financial liabilities is sometimes at fair value.
IFRS 7	If a financial instrument is not measured at fair value that amount must be disclosed.
IFRS 3	Measuring goodwill requires the measurement of the acquisition date fair value of consideration paid and the measurement of the fair value (with some exceptions) of the assets acquired and liabilities assumed in a transaction in which control is achieved .
IFRS 2	Requires an accounting treatment based on the grant date fair value of equity settled share based payment transactions.

Other standards require the use of measures which incorporate fair value.

IASs 36	Recoverable amount is the lower of value in use and fair value less costs of disposal.
IFRS 5	An asset held for sale is measured at the lower of its carrying amount and fair value less costs of disposal.

Some of these standards contained little guidance on the meaning of fair value. Others did contain guidance but this was developed over many years and in a piecemeal manner.

Purpose of IFRS 13

The purpose of IFRS 13 is to:

- define fair value;
- set out a single framework for measuring fair value; and
- specify disclosures about fair value measurement.

IFRS 13 does not change what should be fair valued nor when this should occur.

The fair value measurement framework described in this IFRS applies to both initial and subsequent measurement if fair value is required or permitted by other IFRSs.

Scope of IFRS 13

IFRS 13 applies to any situation where IFRS requires or permits fair value measurements or disclosures about fair value measurements (and other measurements based on fair value such as fair value less costs to sell) with the following exceptions.

IFRS 13 does not apply to:

- share based payment transactions within the scope of IFRS 2; or
- measurements such as net realisable value (IAS 2 *Inventories*) or value in use (IAS 36 *Impairment of Assets*) which have some similarities to fair value but are not fair value.

The IFRS 13 **disclosure requirements** do not apply to the following:

- plan assets measured at fair value (*IAS 19: Employee benefits*);
- retirement benefit plan investments measured at fair value (*IAS 26: Accounting and reporting by retirement benefit plans*); and
- assets for which recoverable amount is fair value less costs of disposal in accordance with IAS 36.

1.2 Definition of fair value

Definition: Fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. it is an exit price).

This definition emphasises that fair value is a market-based measurement, not an entity-specific measurement. In other words, if two entities hold identical assets these assets (all other things being equal) should have the same fair value and this is not affected by how each entity uses the asset or how each entity intends to use the asset in the future.

The definition is phrased in terms of assets and liabilities because they are the primary focus of accounting measurement. However, the guidance in IFRS 13 also applies to an entity's own equity instruments measured at fair value (e.g. when an interest in another company is acquired in a share for share exchange).

Note that the fair value is an exit price, i.e. the price at which an asset would be sold.

Definition: Exit and entry prices

Exit price: The price that would be received to sell an asset or paid to transfer a liability.

Entry price: The price paid to acquire an asset or received to assume a liability in an exchange transaction.

1.3 The asset or liability

A fair value measurement is for a particular asset or liability.

Whether the fair value guidance in IFRS 13 applies to a stand-alone asset or liability or to a group of assets, a group of liabilities or to a group of assets and liabilities depends on the unit of account for the item being fair valued.

Definition: Unit of account

Unit of account: The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes.

The unit of account for the asset or liability must be determined in accordance with the IFRS that requires or permits the fair value measurement.

An entity must use the assumptions that market participants would use when pricing the asset or liability under current market conditions when measuring fair value. The fair value must take into account all characteristics that a market participant would consider relevant to the value. These characteristics might include:

- the condition and location of the asset; and
- restrictions, if any, on the sale or use of the asset.

1.4 Market participants

Definition: Market participants

Market participants: Buyers and sellers in the principal (or most advantageous) market for the asset or liability.

Market participants have all of the following characteristics:

- ❑ They are independent of each other;
- ❑ They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
- ❑ They are able to enter into a transaction for the asset or liability.
- ❑ They are willing to enter into a transaction for the asset or liability, i.e. they are motivated but not forced or otherwise compelled to do so.

2 MEASUREMENT

Section overview

- Measuring fair value
- Principal or most advantageous market
- Fair value of non-financial assets – highest and best use

2.1 Measuring fair value

Fair value measurement assumes that the asset (liability) is exchanged in an orderly transaction between market participants to sell the asset (transfer the liability) at the measurement date under current market conditions.

Sometimes it might be possible to use observable market transactions to fair value an asset or a liability (e.g. a share might be quoted on the Karachi Stock Exchange). For other assets and liabilities this may not be possible. However, in each case the objective is the same, being to estimate the price at which an orderly transaction to sell the asset (or transfer a liability) would take place between market participants at the measurement date under current market conditions.

Active market

If an active market exists then it will provide information that can be used for fair value measurement.

- A quoted price in an active market provides the most reliable evidence of fair value and must be used to measure fair value whenever available.
- It would be unusual to find an active market for the sale of non- financial assets so some other sort of valuation technique would usually be used to determine their fair value.

Definition: Active market

A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

If there is no such active market (e.g. for the sale of an unquoted business or surplus machinery) then a valuation technique would be necessary.

2.2 Principal or most advantageous market

Fair value measurement is based on a possible transaction to sell the asset or transfer the liability in the principal market for the asset or liability.

If there is no principal market fair vale measurement is based on the price available in the most advantageous market for the asset or liability.

Definitions: Most advantageous market and principal market

Most advantageous market: The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

Principal market: The market with the greatest volume and level of activity for the asset or liability.

Identifying principal market (or most advantageous market)

It is not necessary for an entity to make an exhaustive search to identify the principal market (or failing that, the most advantageous market). However, it should take into account all information that is reasonably available.

Unless there is evidence to the contrary, principal market (or failing that, the most advantageous market) is the one in which an entity normally enters into transactions sell the asset or to transfer the liability being fair valued.

If there is a principal market for the asset or liability, the fair value measurement must use the price in that market even if a price in a different market is potentially more advantageous at the measurement date.

The price in a principal market might either be directly observable or estimated using a valuation technique.

Transaction costs

The price in the principal (or most advantageous) market used to measure the fair value of the asset (liability) is not adjusted for transaction costs. Note that:

- fair value is not “net realisable value” or “fair value less costs of disposal”; and
- using the price at which an asset can be sold for as the basis for fair valuation does not mean that the entity intends to sell it

Transport costs

If location is a characteristic of the asset the price in the principal (or most advantageous) market is adjusted for the costs that would be incurred to transport the asset from its current location to that market.

Example: Fair valuation

An entity holds an asset which could be sold in one of two markets.

Information about these markets and the costs that would be incurred if a sale were to be made is as follows:

	Market A ₦	Market B ₦
Sale price	650	625
Transport cost	(50)	(50)
	600	575
Transaction cost	(75)	(25)
Net amount received	525	550

Fair value of the asset if Market A were the principal market

If Market A is the principal market for the asset the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (₦600).

Fair value of the asset if no principal market could be identified

If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market.

The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e. the net amount that would be received in the respective markets). This is Market B where the net amount that would be received for the asset would be ₦550.

The fair value of the asset is measured using the price in that market (₦625), less transport costs (₦50), resulting in a fair value measurement of ₦575.

Transaction costs are taken into account when determining which market is the most advantageous market but the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

Example: Fair valuation

An entity owns an item of industrial equipment (asset x) for which it wishes to ascertain a fair value in accordance with IFRS 13.

Information about the markets in which the asset could be sold and the costs that would be incurred if a sale were to be made is as follows:

	Market A	Market B
	₦	₦
Sale price	500	505
Transport cost	(20)	(30)
	480	475
Volume of sales of asset x (units)	1,000	29,000

Analysis

Most advantageous market

Market A is the most advantageous market as it provides the highest return after transaction costs.

Fair value of the asset in accordance with IFRS 13

The fair value of the asset in accordance with IFRS 13 is ₦505. This is the price available in the principal market before transaction costs. (The principal market is the one with the highest level of activity).

Different entities might have access to different markets. This might result in different entities reporting similar assets at different fair values.

2.3 Fair value of non-financial assets – highest and best use

Fair value measurement of a non-financial asset must value the asset at its highest and best use.

Highest and best use is a valuation concept based on the idea that market participants would seek to maximise the value of an asset.

Definition: Highest and best use

Highest and best use: The use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used.

This must take into account use of the asset that is:

- physically possible;
- legally permissible; and
- financially feasible.

The current use of land is presumed to be its highest and best use unless market or other factors suggest a different use.

Example: Highest and best use

X Limited acquired a plot of land developed for industrial use as a factory. A factory with similar facilities and access has recently been sold for ₦50 million.

Similar sites nearby have recently been developed for residential use as sites for high-rise apartment buildings.

X Limited determines that the land could be developed as a site for residential use at a cost of ₦10 million (to cover demolition of the factory and legal costs associated with the change of use). The plot of land would then be worth ₦62 million.

The highest and best use of the land would be determined by comparing the following:

	₦ million
Value of the land as currently developed	50
Value of the land as a vacant site for residential use (₦62 million – ₦10 million)	52

Conclusion: The fair value of the land is ₦52 million.

3 VALUATION TECHNIQUES

Section overview

- Objective of valuation techniques
- Inputs to valuation techniques
- Fair value hierarchy
- Bid/offer prices

3.1 Objective of valuation techniques

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset (or to transfer the liability) would take place between market participants at the measurement date under current market conditions.

IFRS 13 requires that one of three valuation techniques must be used:

- market approach – uses prices and other relevant information from market transactions involving identical or similar assets and liabilities;
- cost approach – the amount required to replace the service capacity of an asset (also known as the current replacement cost);
- income approach – converts future amounts (cash flows, profits) to a single current (discounted) amount.

An entity must use a valuation technique that is appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

3.2 Inputs to valuation techniques

An entity must use valuation techniques that are appropriate in the circumstances and for which sufficient information is available to measure fair value.

A valuation technique should be used to maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Definition: Inputs

Inputs: The assumptions that market participants would use when pricing the asset or liability, including assumptions about risk, such as the following:

(a) the risk inherent in a particular valuation technique used to measure fair value (such as a pricing model); and

(b) the risk inherent in the inputs to the valuation technique.

Quoted price in an active market provides the most reliable evidence of fair value and must be used to measure fair value whenever available.

3.3 Fair value hierarchy

IFRS 13 establishes a fair value hierarchy to categorise inputs to valuation techniques into three levels.

	Definition	Examples
Level 1	Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date	Share price quoted on the London Stock Exchange
Level 2	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.	Quoted price of a similar asset to the one being valued. Quoted interest rate.
Level 3	Unobservable inputs for the asset or liability.	Cash flow projections.

3.4 Bid /Offer prices

For some assets (liabilities) markets quote prices that differ depending on whether the asset is being sold to or bought from the market.

- The price at which an asset can be sold to the market is called the bid price (it is the amount the market bids for the asset).
- The price at which an asset can be bought from the market is called the ask or offer price (it is the amount the market asks for the asset or offers to sell it for).

The price within the bid-ask spread that is most representative of fair value in the circumstances must be used to measure fair value.

Previously, bid price had to be used for financial assets and ask price for financial liabilities but this is no longer the case.

4 LIABILITIES AND AN ENTITY'S OWN EQUITY INSTRUMENTS

Section overview

- General principles
- Liabilities and equity instruments held by other parties as assets
- Liabilities and equity instruments not held by other parties as assets
- Financial assets and financial liabilities managed on a net basis

4.1 General principles

Fair value measurement assumes the transfer of an item to a market participant at the measurement date.

The fair valuation of a liability assumes that it not be settled with the counterparty at the measurement date but would remain outstanding. In other words, the market participant to whom the liability could be transferred would be required to fulfil the obligation.

The fair valuation of an entity's own equity instrument assumes that market participant to whom the instrument could be transferred would take on the rights and responsibilities associated with the instrument.

The same guidance that applies to the fair value of assets also applies to the fair value of liabilities and an entity's own equity instruments including that:

- an entity must maximise the use of relevant observable inputs and minimise the use of unobservable inputs; and
- quoted price in an active market must be used to measure fair value whenever available.

In the absence of an active market there might be an observable market for items held by other parties as assets.

4.2 Liabilities and equity instruments held by other parties as assets

If a quoted price for the transfer of an identical or a similar liability or entity's own equity instrument is not available it may be possible to measure fair value from the point of view of a party that holds the identical item as an asset at the measurement date.

If this is the case fair value is measured as follows:

- using the quoted price in an active market (if available) for the identical item held by another party as an asset; or failing that
- using other observable inputs (e.g. quoted price in a market that is not active for the identical item held by another party as an asset); or failing that
- another valuation technique (e.g. using quoted prices for similar liabilities or equity instruments held by other parties as assets (market approach).

Adjustments to quoted price

There might be factors that are specific to the asset held by the third party that are not applicable to the fair value of the liability or entity's own equity.

The quoted price of such items is adjusted for such factors. For example, a quoted price might relate to a similar (but not identical) liability or equity instrument held by another party as an asset.

However, the price of the asset must not reflect the effect of a restriction preventing the sale of that asset.

4.3 Liabilities and equity instruments not held by other parties as assets

In this case fair value is measured from the perspective of a market participant that owes the liability or has issued the claim on equity.

For example, when applying a present value technique an entity might take into account the future cash outflows that a market participant would expect to incur in fulfilling the obligation (including the compensation that a market participant would require for taking on the obligation).

4.4 Financial assets and financial liabilities managed on a net basis

An entity might manage a group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk.

In this case the entity is allowed to measure the fair value net position (i.e. a net asset or a net liability as appropriate).

This is an exception to the general rules in IFRS 13 which would otherwise apply separately to the asset and the liability. It applies only to financial assets and financial liabilities within the scope of IFRS 9: *Financial instruments*.

The exception is only allowed if the entity does all the following:

- It manages the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular risk (market risk or credit risk of a particular counterparty) in accordance with its documented risk management or investment strategy;
- It provides information on that basis about the group of financial assets and financial liabilities to the entity's key management personnel; and
- It measures those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.

5 DISCLOSURE

Section overview

- Recurring and non-recurring fair value measurement
- Overall disclosure objective
- Disclosures

5.1 Recurring and non-recurring fair value measurement

The fair value measurement of assets and liabilities might be recurring or non-recurring.

- Recurring fair value measurements are those that are required or permitted in the statement of financial position at the end of each reporting period (e.g. the fair value of investment property when the IAS 40 fair value model is used);
- Non-recurring fair value measurements are those that are required or permitted in the statement of financial position in particular circumstances (e.g. when an entity measures an asset held for sale at fair value less costs to sell in accordance with IFRS 5).

Disclosures are necessary in respect of each of the above.

5.2 Overall disclosure objective

Information must be disclosed to help users assess both of the following:

- the valuation techniques and inputs used to measure the fair value assets and liabilities on a recurring or non-recurring basis;
- the effect on profit or loss or other comprehensive income for the period of recurring fair value measurements using significant unobservable inputs (Level 3).

All of the following must be considered to meet the above objectives:

- the level of detail necessary to satisfy the disclosure requirements;
- how much emphasis to place on each of the various requirements;
- how much aggregation or disaggregation to undertake; and
- the need for additional information.

Classes of assets and liabilities

Classes of assets and liabilities must be identified for the purpose of fulfilling the minimum disclosure requirements of IFRS 15.

Appropriate classes are identified on the basis of the following:

- the nature, characteristics and risks of the asset or liability; and
- the level of the fair value hierarchy within which the fair value measurement is categorised.

5.3 Disclosures

The following information must be disclosed as a minimum for each class of assets and liabilities measured at fair value in the statement of financial position after initial recognition.

For recurring and non-recurring fair value measurements

The fair value measurement at the end of the reporting period and the reasons for the measurement for non-recurring fair value measurements

The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety (Level 1, 2 or 3).

For fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy:

- ❑ a description of the valuation technique(s) and the inputs used in the fair value measurement for;
- ❑ the reason for any change in valuation technique;

Quantitative information about the significant unobservable inputs used in the fair value measurement for fair value measurements categorised within Level 3 of the fair value hierarchy.

A description of the valuation processes used for fair value measurements categorised within Level 3 of the fair value hierarchy.

The reason why a non-financial asset is being used in a manner that differs from its highest and best use when this is the case.

For recurring fair value measurements

The amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy, the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred.

For fair value measurements categorised within Level 3 of the fair value hierarchy:

- ❑ a reconciliation of opening balances to closing balances, disclosing separately changes during the period attributable to the following:
  - total gains or losses recognised in profit or loss (and the line items in which they are recognised);
  - unrealised amounts included in the above;
  - total gains or losses recognised in other comprehensive income(and the line item in which they are recognised);
  - purchases, sales, issues and settlements;
  - details of transfers into or out of Level 3 of the fair value hierarchy;
- ❑ for recurring fair value measurements categorised within Level 3 of the fair value hierarchy:
  - a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs;
  - the fact that a change to one or more of the unobservable inputs would change fair value significantly (if that is the case) and the effect of those changes.

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define fair value
- Measure fair value in situations involving a principal or most advantageous market and situations involving the highest and best use of assets
- Explain different techniques that might be used to arrive at fair value
- Describe the fair value hierarchy set out in the standard

Professional level
Corporate

CHAPTER 17

Financial instruments: Recognition and measurement

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	4	Financial assets and liabilities	
		a	Determine and assess how different bases for recognition, measurement and classification of financial assets and financial liabilities impact on reported performance and position.
		b	Appraise the accounting treatment of Financial Instruments (IFRS 7 and IFRS 9); Borrowing Costs – IAS 23; Government Grants and Disclosure of Government Assistance – IAS 20; including impairment and hedge accounting under IFRS 9 for financial assets and liabilities.

IFRS 9 is an examinable document.

This standard was examinable in a previous paper. It is covered here again in detail for your convenience.

Exam context

This chapter explains the rules on recognition and measurement of financial instruments.

The rules on initial

At the end of this chapter, you should be able to:

- Explain and apply the rules on recognition of financial instruments
- Explain rules on derecognition of financial assets and apply them to simple examples
- Explain and apply the rules on the classification of financial assets on initial recognition and how this affects the subsequent measurement of those assets
- Account for reclassifications of financial assets
- Explain and apply rules on impairment of financial assets
- Explain and apply the accounting treatment for financial liabilities
- Explain and Identify transactions which might contain an embedded derivative
- Explain and apply hedge accounting

1 GAAP FOR FINANCIAL INSTRUMENTS

Section overview

- Background
- Definitions
- Derivatives
- Using derivatives
- Scoping issues
- Initial recognition and measurement of financial instruments

1.1 Background

The rules on financial instruments are set out in three accounting standards:

- IAS 32: Financial instruments: Presentation
- IFRS 7: Financial instruments: Disclosure
- IFRS 9: Financial Instruments

1.2 Definitions

A **financial instrument** is a contract that gives rise to both:

- a financial asset in one entity, and
- a financial liability or equity instrument in another entity.

A **financial asset** is any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity

A **financial liability** is any liability that is a contractual obligation:

- to deliver cash or another financial asset to another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

Financial instruments include:

- cash;
- shares;
- loans;
- accounts receivable or accounts payable; and
- financial derivatives and commodity derivatives.

1.3 Derivatives

A derivative is a financial instrument with all three of the following characteristics:

- Its value changes in response to a specified underlying (interest rate, commodity price, exchange rate etc.); and
- It requires no or little initial investment; and
- It is settled at a future date

Categories of derivatives

Derivatives can be classified into two broad categories:

- Forward arrangements (commit parties to a course of action)
  - Forward contracts
  - Futures
  - Swaps
- Options (Gives the option buyer a choice over whether or not to exercise his rights under the contract)

Forward contracts

A forward contract is a tailor-made contract to buy or sell a specified amount of a specified item (commodity or financial item) on a specified date at a specified price.

A contract like this will require no initial outlay by the company (it has zero fair value at the date it is entered into). Over the life of the contract its fair value will depend on the spot exchange rates and the time to the end of the contract.

Example: Forward contract

A Nigerian company enters into a 6m forward contract to buy US $1,000 at a rate of ₦350 to $1.

This means that the Nigerian company will pay ₦350,000 to buy $1,000 in 6m time.

This removes uncertainty for the Nigerian company.

A simple valuation of the forward contract can be made at any time over the life of the contract by comparing the contracted rate to the spot rate.

	Spot rate at date of valuation	
	Say ₦400 = $1	**Say ₦320 = $1**
Cost of $1,000 under forward contract	₦350,000	₦350,000
Cost of $1,000 on open market	₦400,000	₦320,000
Difference	₦50,000	(₦20,000)
UK company would recognise:	**An asset**	**A liability**

Note that this is a simplification. In practice the time to the end of the contract would need to be built into the value.

Futures

Futures are like forwards but are standardised in terms of amounts, date, currency, commodity etc. This standardisation means that they can be traded. A company can enter into a futures contract and then may make a gain or a loss on the market just like any other traded item.

If a company holds futures they might be an asset or a liability at any particular date.

Swaps

A swap is an agreement between parties to exchange cash flows related to an underlying obligation. The most common type of swap is an interest rate swap. In an interest rate swap, two parties agree to exchange interest payments on the same notional amount of principal, at regular intervals over an agreed number of years.

One party might pay interest to the other party at a variable or floating rate, and in return the other party may pay interest on the same principal at a fixed rate (a rate that is fixed by the swap agreement).

A swap might be recorded as an asset or liability at any particular date. This depends on the interaction between the amount that an entity has contracted to pay out and the amount that it is entitled to receive.

Options

The holder of the option has entered into a contract that gives it the right but not the obligation to buy (call option) or sell (put option) a specified amount of a specified commodity at a specified price.

An option differs from a forward arrangement. An option offers its buyer/holder the choice to exercise his rights under the contract, but also has the choice not to enforce the contract terms.

The seller of the option must fulfil the terms of the contract, but only if the option holder chooses to enforce them.

Holding an option is therefore similar to an insurance policy: it is exercised if the market price moves adversely. As the option holder has a privileged status – deciding whether or not to enforce the contract terms – he is required to pay a sum of money (a premium) to the option seller. This premium is paid when the option is arranged, and non-refundable if the holder later decides not to exercise his rights under the option.

From the point of view of the holder the option will only ever be recorded as an asset. At initial recognition this would be the amount of the premium.
Subsequently the holder would only exercise the option if it was beneficial to do so. Therefore it could only ever be an asset.

1.4 Using derivatives

A company can enter into a transaction involving a derivative for one of two reasons:

- to speculate, and hope to make a profit from favourable movements in rates or prices; or
- to hedge against exposure to a particular risk

Speculation and the use of derivatives

Many derivatives are traded on exchanges, and so are easily available for buying and selling. Entities can buy or sell derivatives in order to set up speculative positions, so that a profit will be made from dealing in the derivatives provided that the market price of the 'underlying item' moves favourably.

For example, forward contracts in cocoa could be purchased by a company that has no interest in the cocoa itself, but just wants to gamble on future cocoa prices. The forward contracts would probably be exchange-traded forward contracts, known as commodity (cocoa) futures.

Speculating in derivatives may expose entities to huge risks, if expectations do not come true and the price of the underlying item moves the 'wrong way'. Occasionally, losses on derivatives positions can result in financial collapse of the company.

A well-known example is the collapse of Barings Bank in 1995. This was caused by one employee, Nick Leeson, who speculated in derivatives in the Japanese futures market, and made losses that were so large that they caused the bank to collapse. In the case of Barings, the losses from speculation were made by a bank, but non-bank companies are able to speculate with derivatives too, should they wish to do so.

Hedging with derivatives

Derivatives can be used to obtain protection against exposure to the risk of an unfavourable movement in the market price of an item, such as the price of a commodity, an interest rate or a foreign exchange rate.

Example: Hedging

A chocolate manufacturer may be worried that the price of cocoa might increase with an adverse effect on its cost of production and operating profits.

The company could manage this risk by entering into a forward contract to fix now the price of his future purchases of cocoa. By fixing the price now for future purchases, the risk of an adverse movement in the market price of cocoa is removed.

This is described as 'hedging' the risk, or hedging the exposure to risk.

1.5 Scoping issues

IFRS 9 applies to all financial assets and liabilities except for those specifically scoped out of the standard.

General comments on scope exclusions

There are a lot of scope exclusions, usually covering transactions which otherwise meet the financial asset or financial liability definition but are covered by other specific accounting rules set out in other standards.

For example, an investment in a subsidiary meets the definition of a financial asset but such investments are subject to detailed accounting rules set out in IFRS 3; *Business Combinations* and IFRS 10: *Consolidated Financial Statements*. The same can be said for investments in associates and joint ventures.

The scope exclusions can be complicated. For example, lease receivables meet the definition of a financial asset but are recognised and measured in accordance with IFRS 16: Leases. However, the IFRS 9 derecognition and impairment rules both apply to lease receivables as do the rules concerning embedded derivatives.

Own equity

An entity's own equity is outside the scope of IFRS 9. Therefore, an entity does not fair value its own equity.

Financial guarantees

An entity might guarantee another entity's borrowing. In such a case, if the borrower fails to repay the loan the entity giving the guarantee (the guarantor) would be called on to repay it. Financial guarantees are accounted for (as a financial liability) under IFRS 9 unless the entity has "previously asserted explicitly" that it regards such contracts as insurance contracts. In this case the entity can elect to apply IFRS 17: *Insurance Contracts* or IFRS 9 on a contract by contract basis.

Contracts to buy or sell non-financial items

Contracts to buy or sell non-financial items are not financial assets or liabilities.

Example: Contracts for non-financial items

X Ltd enters into a forward contract to buy a barrel of crude oil for $100 in 3 months' time.

This is not a financial asset or financial liability according to the definitions (as it is not a contract to exchange cash for another financial asset but rather it is a contract to exchange cash for oil).

However, such contracts are within the scope of IFRS 9 if they can be settled net in cash or another financial instrument unless the contract is entered into for the purpose of the receipt or delivery of a non-financial item in accordance with its expected purchase, sale or usage requirements. The purpose of this rule is to bring derivatives on non-financial items into the scope of IFRS 9.

However, if the contract can be net settled it is within the scope of the standard.

Example: Contracts for non-financial items

X Ltd enters into a forward contract to buy a barrel of crude oil for $100 in 3 months' time.

The fair value of a barrel of oil is $110 at the date of maturity of the contract.

X Ltd can pay $100 for something worth $110.

Net settlement would involve the counterparty giving X Ltd $10 and then X Ltd buying the oil at its market price. Thus X Ltd would have a barrel of oil at a cost of $100 ($110 – $10).

(Note that we are not saying that this is how a forward works. The example is simply being used to illustrate what net settlement means).

IFRS 9 would not apply in the above example if X Ltd had entered into the contract in order to buy the oil for its own use.

IFRS 9 defines net settlement very widely with the result that many derivatives on non-financial items are within the scope of the standard.

Thus IFRS 9 says that a contract is net settled in either of the following circumstances.

- when the ability to net settle is not explicit in the terms of the contract, but the entity has a practice of net settling similar contracts;
- when an entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin.

In the above cases the contract has not been entered into for the entity to buy or sell the underlying commodity for its own use. Therefore, such contracts are in the scope of IFRS 9.

IFRS 9 says that a contract could also be net settled in either of the following circumstances.

- when the terms of the contract permit either party to settle it net; or
- when the non-financial item that is the subject of the contract is readily convertible to cash.

In these cases the contract might have been entered into for the entity to buy or sell the underlying commodity for its own use. Such contracts must be evaluated to see whether or not are in the scope of IFRS 9.

To summarise, IFRS 9 applies to a contract for the purchase or sale of a non-financial item when it is:

- capable of being net settled (which is defined very widely to make it more likely that a contract is within the scope of IFRS 9); unless
- it is entered into for the purpose of the receipt or delivery of a non-financial item in accordance with an entity's expected purchase, sale or usage requirements.

Note that IFRS 9 **allows** a contract to be irrevocably designated as measured at fair value through profit or loss (as if it were a financial instrument) even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements.

1.6 Initial recognition and measurement of financial instruments

A financial asset or a financial liability should be recognised in the statement of financial position when the reporting entity becomes a party to the contractual provisions of the instrument.

This is different from the normal recognition criteria for an asset or a liability. The IASB's Framework states that an item should be recognised when there is a probable inflow or outflow of economic benefits.

Initial measurement

A financial instrument should initially be measured at fair value. This is usually the transaction price, in other words, the price paid for an asset or the price received for a liability.

Despite the above, trade receivables are measured at their transaction price in accordance with ***IFRS 15:*** *Revenue from contracts with customers*.

If the transaction price differs from the fair value a gain or loss would be recognised on initial recognition.

Example: Initial measurement

A company lends ₦1 million at 0% repayable in 12 months.

A market based interest rate for such a loan is 10% and a 1 year discount rate would be 1/1.1 = 0.909

The fair value of the loan on initial recognition = ₦1m × 0.909090 = ₦909,091.

The double entry on initial recognition should be:

Dr	Financial asset	₦909,091	
Dr	P&L (loss)	₦90,909	
Cr	Cash		₦1,000,000

Transaction costs

When a financial instrument is acquired, there will usually be transaction costs incurred in addition to the transaction price. For example, transaction costs may include a broker's fees.

Definition: Transaction costs

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability.

An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

The accounting treatment for transaction costs depends on how the instrument is subsequently measured.

Subsequent measurement	Treatment of transaction cost
Fair value through profit or loss	Written off as an expense in profit and loss.
Other methods (Amortised cost or fair value through OCI)	The transaction cost is capitalised and included in the initial cost of the financial instrument.

There is an example to show this in a later section of this chapter.

Note that trade receivables that do not have a significant financing component must be measured at their transaction price on initial recognition.

Initial recognition and measurement of derivatives

The fair value of a forward arrangement (forward contract, future or swap) is usually zero on initial recognition.

It may seem odd that a financial instrument needs a recognised cost when it is ₦nil, but it is important to recognise these items in the accounting system, because they are remeasured at the end of each reporting period.

2 MEASUREMENT METHODS

Section overview

- An introduction to amortised cost
- Amortised cost: IFRS 9 requirements
- Amortised cost and credit-impaired assets
- Fair value

2.1 An introduction to amortised cost

Amortised cost is a measurement technique that can be applied to both financial assets and financial liabilities.

The basic amortised cost technique is the same for financial assets and financial liabilities but there is a slight difference in the terminology used by IFRS 9 when describing the approach for each.

This section starts by explaining the basic concept of amortised cost and then explains the slight difference in terminology between the IFRS 9 description of amortised cost for financial assets and financial liabilities.

Basic concept

Amortised cost is calculated as follows:

Illustration: Amortised cost

	Carrying amount
Amount at initial recognition	X
Plus: Interest recognised at the effective rate (income for an asset or expense for a liability):	X
Less: cash flows (receipts for an asset or payments for a liability)	(X)
Amortised cost	**X**

IFRS 9 specifies that interest should be calculated using the effective rate.

The effective rate is calculated on initial recognition. It is the discount rate that equates the future cash flows to the amount at initial recognition. In other words it is the IRR of the cash flows associated with the financial asset or financial liability under consideration.

This means that the amortised cost as calculated at each period end is always the present value of the future cash flows discounted at the effective rate.

The following example (which could be either an asset or a liability) demonstrates the above.

Example: Amortised cost

A bond has an issue value of ₦1 million and pays a coupon rate of 5% interest for two years, then 7% interest for two years (this is known as a stepped bond).

Interest is paid annually on the anniversary of the bond issue.

The bond will be redeemed at par after four years.

The effective rate for this bond is 5.942%

The following calculation proves that the IRR of the bond is 5.9423%.

Time	Description	Cash flows	Discount factor (@5.9423%)	Present value
0	Amount borrowed	1,000,000	1	1,000,000
1	Interest	(50,000)	0.94391	(47,196)
2	Interest	(50,000)	0.89097	(44,548)
3	Interest	(70,000)	0.84099	(58,868)
4	Interest	(70,000)	0.79382	(55,567)
4	Repayment of capital	(1,000,000)	0.79382	(793,821)
				nil

The amortised cost model uses the effective rate to determine the interest to be charged in profit and loss in each period. The interest recognised in profit and loss each year is not the cash paid. The interest recognised is calculated by applying the effective rate to the outstanding balance on the bond at the beginning of the period.

The amortised cost at the end of each year over the life of the bond is as follows:

Year	Amortised cost brought forward	Interest at 5.942%	Cash flows	Amortised cost carried forward
1	1,000,000	59,424	(50,000)	1,009,424
2	1,009,424	59,983	(50,000)	1,019,407
3	1,019,407	60,577	(70,000)	1,009,984
4	1,009,984	60,016	(70,000)	1,000,000
		240,000	240,000	

The bond is initially recorded at cost (₦1 million) and by the end of year 1 it has an amortised cost of ₦1,009,424.

The total interest paid over the four years is ₦240,000. However, it is charged to the profit or loss each year at the effective rate (5.942%) on the outstanding balance, not as the actual interest paid on the bonds in cash each year.

The balance at the end of the bond's life would be nil because of the repayment of the principal. This has not been shown above to emphasise that the total interest recognised in profit or loss and the total cash interest is the same figure (₦240,000).

Example (continued): Amortised cost

Note that at each year end the amortised cost is the present value of the future cash flows discounted at the effective rate.

Thus the amortised cost on initial recognition is:

Time	Description	Cash flows	Discount factor (@5.9423%)	Present value
1	Interest	(50,000)	0.94391	(47,196)
2	Interest	(50,000)	0.89097	(44,548)
3	Interest	(70,000)	0.84099	(58,868)
4	Interest	(70,000)	0.79382	(55,567)
4	Repayment of capital	(1,000,000)	0.79382	(793,821)
				1,000,000

The amortised cost at the end of the first year is:

Time	Description	Cash flows	Discount factor (@5.9423%)	Present value
1	Interest	(50,000)	0.94391	(47,196)
2	Interest	(70,000)	0.89097	(62,368)
3	Interest	(70,000)	0.84099	(58,869)
3	Repayment of capital	(1,000,000)	0.84099	(840,992)
				1,009,424

and so on…..

2.2 Amortised cost: IFRS 9 requirements

Amortised cost is used to measure financial assets and financial liabilities in the same way. However, the terminology used in IFRS 9 is slightly different for financial assets and financial liabilities.

This is illustrated using the amortised cost example from the last section.

As a financial liability (from the borrower's viewpoint)

The borrower would calculate the effective rate (5.942%) and construct the amortisation table (repeated here for your convenience) as follows:

Example: Amortised cost

Year	Amortised cost brought forward	Interest at 5.942%	Cash flows	Amortised cost carried forward
1	1,000,000	59,424	(50,000)	1,009,424
2	1,009,424	59,983	(50,000)	1,019,407
3	1,019,407	60,577	(70,000)	1,009,984
4	1,009,984	60,016	(1,070,000)	nil

The borrower would then show the following amounts in its financial statements at each year end:

Year-end	Statement of profit or loss interest expense	Financial liability in statement of financial position
1	59,424	1,009,424
2	59,983	1,019,407
3	60,577	1,009,984
4	60,016	nil

As a financial asset (from the lender's viewpoint)

The lender would calculate the effective interest rate in exactly the same way and construct the same amortisation table for its financial asset.

However, IFRS 9 defines the balances at this stage as the gross carrying amount of the financial asset rather than amortised cost.

The only difference so far is the naming of the balances (amortised cost for financial liabilities and gross carrying amount for financial assets).

The amortised cost of a financial asset is its gross carrying amount less a loss allowance.

The loss allowance is a separate credit balance recognised in respect of expected credit losses in accordance with the IFRS 9 impairment rules. These rules are explained later but for the time being note that the final carrying amount for a financial asset carried at amortised cost is in fact made up of two balances being the gross carrying amount of the financial asset less the loss allowance. (This is similar to the situation for a non-current asset which is carried at cost less accumulated depreciation).

IFRS 9 defines the g**ross carrying amount of a financial asset** as its amortised cost before adjusting for any loss allowance.

The loss allowance has no impact on the calculation of the effective interest rate or on the construction of the amortisation table. It is simply a second balance that is deducted from the gross carrying amount to arrive at amortised cost.

The lender would show the following amounts in its financial statements at each year end (where figures for a loss allowance have been made up):

Example: Amortised cost (lender's view)

	Statement of profit or loss	Statement of financial position Financial asset:		
Year-end	Interest income	Gross carrying amount	Loss allowance (say)	Net (amortised cost)
1	59,424	1,009,424	(1,000)	1,008,424
2	59,983	1,019,407	(1,000)	1,018,407
3	60,577	1,009,984	(1,000)	1,008,984
4	60,016	nil	nil	

This can be summarised as follows:

Illustration: Amortised cost (financial asset compared to financial liability)

	Financial asset		Financial liability
Amount at initial recognition	X	Amount at initial recognition	X
Plus: Interest recognised as income at the effective rate:	X	**Plus:** Interest recognised as expense at the effective rate:	X
Less: receipts	(X)	**Less:** payments	(X)
Gross carrying amount of financial asset	**X**	**Amortised cost of financial liability**	**X**
Less: loss allowance	**(X)**		
Amortised cost of financial asset	**X**		

The recognition of a loss allowance results in a lower value in the books of the lender to that in the books of the borrower for the same instrument.

If there were no loss allowance the amortised cost would be the same for the borrower and lender of a given instrument.

IFRS 9 Definitions

The IFRS 9 definitions are given below (for completeness):

Definition: Amortised cost

The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

Definition: Effective interest rate

The rate that exactly discounts estimated future cash receipts through the expected life of the financial asset to the gross carrying amount of a financial asset or the amortised cost of a financial liability.

Note that from the lender's view, the future cash flows included in the calculation are those to which the lender is entitled rather than those that the lender expects to receive. In other words, the lender does not model expected credit losses into the cash flow forecasts (simply by ignoring the fact that it might not receive all of the flows to which it is entitled). This makes sense as the possibility of future losses due to credit risk is taken into account by recognising a loss allowance so building them into the cash flows used to calculate the effective rate would be double counting.

2.3 Amortised cost and credit-impaired assets

As explained above, the effective interest method is used in the calculation of the amortised cost of a financial asset and in the allocation and recognition of the interest revenue in profit or loss.

An entity might purchase or issue a credit-impaired financial asset (distressed loan). A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. (Examples of such events are given in a later section).

Such financial assets might need to be carried at amortised cost. The IFRS 9, guidance on the effective rate in this case is slightly different.

Financial assets that are not credit impaired	**Credit-impaired financial assets**
Effective interest rate	Credit-adjusted effective interest rate
The rate that exactly discounts estimated future cash flows over the expected life of the financial asset to its gross carrying amount.	The rate that exactly discounts the estimated future cash flows over the expected life of the financial asset to its amortised cost.
An entity must estimate the expected cash flows **excluding** expected credit losses.	An entity must estimate the expected cash flows **including** expected credit losses.
Based on future cash flows to which the entity is entitled.	Based on future cash flows which the entity expects.
On initial recognition: Measured as a gross amount with a separate deduction for a loss allowance (based on an expectation of what might happen in the future.	**On initial recognition:** Measured as a net amount (amortised cost) that anticipates future credit losses arising as a result of the impairment event (which has already happened).
Revenue recognition By applying the effective rate to the gross carrying amount (amortised cost before deduction of the loss allowance).	**Revenue recognition** By applying the credit-adjusted effective rate to the amortised cost.

2.4 Fair value

Definition: Fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. it is an exit price).

Fair value measurement looks at the asset (liability) from the point of view of a market participant. The fair value must take into account all factors that a market participant would consider relevant to the value. These factors might include:

- the condition and location of the asset; and
- restrictions (if any) on the sale or use of the asset.

IFRS 13 defines an active market as a market in which transactions for the asset (liability) take place with sufficient frequency and volume to provide pricing information on an on-going basis.

A quoted price in an active market provides the most reliable evidence of fair value and must be used to measure fair value whenever available.

Bid /Offer prices

For some assets (liabilities) markets quote prices that differ depending on whether the asset is being sold to or bought from the market.

The price at which an asset can be sold to the market is called the bid price (it is the amount the market bids for the asset).

The price at which an asset can be bought from the market is called the ask or offer price (it is the amount the market asks for the asset or offers to sell it for).

The price within the bid-ask spread that is most representative of fair value in the circumstances must be used to measure fair value. Previously, IAS 39 required that the bid price had to be used for financial assets and ask price for financial liabilities but this is no longer the case.

Valuation techniques

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset (or to transfer the liability) would take place between market participants at the measurement date under current market conditions.

IFRS 13 requires that one of three valuation techniques must be used:

- market approach – uses prices and other relevant information from market transactions involving identical or similar assets and liabilities;
- cost approach – the amount required to replace the service capacity of an asset (but this approach cannot be used to measure the fair value of financial assets);
- income approach – converts future amounts (cash flows, profits) to single current (discounted) amount.

An entity must use a valuation technique that is appropriate in the circumstances and for which sufficient data is available to measure fair value. The technique must maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Quoted price in an active market provides the most reliable evidence of fair value and must be used to measure fair value whenever available.

Fair value hierarchy

IFRS 13 establishes a fair value hierarchy that categorises inputs to valuation techniques into three levels.

	Definition	Examples
Level 1	Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date	Share price quoted on the London Stock Exchange
Level 2	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.	Quoted price of a similar asset to the one being valued. Quoted interest rate.
Level 3	Unobservable inputs for the asset or liability.	Cash flow projections.

3 CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

Section overview

- Introduction
- Classification of financial assets
- Subsequent measurement of financial assets at amortised cost
- Subsequent measurement of financial assets at fair value through other comprehensive income
- Transaction costs

3.1 Introduction

Financial assets must be classified into one of three categories on initial recognition. This classification of a financial asset drives its subsequent measurement.

The three categories are:

- financial assets at amortised cost;
- financial assets at fair value with gains and losses recognised in other comprehensive income (described as fair value through OCI or FVOCI); or
- financial assets at fair value with gains and losses recognised in profit or loss (described as fair value through P&L or FVPL).

The classification is based on an assessment of the business model followed for holding the financial asset and the cash flow characteristics of the asset.

This assessment is not on an asset by asset basis. Thus, an entity might hold different portfolios for different purposes resulting in the entity using more than one business model in turn resulting in financial assets being measured using each of the three methods.

Reclassification

Reclassification of financial assets after initial recognition is required when an entity changes its model for managing financial assets. It is not allowed in any other circumstance.

3.2 Classification of financial assets

Financial assets at amortised cost

A financial asset is measured at amortised cost if both of the following conditions are met:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Financial assets at fair value through OCI (FVOCI)

A financial asset is measured at fair value through OCI if both of the following conditions are met:

- the asset is held within a business model whose objective is achieved by **both** holding and collecting contractual cash flows **and** selling the financial assets; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Financial assets at fair value through P&L (FVPL)

All other financial assets must be measured at fair value through P&L.

Irrevocable designations

On initial recognition of a financial asset that would otherwise be measured at amortised cost or at fair value through OCI a company can make an irrevocable decision to designate them as at fair value through P&L. This is only allowed where it eliminates or significantly reduces a measurement or recognition inconsistency.

Investments in equity instruments are measured at fair value through P&L. However, on initial recognition an entity is allowed to make an irrevocable decision to measure an investment in equity at fair value with movements reported in OCI.

Amortised cost criteria - commentary

The rules try to limit the use of amortised cost to those situations where it best reflects the substance of the transactions. Therefore it can only be used by a company whose business model is to make loans and collect future repayments.

A company might sell a loan before its maturity. This does not preclude classification of loans at amortised cost as long as the company's overall business model is to hold assets in order to receive contractual cash flows.

On the other hand a company might hold a portfolio of loans in order to profit from the sale of these assets when market conditions are favourable. In this case the company's business model is not to hold assets in order to receive contractual cash flows. The loans in this portfolio must be measured at fair value.

The cash flows received by a company must be solely payments of the principal lent and interest on this principal. An investment in a convertible bond would not satisfy this criteria as a company might convert it into equity. In that case the amount received by the company would not solely be repayments of principal or Interest.

Overview of classification of financial assets

Method	Which instruments?
Amortised cost	Loans and receivables that satisfy the amortised cost criteria
Fair value through OCI (FVOCI)	Loans and receivables that would otherwise satisfy the amortised cost criteria except that they are traded Equity that has been designated into this category on initial recognition
Fair value through profit or loss (FVPL)	Equity Derivatives Loans and receivables that fail the amortised cost or FVOCI criteria Loans and receivables that have been designated into this category on initial recognition in order to eliminate or significantly reduce a measurement or recognition inconsistency

3.3 Subsequent measurement of financial assets at amortised cost

This has been covered in an earlier section.

The following example is provided as a foundation to more complex examples later in this chapter based on the same central fact pattern but with further complications added.

Example: Financial asset at amortised cost

X purchased a loan on 1 January 20X5 and classified it as measured at amortised cost.

Terms:

Nominal value	₦50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	₦48 million
Effective rate	11.67%

Required

Show the double entry for each year to maturity of the bond. (Ignore loss allowances).

An amortisation table is a useful working as a starting point and is prepared as follows:

Year	Amortised cost b/f	Interest at 11.67%	Cash receipts	Amortised cost c/f
20X5	48.00m	5.60m	(5m)	48.60m
20X6	48.60m	5.65m	(5m)	49.25m
20X7	49.25m	5.75m	(55m)	nil

(The amortised cost at each date would be more correctly described as "gross carrying amount of the financial asset").

Example (continued): Financial asset at amortised cost

The following table summarises the above double entries.
Credit entries are shown as figures in brackets.

	Cash ₦m	Financial asset ₦m	P&L ₦m
20X5			
Purchase of financial asset	(48.00)	48.00	
Interest accrual		5.60	(5.60)
Interest receipt	5.00	(5.00)	
Amortised cost		48.60	
20X6			
Brought forward		48.60	
Interest accrual		5.65	(5.65)
Interest receipt	5.00	(5.00)	
		49.25	
20X7			
Brought forward		49.25	
Interest accrual		5.75	(5.75)
Interest receipt	5.00	(5.00)	
Redemption	50.00	(50.00)	
		nil	

Note that in this example the total cash flow interest received is ₦15m (being 3 receipts of ₦5m per annum).

The total interest recognised by applying the effective interest rate is ₦17m (being ₦5.6m + ₦5.65m + ₦5.75m).

The ₦2m difference is the difference between the amount paid for the bond (₦48m) and the amount received on redemption (₦50m). The calculation of the effective interest rate takes this into account. Interest recognised using the effective rate includes the total interest received and the difference between the initial outlay and redemption proceeds if any.

In other words, the lender receives a total cash return of ₦17m on its investment of ₦48m (being 3 receipts of ₦5m plus the difference between the initial investment and the redemption proceeds). This has been recognised in the statement of profit or loss (as ₦5.6m + ₦5.65m + ₦5.75m).

3.4 Subsequent measurement of financial assets at fair value through other comprehensive income

As explained earlier, a financial asset is measured at fair value through OCI if both of the following conditions are met (unless it has been designated at FVPL):

- the asset is held within a business model whose objective is achieved by **both** holding and collecting contractual cash flows **and** selling the financial assets; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Only the fair value movement is recognised in other comprehensive income. Interest income, foreign exchange gains and losses and impairment are recognised in profit or loss.

Interest is always recognised by applying the effective rate to the amortised cost of the bond at the start of the period. The fair value adjustment does not affect the recognition of interest income.

The fair value adjustment in OCI will always be the accumulated difference between the fair value and the amortised cost of the bond at the year end.

Example: Financial asset at fair value through OCI

X purchased a loan on 1 January 20X5 and classified it as measured at Fair value through OCI.

Terms:

Nominal value	₦50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	₦48 million
Effective rate	11.67%

Fair values at each year end to maturity are as follows

31 December 20X5	₦49.2 million
31 December 20X6	₦49.5 million
31 December 20X7	₦50.0 million

Required

Show the double entry for each year to maturity of the bond. (Ignore loss allowances).

Example (continued): Financial asset at fair value through OCI

The amortisation table can be constructed in the usual way and it can be extended to show the cumulative fair value adjustment at each reporting date. This can then be used to calculate the annual fair value adjustment.

Year	AC b/f	Interest at 11.67%	Cash receipt	AC c/f	Fair value (given)	Cumulative fair value adjustment
20X5	48.00m	5.60m	(5m)	48.60m	49.20	0.60
20X6	48.60m	5.65m	(5m)	49.25m	49.50	0.25
20X7	49.25m	5.75m	(55m)	nil	Nil	nil

(Only the fair value adjustments are recognised in OCI. Other transactions in respect of the financial asset (e.g. interest) are recognised in P&L in the usual way).

The following table summarises the necessary double entries.

Credit entries are shown as figures in brackets

	Cash ₦m	Financial asset ₦m	OCI ₦m	P& L ₦m
20X5				
Purchase of financial asset	(48.00)	48.00		
Interest accrual		5.60		(5.60)
Interest receipt	5.00	(5.00)		
Amortised cost		48.60		
Fair value adjustment		0.60	(0.60)	
		49.20	(0.60)	
20X6				
Brought forward		49.20	(0.60)	
Interest accrual		5.65		(5.65)
Interest receipt	5.00	(5.00)		
Fair value adjustment		(0.35)	0.35	
		49.50	(0.25)	
20X7				
Brought forward		49.50	(0.25)	
Interest accrual		5.75		(5.75)
Interest receipt	5.00	(5.00)		
Fair value adjustment		(0.25)	0.25	
Redemption	50.00	(50.00)		
		nil	Nil	

Note that the balances carried down for the financial asset are at fair value.

Disposal of financial assets measured at fair value through OCI

A financial asset in this category might be sold. When this occurs, the accumulated gain or loss previously recognised in OCI in respect of the asset is reclassified to P&L.

(Note that this only applies to financial assets that are debt instruments. It does not apply to those investments in equity in respect of which an entity has made an irrevocable decision to measure at fair value through OCI).

Example: Disposal of financial asset at fair value through OCI

X purchased a loan on 1 January 20X5 and classified it as measured at fair value through OCI.

The amortised cost table and the fair value adjustments in the first two years were as follows:

Year	AC b/f	Interest at 11.67%	Cash receipt	AC c/f	Fair value (given)	Cumulative fair value adjustment
20X5	48.00m	5.60m	(5m)	48.60m	49.20	0.60
20X6	48.60m	5.65m	(5m)	49.25m	49.50	0.25

X sold the asset for ₦50m on 10 January 20X7.

The journal entry to record the disposal is as follows:

	Dr (₦m)	Cr (₦m)
Cash	50	
Investment		49.5
Profit or loss		0.5
AND		
Other comprehensive income	0.25	
Profit or loss		0.25

Notes:

The total profit recognised on disposal is ₦0.75m (₦0.5m + ₦0.25m).

This is the amount that would have been recognised on disposal of the asset if it had been measured at amortised cost. (₦50m - ₦49.25m = ₦0.75m).

Interaction of IFRS 9 and IAS 21

IAS 21: *The effects of changes in foreign exchange rates* are covered in more detail in a later chapter.

IAS 21 requires the retranslation of foreign currency monetary items to the closing rate at each reporting date. Any exchange difference arising is recognised in the statement of profit or loss.

Debt instruments are monetary items.

Example: Interaction of IFRS 9 and IAS 21

X purchased a loan on 1 January 20X5 and classified it as measured at fair value through OCI.

Terms:

Nominal value	FC50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	FC48 million
Effective rate	11.67%

Fair values at each year end to maturity are as follows

Other information:	**Fair values**	**Exchange rates (FC1 = ₦)**
1 January 20X5	FC48 million	5
Average for 20X5	–	6
31 December 20X5	FC49.2 million	7
Average for 20X6	–	7.5
31 December 20X6	FC49.5 million	8
Average for 20X7	–	7
31 December 20X7	FC50.0 million	6

Required

Show the double entry for each year to maturity of the bond. (Ignore loss allowances).

Example (continued): Interaction of IFRS 9 and IAS 21

The amortisation table can be constructed in the usual way (in the foreign currency) and extended to show the cumulative fair value adjustment at each reporting date.

Year	AC b/f	Interest at 11.67%	Cash rec.	AC c/f	Fair value (given)	Cumulative fair value adjustment
20X5	48.00m	5.60m	(5m)	48.60m	49.20	0.60
20X6	48.60m	5.65m	(5m)	49.25m	49.50	0.25
20X7	49.25m	5.75m	(55m)	nil	nil	nil

Only the fair value adjustments are recognised in OCI. Other transactions in respect of the financial asset (e.g interest, and foreign exchange differences) are recognised in P&L in the usual way.

The exchange difference is calculated as a balancing figure in a translation of the amortised cost working.

Each row of the amortisation table is then translated into the reporting currency using appropriate rates and the exchange difference calculated as a balancing figure needed to ensure that the row sums to the amortised cost carried forward balance.

The fair value difference is calculated in the usual way and can be translated into the reporting currency at the year-end rate.

The translations are set out in the following table:

	To calculate the exchange difference				To calculate the fair value adjustment		
Year	AC b/f	Int. at 11.67 %	Cash receipt	Exch. diff. (bal. fig)	AC c/f	Fair value	Cum. FV adj.
20X5	48.00	5.60	(5.00)		48.60	49.20	0.60
Rate	5	6	7		7	7	7
	240.00	33.60	-35.00	**101.6**	340.20	344.40	4.20
20X6	48.60	5.65	(5.00)		49.25	₦49.50	0.25
Rate	7	7.5	8		8	8	8
	340.20	42.38	(40.00)	**51.42**	394.00	396.00	2.00
20X7	49.25	5.75	(5.00)		50.00	₦50.00	nil
Rate	8	7	6		6	6	6
	394.00	40.25	(30.00)	**(104.25)**	300.00	300.00	nil

Example (continued): Interaction of IFRS 9 and IAS 21

The following table summarises the necessary double entries. Credit entries are shown as figures in brackets.

	Cash ₦m	Financial asset ₦m	OCI (FV adj) ₦m	P&L ₦m
20X5				
Initial recognition of financial asset	(240.00)	240.00		
Interest accrual		33.60		(33.60)
Interest receipt	35.00	(35.00)		
Exchange gain on asset		101.60		(101.60)
Fair value adjustment		4.20	(4.20)	
		344.40	(4.20)	
20X6				
Brought forward		344.40	(4.20)	
Interest accrual		42.38		(42.38)
Interest receipt	40.00	(40.00)		
Exchange gain on asset		51.42		(51.42)
Fair value adjustment		(2.20)	2.20	
		396.00	(2.00)	
20X7				
Brought forward		396.00	(2.00)	
Interest accrual		40.25		(40.25)
Interest receipt	30.00	(30.00)		
Exchange gain on asset		(104.25)		104.25
Fair value adjustment		(2.00)	2.00	
Redemption	300.00	(300.00)		
		nil	nil	

3.5 Transaction costs

An earlier section explained the accounting treatment of transaction costs as follows:

Subsequent measurement	Treatment of transaction cost
Fair value through profit or loss	Written off as an expense in profit and loss.
Other methods (Amortised cost of fair value through OCI)	The transaction cost is capitalised and included in the initial cost of the financial instrument.

An earlier section explained that the price at which an asset can be sold to the market is called the bid price and the price at which it can be bought from the market is the offer price.

Previously, IAS 39 required that bid price had to be used for financial assets and ask price for financial liabilities but this is no longer the case. However, a company might have a policy of measuring the fair value of financial assets at the bid price. This means that there would be a difference on initial recognition between the amount paid for the asset (offer price) and the fair value of the asset using the bid price. This difference is treated as transaction cost and accounted for following the above rules.

Example: Transaction costs

An equity investment is purchased for ₦30,000 plus 1% transaction costs on 1 January 20X6. (Equity assets must be measured at FVPL).

At the end of the financial year (31 December 20X6) the investment is revalued to its fair value of ₦40,000.

On 11 December 20X7 it is sold for ₦50,000.

The accounting treatment for this investment is as follows:

1 January 20X6 The investment is recorded at cost at ₦30,000 and transaction costs of ₦300 are expensed to profit or loss.

31 December 20X6 The investment is revalued to its fair value of ₦40,000. There is a gain of ₦10,000 (₦40,000 – ₦30,000).

11 December 20X7 The journal entry to record the disposal is as follows:

	₦	₦
DR Cash	50,000	
CR Investment		40,000
CR Profit or loss		10,000

Example: Transaction costs

An equity investment is purchased for ₦30,000 plus 1% transaction costs on 1 January 20X6.

The company made an irrevocable decision to designate the investment as at fair value through OCI.

At the end of the financial year (31 December) the investment is revalued to its fair value of ₦40,000.

On 11 December 20X7 it is sold for ₦50,000.

The accounting treatment for this investment is as follows:

1 January 20X6 - The investment is recorded at ₦30,300. This is the cost plus the capitalised transaction costs.

31 December 20X6 - The investment is revalued to its fair value of ₦40,000. There is a gain of ₦9,700 (₦40,000 – ₦30,300). This gain of ₦9,700 is included nother comprehensive income for the year and may be accumulated in a separate reserve.

11 December 20X7

The journal entry to record the disposal is as follows:

	₦	₦
DR Cash	50,000	
CR Investment		40,000
CR P&L		10,000

Amounts previously recognised in OCI in respect of equity instruments for which an irrevocable designation has been made must **not** be reclassified to P&L.

4 CLASSIFICATION AND MEASUREMENT OF FINANCIAL LIABILITIES

Section overview

- Classification of financial liabilities
- Subsequent measurement of financial liabilities at amortised cost
- Financial guarantee contracts
- Summary of accounting for items measured at fair value

4.1 Classification of financial liabilities

All financial liabilities are classified (on initial recognition) as subsequently measured at amortised cost with specific exceptions including:

- Derivatives that are liabilities at the reporting date; and
- Financial liabilities that might arise when a financial asset is transferred but this transfer does not satisfy the derecognition criteria (see later in this chapter).

Reclassification of a financial liability after initial recognition is not allowed.

Irrevocable designation

A company is allowed to designate a financial liability as measured at fair value through profit or loss. This designation is irrevocable and can only be made if:

- it eliminates or significantly reduces a measurement or recognition inconsistency; or
- this would allow the company to reflect a documented risk management strategy.

Where this designation is used, the part of the change in fair value due to a change in the entity's own credit risk must be recognised in other comprehensive income. This is a little difficult to understand but the rule exists to prevent an undesired effect.

Example: Changes in own credit risk

A company issues a bond (borrows) for ₦1 million.

The company designates the bond as measured at fair value through profit or loss.

Situation 1

Suppose at the end of the first year the company's credit risk had improved. This would make the company's debt more desirable to investors causing its fair value to increase say to ₦1.1 million.

In the absence of the above rule the double entry to reflect the fair value change would be:

Dr	P&L		₦0.1 million
	Cr	Liability	₦0.1 million

In other words, the improvement in the company's economic situation would result in the recognition of an expense in its P&L account.

Situation 2

Suppose at the end of the first year the company's credit risk had deteriorated. This would make the company's debt less desirable to investors causing its fair value to decrease say to ₦0.9 million.

In the absence of the above rule the double entry to reflect the fair value change would be:

Dr	Liability		₦0.1 million
	Cr	P&L	₦0.1 million

In other words, the deterioration in the company's economic situation would result in the recognition of a gain in the P&L account.

The requirement to recognise change in fair value due to a change in the entity's own credit risk in other comprehensive income is an attempt to reduce the perceived effect of the above.

4.2 Subsequent measurement of financial liabilities at amortised cost

This has been covered in an earlier section so only a basic revision is provided here.

Amortised cost of a financial liability: The amount at which the financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount.

Effective interest rate: The rate that exactly discounts estimated future cash payments through the expected life of financial liability to the **amortised cost of a financial liability**.

Example: Financial liability

X issued a loan on 1 January 20X5 and classified it as measured at amortised cost.

Terms:	
Nominal value	₦50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	₦48 million
Effective rate	11.67%

Required

Show the double entry for each year to maturity of the bond. (Ignore loss allowances).

An amortisation table is a useful working as a starting point and is prepared as follows:

Year	Amortised cost b/f	Interest at 11.67%	Cash payments	Amortised cost c/f
20X5	48.00m	5.60m	(5m)	48.60m
20X6	48.60m	5.65m	(5m)	49.25m
20X7	49.25m	5.75m	(55m)	nil

This is the same as the table from the lender's viewpoint except the interest is an expense rather than income and the cash flows are outflows rather than inflows.

Example (continued): Financial liability

The following table summarises the necessary double entries.
Credit entries are shown as figures in brackets.

	Cash ₦m	Financial liability ₦m	P&L ₦m
20X5			
Proceeds of issue	48.00	(48.00)	
Interest accrual		(5.60)	5.60
Interest receipt	(5.00)	5.00	
Amortised cost		(48.60)	
20X6			
Brought forward		(48.60)	
Interest accrual		(5.65)	5.65
Interest receipt	(5.00)	5.00	
		(49.25)	
20X7			
Brought forward		(49.25)	
Interest accrual		(5.75)	5.75
Interest receipt	(5.00)	5.00	
Redemption	(50.00)	50.00	
		nil	

4.3 Financial guarantee contracts

A financial guarantee within the scope of IFRS 9 is a financial liability. It is initially measured at its fair value. At subsequent reporting dates it is measured at the higher of:

- the amount of the loss allowance (see section 5 of this chapter); or
- the amount initially recognised (amortised to recognise income in accordance with IFRS 15: *Revenue from Contracts with Customers* if appropriate).

Example: Financial guarantees

On 1st January Year 1, P Ltd gave a guarantee of a ₦50m loan taken by its subsidiary, S Ltd on that date.

S Ltd was to repay the loan in four equal annual instalments (to cover the ₦50m principal together with related interest) on 31st December Years 1 to 4.

Under the terms of the guarantee, P Ltd would be called on to repay the principal amount of the loan in the event of S Ltd defaulting on any of these payments.

The fair value of the guarantee at inception was assessed as ₦1.6m.

P Ltd's reporting date is 31 December.

Situation 1

S Ltd makes all payments in accordance with the terms of the loan.

P Ltd would account for the guarantee as follows (ignoring time value):

1st January Year 1 (initial recognition)

Dr	P&L	₦1.6m	
Cr	Liability		₦1.6m

31st December Years 1 to 4

Dr	Liability	₦0.4m	
Cr	P&L		₦0.4m

The amortisation of the guarantee over its life reflects the recognition of income (through reduction of the liability) as the service is provided.

Situation 2

S Ltd made the first payment in accordance with the loan but failed in Year 2.

1st January Year 1 (initial recognition)

Dr	P&L	₦1.6m	
Cr	Liability		₦1.6m

31st December Year 1

Dr	Liability	₦0.4m	
Cr	P&L		₦0.4m

31st December Year 2

Dr	P&L	₦36.3m	
Cr	Liability		₦36.3m

(₦50m – ₦12.5m (Year 1 repayment) – ₦1.2m (financial liability brought forward from year 1).

This results in a liability at the end of year of ₦37.5m (₦1.2m + 36.3m) being ¾ of the initial loan of ₦50m.

4.4 Summary of accounting for items measured at fair value

Category	Examples
Financial asset at fair value through profit or loss	Whole fair value movement to profit or loss
Financial asset at fair value through OCI	Whole fair value movement to OCI **Subsequent sale of the asset** Gain or loss on disposal calculated based on the carrying amount of the asset at the date of disposal. Reclassification of the amounts previously recognised in OCI is required on sale of a debt investment classified as FVOCI. (An entity might make an irrevocable decision to measure an investment in equity at FVOCI. Reclassification of the amounts previously recognised in OCI is not allowed on the sale of such an asset. However, an amount might be transferred from an equity reserve to accumulated profits in this case).
Financial liability at fair value through profit or loss	Change in fair value attributed to change in credit risk to OCI. Remaining change in fair value to profit or loss

5 IMPAIRMENT OF FINANCIAL ASSETS

Section overview

- Introduction
- Definitions
- General approach
- Accounting for the loss allowance: financial assets at amortised cost
- Accounting for the loss allowance: financial assets at FVOCI
- Credit impairment
- Simplified approach

5.1 Introduction

Impairment of most non-current assets is covered by IAS 36. IAS 36 operates an **incurred loss model**. This means that impairment is recognised only when an event has occurred which has caused a fall in the recoverable amount of an asset.

Impairment of financial instruments is dealt with by IFRS 9. IFRS 9 contains an **expected loss model**. The expected loss model applies to all debt instruments (loans, receivables etc.) recorded at amortised cost or at fair value through OCI. It also applies to lease receivables (IFRS 16), contract assets (IFRS 15).

The aim of the expected loss model is that financial statements should reflect the deterioration or improvement in the credit quality of financial instruments held by an entity. This is achieved by recognising amounts for the expected credit loss associated with financial assets.

The rules look complex because they have been drafted to provide guidance to banks and similar financial institutions on the recognition of credit losses on loans made. However, there is a simplified regime that applies to other financial assets as specified in the standard (such as trade receivables and lease receivables).

5.2 Definitions

Definition: Credit loss

The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate.

Definition: Lifetime expected credit losses

The expected credit losses that result from all possible default events over the expected life of a financial instrument.

Definition: 12**-month expected credit losses**

The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

5.3 General approach

This approach must be applied to financial assets measured at amortised cost and financial assets measured at fair value through OCI. The approach also applies to lease receivables and contract assets unless the entity adopts the simplified approach described later. (Any impairment losses on financial assets measured at fair value through profit and loss are automatically recognised in profit or loss).

The objective of the requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition (whether assessed on an individual or collective basis) considering all reasonable and supportable information.

Overview

For those financial assets to which the general approach applies, a loss allowance measured as the **12-month expected credit losses** is recognised at initial recognition.

The expected credit loss associated with the financial asset is then reviewed at each subsequent reporting date and remeasured as necessary. The amount of expected credit loss recognised as a loss allowance depends on the extent of credit deterioration since initial recognition.

- If there is no significant increase in credit risk the loss allowance for that asset is remeasured to the 12 month expected credit loss as at that date.
- If there is a significant increase in credit risk the loss allowance for that asset is remeasured to the **lifetime expected credit losses** as at that date. This does not mean that the financial asset is impaired. The entity still hopes to collect amounts due but the possibility of a loss event has increased.
- If there is credit impairment, the financial asset is written down to its estimated recoverable amount. The entity accepts that not all contractual cash flows will be collected and the asset is impaired.

Credit impairment (the third bullet above) will be dealt with in a separate section.

The first two bullets simply differ in terms of how the expected loss is measured. There is no difference between the necessary double entry in each case.

Basis for estimating credit losses

Credit loss is measured as the present value of the difference between:

- the contractual cash flows that are due to an entity under the contract; and
- the cash flows that the entity expects to receive.

Expected credit losses are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument.

A cash shortfall is the difference between the cash flows that are due in accordance with a contract and the cash flows that an entity expects to receive.

Credit loss can arise even if the entity expects to be paid in full later than when contractually due.

The measurement of a possible credit loss might be influenced by the availability of collateral held by an entity.

Expected credit losses must be measured in a way that reflects:

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- the time value of money; and
- reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Determining significant increases in credit risk

At each reporting date, an assessment is needed about whether the credit risk on a financial instrument has increased significantly since initial recognition.

This assessment is based on the change in the risk of a default occurring over the expected life of the financial instrument. This assessment compares the risk of a default occurring as at the reporting date with the risk of a default occurring as at the date of initial recognition. This comparison should be based on reasonable and supportable information, that is available without undue cost or effort that is indicative of significant increases in credit risk since initial recognition.

If a financial asset is determined to have low credit risk at the reporting date then its credit risk cannot have increased significantly since initial recognition.

5.4 Accounting for the loss allowance: financial assets at amortised cost

The movement on the loss allowance is recognised in profit or loss.

The loss allowance balance is netted against the financial asset to which it relates on the face of the statement of financial position. **NB**: this is just for presentation only; the loss allowance does not reduce the carrying amount of the financial asset in the double entry system.

The loss allowance does not affect the recognition of interest revenue. Interest revenue is calculated on the gross carrying amount (i.e. without adjustment for credit losses).

Example: Financial asset at amortised cost

X purchased a loan on 1 January 20X5 and classified it as measured at amortised cost.

Terms:

Nominal value	₦50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	₦48 million
Effective rate	11.67%

Loss allowances (estimated in accordance with IFRS 9):

1 January 20X5	₦1 million
31 December 20X5	₦1.5 million
31 December 20X6	₦1.2 million
31 December 20X7 (principal repaid)	nil

Required

Show the double entry for each year to maturity of the bond.

The amortisation table and the double entry for the financial asset are not affected by the existence of the loss allowance.

Accounting for the loss allowance sits alongside the accounting treatment for the financial asset.

The amortisation table is prepared as follows (in the same way as before):

Year	Amortised cost b/f	Interest at 11.67%	Cash receipts	Amortised cost c/f
20X5	48.00m	5.60m	(5m)	48.60m
20X6	48.60m	5.65m	(5m)	49.25m
20X7	49.25m	5.75m	(55m)	nil

(The amortised cost at each date would be more correctly described as "gross carrying amount of the financial asset").

Example (continued): Financial asset at amortised cost

The loss allowance is established as a credit balance in the statement of financial position and is remeasured at each reporting date.

The redemption of the loan brings certainty that no loss is incurred so the loss allowance is released to P&L when this happens.

The following table summarises the above double entries.

Credit entries are shown as figures in brackets.

	Cash ₦m	Financial asset ₦m	Loss allowance ₦m	P&L ₦m
20X5				
Initial recognition of:				
financial asset	(48.00)	48.00		
loss allowance			(1.00)	1.00
Interest accrual		5.60		(5.60)
Interest receipt	5.00	(5.00)		
Remeasurement of loss allowance			(0.50)	0.50
Amortised cost		48.60	(1.50)	
20X6				
Brought forward		48.60	(1.50)	
Interest accrual		5.65		(5.65)
Interest receipt	5.00	(5.00)		
Remeasurement of loss allowance			0.30	(0.30)
		49.25	(1.20)	
20X7				
Brought forward		49.25		
Interest accrual		5.75		(5.75)
Interest receipt	5.00	(5.00)		
Redemption	50.00	(50.00)		
Remeasurement of loss allowance			1.20	(1.20)
		nil	nil	

5.5 Accounting for the loss allowance: financial assets at FVOCI

There is no separate loss allowance account for financial assets at fair value through OCI.

Any impairment on these assets is automatically recognised in OCI as part of the fair value adjustment. In other words, part of the movement in fair value would be due to impairment.

A second double entry is then made to recognise the movement in the loss allowance in profit or loss with the other side of the entry in OCI. In effect, this transfers that part of the fair value movement which was due to impairment into OCI.

Example: Accounting for the loss allowance: financial assets at FVOCI

X purchased a loan on 1 January 20X5 and classified it as measured at fair value through OCI.

Terms:

Nominal value	₦50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	₦48 million
Effective rate	11.67%

Fair values at each year end to maturity are as follows

31 December 20X5	₦49.2 million
31 December 20X6	₦49.5 million
31 December 20X7	₦50.0 million

Loss allowances (estimated in accordance with IFRS 9):

1 January 20X5	₦1 million
31 December 20X5	₦1.5 million
31 December 20X6	₦1.2 million
31 December 20X7 (principal repaid)	nil

Required

Show the double entry for each year to maturity of the bond.

Note

The amortisation table and the double entry for the financial asset are not affected by the existence of the loss allowance.

Accounting for the loss allowance sits alongside the accounting treatment for the financial asset.

(The amortised cost at each date would be more correctly described as “gross carrying amount of the financial asset”).

Example (continued): Accounting for the loss allowance: financial assets at FVOCI

The amortisation table can be constructed in the usual way and it can be extended to show the cumulative fair value adjustment at each reporting date. This can then be used to calculate the annual fair value adjustment.

Year	AC b/f	Interest at 11.67%	Cash receipt	AC c/f	Fair value (given)	Cumulative fair value adjustment
20X5	48.00m	5.60m	(5m)	48.60m	49.20	0.60
20X6	48.60m	5.65m	(5m)	49.25m	49.50	0.25
20X7	49.25m	5.75m	(55m)	nil	nil	nil

(The loss allowance on financial assets at FVOCI is not recognised as a separate balance but is recognised in OCI).

The following table summarises the necessary double entries. The OCI entries are split into two columns in order make it easier to keep track of the double entries.

Credit entries are shown as figures in brackets

	Cash ₦m	Financial asset ₦m	OCI (FV adj) ₦m	OCI (loss all.) ₦m	P&L ₦m
20X5					
Initial recognition of:					
financial asset	(48.00)	48.00			
loss allowance				(1.00)	1.00
Interest accrual		5.60			(5.6)
Interest receipt	5.00	(5.00)			
Fair value adjustment		0.60	(0.60)		
Remeasurement of loss allowance				(0.50)	0.50
		49.20	(0.60)	(1.50)	
20X6					
Brought forward		49.20	(0.60)	(1.50)	
Interest accrual		5.65			(5.65)
Interest receipt	5.00	(5.00)			
Fair value adjustment		(0.35)	0.35		
Remeasurement of loss allowance				0.30	(0.30)
		49.50	(0.25)	(1.20)	
20X7					
Brought forward		49.50	(0.25)	(1.20)	
Interest accrual		5.75			(5.75)
Interest receipt	5.00	(5.00)			
Fair value adjustment		(0.25)	0.25		
Redemption	50.00	(50.00)			
Remeasurement of loss allowance				1.20	(1.20)
		nil	nil	nil	

Interaction of IFRS 9 and IAS 21

Example: Accounting for the loss allowance: financial assets at FVOCI – Interaction of IFRS 9 and IAS 21

X purchased a loan on 1 January 20X5 and classified it as measured at fair value through OCI.

Terms:

Nominal value	FC50 million
Coupon rate	10%
Term to maturity	3 years
Purchase price	FC48 million
Effective rate	11.67%

Fair values at each year end to maturity are as follows

Other information:

	Fair values	Exchange rates (FC1 =₦)
1 January 20X5	FC48 million	5
Average for 20X5	–	6
31 December 20X5	FC49.2 million	7
Average for 20X6	–	7.5
31 December 20X6	FC49.5 million	8
Average for 20X7	–	7
31 December 20X7	FC50.0 million	6

Required

Show the double entry for each year to maturity of the bond. (Ignore loss allowances).

Notes

An amortisation table is constructed in the usual way in the foreign currency (₦ in this case).

A working is also needed to identify the exchange difference on the loss allowance.

Example (continued): Accounting for the loss allowance: financial assets at FVOCI – Interaction of IFRS 9 and IAS 21

Year	AC b/f	Interest at 11.67%	Cash rec.	AC c/f	Fair value (given)	Cumulative fair value adjustment
20X5	48.00m	5.60m	(5m)	48.60m	49.20	0.60
20X6	48.60m	5.65m	(5m)	49.25m	49.50	0.25
20X7	49.25m	5.75m	(55m)	nil	nil	nil

Translation of amortisation table into reporting currency:

Year	AC b/f	Int. at 11.67 %	Cash receipt	Exch. diff. (bal. fig)	AC c/f	Fair value	Cum. FV adj.
20X5	48.00	5.60	(5.00)		48.60	49.20	0.60
Rate	5	6	7		7	7	7
	240.00	33.60	-35.00	**101.6**	340.20	344.40	4.20
20X6	48.60	5.65	(5.00)		49.25	₦49.50	0.25
Rate	7	7.5	8		8	8	8
	340.20	42.38	(40.00)	**51.42**	394.00	396.00	2.00
20X7	49.25	5.75	(5.00)		50.00	₦50.00	nil
Rate	8	7	6		6	6	6
	394.00	40.25	(30.00)	**(104.25)**	300.00	300.00	nil

Exchange difference on loss allowance

Year	Loss at start	Remeasurement	Exch. diff	Loss at end
20X5	1.00	0.50		1.50
Rate	5	6		7
	5.00	3.00	**2.50**	10.50
20X6	1.50	(0.30)		1.20
Rate	7	7.5		8
	10.50	(2.25)	**1.35**	9.60
20X7	1.20	(1.20)		nil
Rate	8	7		6
	9.60	(8.40)	**(1.20)**	nil

Example (continued): Accounting for the loss allowance: financial assets at FVOCI – Interaction of IFRS 9 and IAS 21

The following table summarises the necessary double entries.
Credit entries are shown as figures in brackets.

	Cash ₦m	Financial asset ₦m	OCI (FV adj) ₦m	OCI (loss all.) ₦m	P&L ₦m
20X5					
Initial recognition of:					
financial asset	(240.00)	240.00			
loss allowance				(5.00)	5.00
Interest accrual		33.60			(33.60)
Interest receipt	35.00	(35.00)			
Exchange gain on asset		101.60			(101.60)
Fair value adjustment		4.20	(4.20)		
Remeasurement of loss allowance				(3.00)	3.00
Exchange loss on loss allowance				(2.50)	2.50
		344.40	(4.20)	(10.50)	
20X6					
Brought forward		344.40	(4.20)	(10.50)	
Interest accrual		42.38			(42.38)
Interest receipt	40.00	(40.00)			
Exchange gain on asset		51.42			(51.42)
Fair value adjustment		(2.20)	2.20		
Remeasurement of loss allowance				2.25	(2.25)
Exchange loss on loss allowance				(1.35)	1.35
		396.00	(2.00)	(9.60)	
20X7					
Brought forward		396.00	(2.00)	(9.60)	
Interest accrual		40.25			(40.25)
Interest receipt	30.00	(30.00)			
Exchange gain on asset		(104.25)			104.25
Fair value adjustment		(2.00)	2.00		
Redemption	300.00	(300.00)			
Remeasurement of loss allowance				8.40	(8.40)
Exchange gain on loss allowance				1.20	(1.20)
		nil	nil	nil	

5.6 Credit impairment

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include (but is not limited to) observable data about the following events:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract, such as a default or past due event;
- the lender has granted to the borrower a concession for economic or contractual reasons relating to the borrower's financial difficulty that the lender would not otherwise have considered:
- it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

If an entity revises its estimates of receipts it must adjust the gross carrying amount of the financial asset to reflect actual and revised estimated contractual cash flows. The financial asset must be remeasured to the present value of estimated future cash flows from the asset discounted at the original effective rate.

Example: Credit impairment (I)

Company X invests in a bond.

The bond has an issue value of ₦1 million and pays a coupon rate of 5% interest for two years, then 7% interest for two years.

Interest is paid annually on the anniversary of the bond issue.

The bond will be redeemed at par after four years.

The effective rate for this bond is 5.942%

At the end of the second year it becomes apparent that the issuer has financial difficulties and it is estimated that Company X will only receive 60c in the dollar of the future cash flows.

At the end of year 2 the amortised cost is:

Year	Amortised cost brought forward	Interest at 5.942%	Cash paid	Amortised cost carried forward
1	1,000,000	59,424	(50,000)	1,009,424
2	1,009,424	59,983	(50,000)	1,019,407

The recoverable amount is calculated as follows:

Year	Future cash flows	Discount factor (@5.942%)	
3	70,000 @ 60% = 42,000	0.9439	39,644
4	1,070,000 @ 60% = 642,000	0.891	572,022
Recoverable amount			611,666
Carrying amount			1,019,407
Impairment			407,741

Note that the recoverable amount could have been calculated easily as 60% of the carrying amount:

60% of 1,019,407 = 611,644 (22 difference due to rounding)

The impairment loss is charged to profit or loss taking into account the balance on the loss allowance account already recognised for the asset.

Example: Credit impairment (II)

Suppose in the above example there was a loss allowance of ₦100,000 recognised on the asset before the impairment event.

The necessary double entries would be as follows:

	Debit	Credit
Statement of profit or loss	307,741	
Loss allowance	100,000	
Financial asset		407,741

Future revenue recognition

Interest is recognised in the future by applying the effective rate to the new amortised cost (after the recognition of the impairment loss).

5.7 Simplified approach

This applies to trade receivables, contract assets and lease receivables. The approach involves the recognition of lifetime expected losses for the relevant assets.

The following table summarises when the approach must or may be used.

Financial asset	Simplified approach
Trade receivables or contract assets (IFRS 15) that do not contain a significant financing component.	Must be used.
Trade receivables or contract assets that contain a significant financing component.	May be used if chosen as an accounting policy to be applied consistently to all trade receivables or contract assets. It may be applied separately to trade receivables and contract receivables.
Lease receivables	May be used if chosen as an accounting policy to be applied consistently.

A company might use a provision matrix to measure expected lifetime credit losses. This is a system based on its experience of historical default rates as updated for forward looking estimates.

Example: Simplified approach

X Plc has total trade receivables of ₦30,000,000.

The trade receivables do not have a significant financing component.

The loss allowance recognised at the end of the previous year was ₦500,000.

X Plc has constructed the following provision matrix to calculate expected lifetime losses of trade receivables.

	Number of days past due (overdue)				
	Current	1 to 30	31 to 60	61 to 90	More than 90
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

Example (continued): Simplified approach

The expected lifetime credit loss is measured as follows:

	Gross carrying amount of trade receivables	Default rate	Lifetime expected credit loss
	₦	%	₦
Current	15,000,000	0.3	45,000
1 to 30 days	7,500,000	1.6	120,000
31 to 60 days	4,000,000	3.6	144,000
61 to 90 days	2,500,000	6.6	165,000
More than 90	1,000,000	10.6	106,000
	30,000,000		580,000

X plc must recognise a loss provision of ₦580,000.

The following double entry would be necessary to increase the opening loss provision to this amount:

	Debit	Credit
Statement of profit or loss	80,000	
Loss allowance		80,000

The trade receivables would be presented at an amount net of this allowance in the statement of financial position (₦30,000,000 - ₦580,000 = ₦29,420,000).

6 OTHER ISSUES

Section overview

- Embedded derivatives
- Derecognition
- Reclassification

6.1 Embedded derivatives

A non-derivative contract might include terms that cause some of its cash flows to behave in the same way as those of a derivative. Such a contract is described as being a hybrid. A hybrid is made up of two components, a host and an embedded derivative.

It may be necessary to separate the embedded derivative from its host and account for each separately. The result is that the embedded derivative would be measured at fair value though profit and loss in the same way as any other derivative.

Whether an embedded derivative is separated, depends on whether its host is an asset within the scope of IFRS 9, and if not, whether certain criteria are met.

Hosts which are financial assets within the scope of IFRS 9

An embedded derivative embedded in a financial asset host that is within the scope of IFRS 9 is not separated.

The normal rules of classification and accounting would apply to such a contract. A financial asset is measured at FVPL if any of its cash flows do not represent payments of principal and interest. The presence of a derivative embedded in a financial asset prevents its cash flows being solely payments of principal and interest.

This means that existence of an embedded derivative (if any) would result in the whole financial asset being measured at fair value through profit or loss.

Hosts which are financial assets within the scope of IFRS 9

If the host contract is an asset within the scope of IFRS 9 the normal rules of classification and accounting apply. and there is no need to separate the embedded derivative.
The contractual cash flows of the financial asset are assessed in their entirety, and the asset as a whole is measured at FVPL if any of its cash flows do not represent payments of principal and interest. The presence of the derivative would prevent cash flows representing only payments of principal and interest.

This means that existence of the embedded derivative (if any) would result in the whole instrument being measured at fair value through profit or loss.

Other hybrid contracts (financial assets outside the scope of IFRS 9 and financial liabilities)

If a hybrid contract contains a host that is not an asset within the scope of IFRS 9, an embedded derivative must be separated from the host and accounted for as a derivative if, and only if:

- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (in other words it is unusual in the context of the host contract);
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).

When these conditions are met, the embedded derivative is separated from the host contract and accounted for like any other derivative. The host contract is accounted for in accordance with the relevant accounting standard, separately from the derivative.

Example: Embedded derivatives

A company borrows ₦25m and agrees to pay interest at a rate that is linked to oil price. (Therefore, it has some kind of oil derivative embedded in it).

This is not an asset that is in the scope of IFRS 9 (it is a liability). Therefore the entity needs to decide if the embedded derivative should be separated and measured at fair value through profit or loss.

The economic characteristics and risks of the embedded derivative are not closely related to those of the host. (Oil price is different to interest rates).

The derivative should be separated and measured at FVPL.

6.2 Derecognition

Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

Derecognition of a financial liability

A financial liability (or a part of a financial liability) is derecognised when, and only when, it is extinguished.

This is when the obligation specified in the contract is discharged or cancelled or expires.

Derecognition of a financial asset

Most transactions involving derecognition of a financial asset are straightforward. However, financial assets may be subject to complicated transactions where some of the risks and rewards that attach to an asset are retained but some are passed on. IFRS 9 contains complex guidance designed to meet the challenge posed by complex transactions.

The guidance is structured so that a transaction involving a financial asset is subject to a series of tests to establish whether the asset should be derecognised. These tests can be framed as a series of questions.

1 Have the contractual rights to cash flows of the financial asset expired?

- If the answer is "yes" – derecognise the financial asset
- If the answer is "no" – ask the next question

2 Has the asset been transferred to another party?

- If the answer is "no" – the asset is retained (not derecognised)
- If the answer is "yes" – ask the next question

3 Have substantially all of the risks and rewards of ownership passed?

- If the answer is "yes" – derecognise the financial asset
- If the answer is "no" – the asset is retained (not derecognised)
- If the answer is "the risks and rewards are neither passed nor retained (i.e. some are passed but some kept)" – ask the next question

4 Has the asset been transferred in a way such that risks and rewards of ownership have neither passed nor been retained but control has been lost.

- If the answer is "yes" – derecognise the financial asset
- If the answer is "no" – the asset is retained (not derecognised)

This all sounds very complicated but what it means is that a financial asset is derecognised if one of three combinations of circumstances occur:

- ❑ The contractual rights to the cash flows from the financial asset expire; or
- ❑ The financial asset is transferred and substantially all of the risks and rewards of ownership pass to the transferee; or
- ❑ The financial asset is transferred, substantially all of the risks and rewards of ownership are neither transferred nor retained but control of the asset has been lost.

Most transactions being considered involve the receipt of cash.

- Transactions where the asset is derecognised may lead to the recognition of a profit or loss on disposal.
- Transactions where the asset is not derecognised lead to the recognition of a liability for the cash received.

Example: Derecognition (I)

ABC collects ₦10,000 that it is owed by a customer.

Analysis

1 Have the contractual rights to cash flows of the financial asset expired?

Yes – Derecognise the asset

Dr	Cash	₦10,000	
	Cr Receivable		₦10,000

Example: Derecognition (II)

ABC sells ₦100,000 of its accounts receivables to a factor and receives an 80% advance immediately. The factor charges a fee of ₦8,000 for the service.

The debts are factored without recourse and a balancing payment of ₦12,000 will be paid by the factor 30 days after the receivables are factored.

Analysis

1 Have the contractual rights to cash flows of the financial asset expired?

No – ask the next question

2 Has the asset been transferred to another party?

Yes (for 80% of it)

3 Have substantially all of the risks and rewards of ownership passed?

The receivables are factored without recourse so ABC has passed on the risks and rewards of ownership.

ABC must derecognise the asset transferred.

Dr	Cash	₦80,000	
	Cr Receivables		₦80,000

In addition ABC has given part of the receivable to the factor as a fee:

Dr	P&L	₦8,000	
	Cr Receivables		₦8,000

Example: Derecognition (II)

ABC sells ₦100,000 of its accounts receivables to a factor and receives an 80% advance immediately. The factor charges a fee of ₦8,000 for the service.

The debts are factored with recourse and a further advance of 12% will be received by the seller if the customer pays on time.

Analysis

1 Have the contractual rights to cash flows of the financial asset expired?

No – ask the next question

2 Has the asset been transferred to another party?

Yes (for 80% of it)

3 Have substantially all of the risks and rewards of ownership passed?

The debt is factored with recourse so the bad debt risk stays with ABC. In addition, ABC has access to future rewards as further sums are receivable if the customers pay on time.

As ABC has kept the future risks and rewards relating to the ₦80,000, this element of the receivable is not derecognised.

Dr	Cash		₦80,000	
	Cr	Liability		₦80,000

Being receipt of cash from factor – This liability is reduced as the factor collects the cash.

Dr	Liability		₦X	
	Cr	Receivable		₦X

In addition ABC has given part of the receivable to the factor as a fee:

Dr	P&L		₦8,000	
	Cr	Receivables		₦8,000

6.3 Reclassification

Reclassification of financial assets

Generally, financial assets should not be reclassified. However, it might be necessary to reclassify a financial asset when an entity changes its business model.

Sometimes a financial instrument might be designated as a hedging instrument in a cash flow hedge or net investment hedge. Similarly, a financial instrument that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge might no longer qualify as such. These are not reclassifications.

Reclassification applies prospectively from the reclassification date (defined as the first day of the reporting period following that in which there is a change in the business model leading to a reclassification). Previously recognised gains, losses etc. are not restated as a result of the reclassification.

Reclassification from	Reclassification to	Accounting consequences
Amortised cost	Fair value through profit or loss	Remeasure to FV at the reclassification date Recognise any gain or loss arising in P&L
Fair value through profit or loss	Amortised cost	FV at reclassification date becomes gross carrying amount Calculate effective interest rate using fair value at the reclassification date as the amount at initial recognition Recognise credit losses
Amortised cost	Fair value through OCI	Remeasure to FV at the reclassification date Recognise any gain or loss arising in OCI There is no adjustment to the effective interest rate or measurement of credit losses as a result of the reclassification Credit losses transferred to OCI
Fair value through OCI	Amortised cost	Remeasure to FV at the reclassification date adjusted for the cumulative gain or loss previously recognised in equity. There is no adjustment to the effective interest rate or measurement of credit losses as a result of the reclassification Loss allowance transferred out of OCI
Fair value through profit or loss	Fair value through OCI	Continue to measure the financial asset at fair value
Fair value through OCI	Fair value through profit or loss	Continue to measure the financial asset at fair value Cumulative gain or loss previously recognised in equity is reclassified from equity to P&L as a reclassification adjustment

Reclassification of financial liabilities

Financial liabilities cannot be reclassified.

AC to FVPL

Example: Amortised cost to FVPL

A change in business model requires the reclassification of a bond.

The following information as at the date of the reclassification is relevant:

	₦000
Original cost	1,000
Carrying amount (Amortised cost)	1,000
Loss allowance	10
Fair value	1,050

The double entries needed to reflect the reclassification are as follows:

	Dr	Cr
Financial asset at amortised cost		1,000
Financial asset at FVPL	1,000	
Financial asset at FVPL	50	
P&L (reclassification)		50
Loss allowance	10	
P&L (reclassification)		10

The following table summarises the above double entries.

Credit entries are shown as figures in brackets.

	Financial asset at AC	Loss allowance	Financial asset at FVPL	P&L
Before reclassification	1,000	(10)		
Adjustments:				
	(1,000)		1,000	
			50	(50)
		10		(10)
				(60)
After reclassification	nil	nil	1,050	

AC to FVOCI

Example: Amortised cost to FVOCI

A change in business model requires the reclassification of a bond.

The following information as at the date of the reclassification is relevant:

	₦000
Original cost	1,000
Carrying amount (Amortised cost)	1,000
Loss allowance	10
Fair value	1,050

The double entries needed to reflect the reclassification are as follows:

	Dr	Cr
Financial asset at amortised cost		1,000
Financial asset at FVOCI	1,000	
Financial asset at FVOCI	50	
OCI (FV gain)		50
Loss allowance	10	
OCI (credit loss)		10

Loss allowance on financial assets which are FVOCI is not recognised as a credit to be deducted from the carrying amount of the asset but is recognised as a credit in OCI. Therefore, the loss allowance before reclassification has not been remeasured or derecognised but is transferred to OCI.

The following table summarises the above double entries.

Credit entries are shown as figures in brackets.

	Financial asset at AC	Loss allowance	Financial asset at OCI	OCI
Before reclassification	1,000	(10)		
Adjustments:				
	(1,000)		1,000	
			50	(50)
		10		(10)
				60
After reclassification	nil	nil	1,050	60

7 HEDGE ACCOUNTING

Section overview

- What is hedging?
- Qualifying items
- Qualifying criteria for hedge accounting
- Fair value hedge
- Cash flow hedge
- Cash flow hedge – basis adjustment
- Hedges of a net investment in a foreign operation

7.1 What is hedging?

Hedging is the process of entering into a transaction in order to reduce risk. Companies may use derivatives to establish 'positions', so that gains or losses from holding the position in derivatives will offset losses or gains on the related item that is being hedged.

Example:

A Nigerian company has a liability to pay a US supplier $200,000 in three months' time.

The company is exposed to the risk that the US dollar will increase in value against the naira in the next three months, so that the payment in dollars will become more expensive (in naira).

A hedge can be created for this exposure to foreign exchange risk by making a forward contract to buy $200,000 in three months' time, at a rate of exchange that is fixed now by the contract.

This is an example of hedging: the exposure to risk has been removed by the forward contract.

The logic of accounting for hedging should be that if a position is hedged, gains (or losses) on the hedged position that are reported in profit and loss should be offset by matching losses (or gains) on the hedging position in derivatives also reported in profit or loss.

However, without special rules to account for hedging, the financial statements may not reflect the offsetting of the risk and the economic reality of hedging.

7.2 Qualifying items

A company can hedge whatever it wants to but IFRS 9 only allows hedge accounting when certain conditions are satisfied. IFRS 9 uses the following definitions in describing the hedge accounting rules.

Hedged item

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a forecast transaction or a net investment in a foreign operation.

- The hedged item can be a single item or a group of items (subject to certain conditions).
- A hedged item can also be a component of such an item or group of items.

Only the following types of components (including combinations) may be designated as hedged items:

- changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component) as long as the risk component is separately identifiable and reliably measurable;
- one or more selected contractual cash flows; or
- components of a nominal amount, i.e. a specified part of the amount of an item.

A hedged item must be reliably measurable.

If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

Hedged item limitations

For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting entity can be designated as hedged items.

This means that hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities but not in the consolidated financial statements of the group.

However, the foreign currency risk of an intragroup monetary item (for example, a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. (See IAS 21: *The effects of changes in foreign exchange rates*).

Hedging instrument

The following instruments may be designated as a hedging instrument:

- A derivative measured at fair value through profit or loss (except for some written options);
- A non-derivative financial asset measured at fair value through profit or loss;
- A non-derivative financial liability measured at fair value through profit or loss (unless it is a financial liability designated as at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income).
- the foreign currency risk component of a non-derivative financial instrument may be designated as a hedge of foreign currency risk provided that the instrument is not an investment in an equity instrument for which an election has been made to present changes in fair value in other comprehensive income.

A qualifying instrument must be designated in its entirety as a hedging instrument. This means that all of the fair value change must be included in the hedge accounting model. The only exceptions permitted are that an entity is allowed to designate only:

- the change in intrinsic value of an option contract (and not the change in its time value);
- the change in the fair value of the spot element of a forward contract (and not the forward element) may be designated
- a proportion of the entire hedging instrument, such as 50 per cent of the nominal amount.

Hedging instrument limitations

Hedge accounting is only allowed for hedges involving derivatives external to the entity. A member of a group might take a derivative position with another member of the group in order to hedge a risk and (subject to meeting the hedge accounting criteria) it may use hedge accounting in its own financial statements. However, this hedge accounting is removed on consolidation because the derivative is not external to the group.

A hedging instrument may not be designated for a part of its change in fair value that results from only a portion of the time period during which the hedging instrument remains outstanding.

Hedge effectiveness

Definition

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.

IFRS 9 does not specify methods of measuring effectiveness but does require that it be measured on every reporting date (at least). Whatever method is used must be documented and in place before hedge accounting is allowed.

7.3 Qualifying criteria for hedge accounting

Hedge accounting provides special rules that allow the matching of the gain or loss on the derivatives position with the loss or gain on the hedged item. This reduces volatility in the statement of financial position and the statement of profit or loss, and so is very attractive to the preparers of accounts.

Hedge accounting can only be used where all of the following criteria are met:

- ❑ the hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- ❑ at the inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.
- ❑ The documentation must include:
  - identification of the hedging instrument,
  - identification of the hedged item,
  - the nature of the risk being hedged; and
  - how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements.
- ❑ the hedging relationship meets all of the following hedge effectiveness requirements:
  - there is an economic relationship between the hedged item and the hedging instrument;
  - the effect of credit risk does not dominate the value changes that result from that economic relationship; and
  - the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

Hedge accounting is allowed but not required. Where the conditions for using hedge accounting are met, the method of hedge accounting to be used depends on the type of hedge. IFRS 9 identifies three types of hedging relationship:

- ❑ fair value hedge
- ❑ cash flow hedge
- ❑ hedge of a net investment in a foreign entity (accounted for as a cash flow hedge).

7.4 Fair value hedge

A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss

For example:

- oil held in inventory could be hedged with an oil forward contract to hedge the exposure to a risk of a fall in oil sales prices; or
- the risk of a change in the fair value of a fixed rate debt owed by a company could be hedged using an interest rate swap.

Accounting treatment of fair value hedges

Accounting for a fair value hedge is as follows:

- The **gain or loss** on the hedging instrument (the derivative) is taken to profit or loss, as normal. (Note the exception to this that is explained below).
- The carrying amount of the hedged item is adjusted by the **loss or gain** on the hedged item attributable to the hedged risk with the other side of the entry recognised in profit or loss.

Example: Fair value hedge accounting

X Ltd holds an inventory of 100 barrels of oil at a cost of $70 a barrel.

30th September 20X1: Oil is trading at $100 a barrel. X Ltd decides to hedge the fair value of its oil inventory by entering into a 12m forward contract to sell the oil at $100 per barrel.

31st December 20X1: Oil is trading at $90 per barrel.

Assuming that the hedge has been properly documented the accounting treatment for this hedge (ignore time value) would be as follows:

Hedging instrument (gain)

The forward contract gives X Ltd the right to sell oil at $100 per barrel but it is only worth $90 per barrel. This represents a gain of $10 per barrel

Dr	Derivative asset (100 barrels @ $10)	$1,000	
	Cr P&L		$1,000

Hedged item (loss)

The fair value of oil has fallen by $10 per barrel. The carrying amount of the inventory is adjusted by this amount.

Dr	P&L	$1,000	
	Cr Inventory		$1,000

Note that the hedged item is not fair valued. Its carrying amount is adjusted by the change in its fair value.

Example (continued): Fair value hedge accounting

The following table summarises the above double entries. Credit entries are shown as figures in brackets

	Inventory	Derivative (asset)	P&L
30th September 20X1	10,000		
31st December 20X1:			
Fair value change			
Derivative		1,000	(1,000)
Inventory	(1,000)		1,000
	9,000	1,000	nil

Financial asset measured at fair value through other comprehensive income

A financial asset measured at fair value through other comprehensive income would (of course) normally result in the recognition of the full fair value change in OCI. If such an asset is a hedged item in a relationship that qualifies for fair value hedge accounting, that part of the value change due to the hedged risk is recognised in profit or loss.

Example: Financial asset measured at fair value through other comprehensive income

X Plc purchased a financial asset for ₦1,000,000.

This asset was classified as at fair value through OCI.

X Plc hedged this item with a derivative instrument.

At the reporting date

The financial asset had a fair value of ₦1,050,000. Only ₦40,000 of this value change related to the hedged risk.

The fair value of the hedging instrument was ₦40,000 liability.

Example: Financial asset measured at fair value through other comprehensive income

The double entries to account for the hedge if the hedge accounting criteria were not met are as follows:

a)	**Hedge accounting criteria not met**	**Debit**	**Credit**
	Financial asset	50,000	
	Other comprehensive income		50,000
	Being: Recognition of fair value gain on financial asset		
	Statement of profit or loss	40,000	
	Derivative		40,000
	Being: Recognition of fair value loss on derivative		

The double entries to account for the hedge if the hedge accounting criteria were not met are as follows:

b)	**Hedge accounting criteria met**	**Debit**	**Credit**
	Financial asset	50,000	
	Other comprehensive income		10,000
	Statement of profit or loss		40,000
	Being: Recognition of fair value gain on hedged financial asset		
	Statement of profit or loss	40,000	
	Derivative		40,000
	Being: Recognition of fair value loss on derivative		

This rule does not apply to equity instruments for which an election has been made for gains and losses to be recognised in OCI (see below).

Exception

IFRS 9 allows an entity to may make an irrevocable election at initial recognition for an investment in equity instruments that would otherwise be measured at fair value through profit or loss to be measured at fair value through other comprehensive income.

If such an asset is a hedged item the fair value hedge accounting rules are different and are as follows:

- The **gain or loss** on the hedging instrument (the derivative) is taken to OCI.
- The fair value difference on the hedged item (which would include that part attributable to the hedged risk) is recognised in OCI in the usual way.

Hedge of a firm commitment

Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted by the **loss or gain** on the hedged item attributable to the hedged risk.

Firm commitments are not recognised but may be hedged. For fair value hedges of firm commitments the gain or loss attributable to the hedged risk is recognised as an asset or liability in its own right.

A hedged item may be a firm commitment to acquire an asset (or to assume a liability). In such a case carrying amount of an asset (or liability) that results from the firm commitment being met is adjusted to include the cumulative change in the fair value of the hedged item recognised in the statement of financial position.

7.5 Cash flow hedge

A cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction, and could affect profit or loss

Hedges relating to future cash flows from interest payments or foreign exchange receipts are common cash flow hedges. For example:

- floating rate debt issued by a company might be hedged using an interest rate swap to manage increases in interest rates;
- future US dollar sales of airline seats by a Nigerian company might be hedged by a US$/₦ forward contracts to manage changes in exchange rates.

Accounting treatment of cash flow hedges

Accounting for a cash flow hedge is as follows:

- The change in the fair value of the hedging instrument is analysed into 'effective' and 'ineffective' elements.
- The 'effective' portion is recognised in other comprehensive income (and accumulated as a reserve in equity).
- The 'ineffective' portion is recognised in profit or loss.
- The amount recognised in other comprehensive income is subsequently released to the profit or loss as a reclassification adjustment in the same period as the hedged forecast cash flows affect profit or loss.

Example: Cash flow hedge

X SA is a French company

It expects to sell $1,000 of airline seats for cash in six months' time.

The current spot rate is €1 = $1.

It sells the future dollar receipts forward to fix the amount to be received in euros and to provide a hedge against the risk of a fall in the value of the dollar against the euro.

At inception (30 September 20X1)

At inception, the anticipated future sale is not recorded in the accounts, and the derivative (the forward contract) has an initial value of zero.

Reporting date (31 December 20X1)

The dollar has weakened with the following results:

a. The derivative is an asset with a fair value of €80.

b. The change in expected cash flows in euros from the forecast seat sales has fallen by €75 (€1,000 to €925).

Effectiveness:

The hedge is highly effective, because the change in the value of the forward contract (+ €80) closely matches the change in the value of the forecast sales receipts (– €75).

Accounting:

The gain on the derivative of €80 must be split into 'effective' and 'ineffective' elements.

The 'effective' gain is the amount of the gain that matches the fall in value in the hedged item. In this example, this is €75.

The 'ineffective' gain is the difference (€80 - €75 = €5).

The effective gain is recognised in other comprehensive income and accumulated in an equity reserve.

The ineffective element of €5 is reported as a gain in profit or loss for the period.

	Dr	Cr
Derivative	80	
Equity reserve		75
Profit or loss		5

Example (continued): Cash flow hedge.

31 March 20X2 (At settlement)

The forward contract is settled with a gain of €103. This is €23 more than expected at the last reporting date. The amount must be recognised with the effective element being taken to OCI and the ineffective element recognised in P&L.

The airline seats are sold, but the proceeds in euros are €905. This is €20 less than the €925 estimated at the last reporting date.

The further gain on the derivative must be split into effective and ineffective elements:

a. Effective = €20 (€ 925 – € 905, which is the loss on the euro receipts)

b. Ineffective = €3 (the balance, €23 – €20).

	Dr	Cr
Derivative	23	
Equity reserve		20
Profit or loss		3

Accounting on settlement

The income from the sales is €905.

The 'effective' gains on the derivative held in the equity reserve are released to profit or loss as a reclassification adjustment in other comprehensive income.

The release of the €95 to profit or loss means that the total income from the seat sales and the effective hedged gains is €1,000. This was the amount of income that was 'hedged' by the original forward contract.

Summary:

	Debit /(credit)			
	Cash	Derivative (asset)	OCI	Profit or loss
Previous period		80	(75)	(5)
Current period:				
Fair value change		23	(20)	(3)
Sale of seats	905			(905)
Reclassification adjustment			95	(95)
Settle forward contract	103	(103)		
	1,008	0	0	(1,008)

The statement of profit or loss includes €1,000 revenue that the company 'locked into' with the hedging position, plus the gain of €8 (€5 + €3) on the ineffective part of the hedge (= the speculative element of the derivative).

7.6 Cash flow hedge – Basis adjustment

A cash flow hedged transaction might be the future purchase of a non-financial asset.

Example: Cash flow hedge – Basis adjustment

X Ltd is a Nigerian company and has a December year end. Its functional currency is naira.

X Ltd forecasts the purchase of a machine from a US supplier and will be paid for in dollars (USD). The purchase is expected to occur on 1st January 20X3.

It is now 30th September 20X2. The cost of the machine is $15,000. The exchange rate is ₦350=$1 giving a cost to X Ltd of ₦5,250,000.

X Ltd hedges the exchange risk be entering into a forward contract for $15,000 @ ₦350=$1. This is designated as a cash flow hedge and accounted for accordingly.

1st January 20X3

X Ltd buys the machine for $15,000. The exchange rate is ₦370=$1 giving a cost to X Ltd of ₦5,550,000.

A gain on the forward contract of ₦300,000 has been recognised through OCI by this date and this has been accumulated as a credit balance in the cash flow hedge reserve in equity.

This must be released to profit as the hedged transaction impacts the profit and loss account. The hedged transaction impacts the profit and loss account as the asset is depreciated.

IFRS 9 says that if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability (or a hedged forecast transaction for a non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied), the amount held in the cash flow hedge reserve is included directly in the initial cost of the asset or the liability. This is not a reclassification adjustment (see IAS 1) and hence it does not affect other comprehensive income. This is known as a basis adjustment.

The double entry to achieve this is as follows:

		Debit /(credit)	
	Machine	**Equity reserve (via OCI)**	**Profit or loss (P&L)**
1 January 20X3	5,550,000	(300,000)	
Basis adjustment	(300,000)	300,000	
Carrying amount on initial recognition	5,250,000	nil	
31 December 20X3: Depreciation (say 10 years)	(525,000)		525,000
Charge for the year			525,000
Balance carried forward	4,725,000	nil	

A basis adjustment is required for hedges of non-financial assets and liabilities but is not allowed for hedges of financial assets and liabilities.

7.7 Hedges of a net investment in a foreign operation

The net assets of the foreign subsidiary are translated at the end of each financial year, and any foreign exchange differences are recognised in other comprehensive income (until the foreign subsidiary is disposed of, when the cumulative profit or loss is then reclassified from 'equity' to profit or loss).

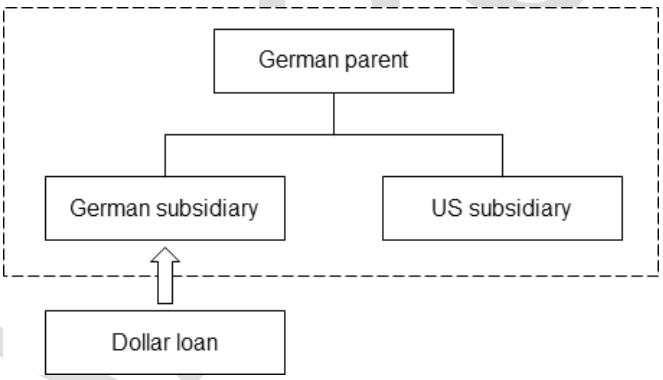
IFRS 9 allows hedge accounting for an investment in a foreign subsidiary. An entity may designate an eligible hedging instrument for a net investment in a foreign subsidiary, provided that the hedging instrument is equal to or less than the value of the net assets in the foreign subsidiary.

For example, suppose that a German company has a US subsidiary and a German subsidiary, and the German subsidiary has a US dollar loan as a liability. If the German parent chooses to use hedge accounting, the US dollar loan in its German subsidiary can be accounted for as a hedge for the parent company's net investment in the US subsidiary, provided that the size of the dollar loan is not larger than the net investment in the US subsidiary.

Illustration: Hedges of a net investment in a foreign operation

A German company has a US subsidiary and a German subsidiary.

The German subsidiary has a US dollar loan as a liability.



If the German parent chooses to use hedge accounting, the US dollar loan in its German subsidiary can be accounted for as a hedge for the parent company's net investment in the US subsidiary, provided that the size of the dollar loan is not larger than the net investment in the US subsidiary.

In the absence of hedge accounting

Any gain or loss arising on the translation of the currency loan is reported in profit or loss for the German subsidiary, and hence in the consolidated profit or loss for the group.

Any exchange gain or loss arising from the net investment in the US subsidiary would be reported in other comprehensive income.

With hedge accounting

Any gain or loss arising on the translation of the currency loan is recognised in other comprehensive income and included within the foreign exchange differences arising on translation.

The gain or loss on the hedge offsets the loss or gain on the translation of the net assets of the subsidiary.

IFRIC 16

IFRIC 16 provides the following clarifications about the rules on hedging a net investment in a foreign currency:

- Hedge accounting may be applied only to foreign exchange differences arising between the functional currency of the foreign subsidiary and the functional currency of the parent company, not the presentational currency of the parent (if this is different).
- The hedging instrument may be held within any entity in the group provided that the conditions for hedge accounting are met in terms of the designation, documentation and effectiveness of hedging requirements of IFRS 9.
- When a foreign subsidiary is disposed of and hedge accounting has been used, the amount reclassified from the foreign translation reserve ('equity') to profit or loss should be the cumulative gain or loss on the hedging instrument.

8 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain and apply the rules on recognition of financial instruments
- Explain rules on derecognition of financial assets and apply them to simple examples
- Explain and apply the rules on the classification of financial assets on initial recognition and how this affects the subsequent measurement of those assets
- Account for reclassifications of financial assets
- Explain and apply rules on impairment of financial assets
- Explain and apply the accounting treatment for financial liabilities
- Explain and Identify transactions which might contain an embedded derivative
- Explain and apply hedge accounting

CHAPTER 18

Financial instruments: Presentation and disclosure

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		a	Evaluate how different bases of measurement and recognition of assets and liabilities affect reported financial performance.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.
	4	Financial assets and liabilities	
		a	Determine and assess how different bases for recognition, measurement and classification of financial assets and financial liabilities impact on reported performance and position.
		b	Appraise the accounting treatment of financial instruments (IFRS 7 and IFRS 9); Borrowing Costs – IAS 23; Government Grants and Disclosure of Government Assistance – IAS 20; including impairment and hedge accounting under IFRS 9 for financial assets and liabilities.

IAS 32 and IFRS 7 are examinable documents.

These standards were examinable in a previous paper. They are covered here again in detail for your convenience.

Exam context

This chapter explains the basic rules on presentation and disclosure of financial instruments.

At the end of this chapter, you should be able to:

- Distinguish between debt and equity;
- Apply split accounting in the books of the issue on the initial recognition of a convertible bond; and
- Explain the IFRS 7 disclosures in respect of financial instruments in overview.

1 IAS 32: PRESENTATION

Section overview

- Liability or equity?
- Preference shares: debt or equity?
- Compound instruments
- Transactions in own equity
- Offsetting
- Distributable profit

1.1 Liability or equity?

Financial instruments issued by a company must be classified as either liabilities or equity. This classification should be based on the substance of the contract, rather than the legal form.

A financial liability is any liability where the issuer has a contractual obligation:

- To deliver cash or another financial asset to another entity, or
- To exchange financial instruments with another entity on potentially unfavourable terms.

The owner of an equity instrument is entitled to receive a dividend, but the company does not have a contractual obligation to make the payment. So equity does not meet the above definition of a financial liability.

An equity instrument is defined as any contract that offers the residual interest in the assets of the company after deducting all of the liabilities.

Returns on financial instruments

Returns on financial instruments are reported differently, depending on whether the instrument is a liability or equity. The classification of the financial instrument determines the treatment of the interest, dividends, gains and losses.

- Interest expense, dividend payments, gains and losses relating to a financial liability are recognised in the statement of profit or loss.
- Distributions to equity holders are debited to equity and shown in the statement of changes in equity.

1.2 Preference shares: debt or equity?

Preference shares are shares that are entitled to a payment of their dividend, usually a fixed amount each year, before the ordinary shareholders can be paid any dividend or that rank ahead of ordinary shares for any distribution of net assets in the event of a winding up of the company.

Preference shares include the following types:

- Redeemable preference shares are those that the entity has an obligation to buy back (or the right to buy back) at a future date.
- Irredeemable (perpetual) preference shares are those that will not be bought back at any time in the future.

- convertible preference shares are those that are convertible at a future date into another financial instrument, usually into ordinary equity shares of the entity.

Classification of preference shares

Depending on their characteristics, preference shares issued by a company might be classified as:

- equity; or
- a financial liability of the company; or
- a compound financial instrument containing elements of both financial liability and equity.

IAS 32 states (in a guidance note) that the key factor for classifying preference shares is the extent to which the entity is obliged to make future payments to the preference shareholders.

- Redeemable preference shares.
  - Redemption is mandatory: Since the issuing entity will be required to redeem the shares, there is an obligation. The shares are a financial liability.
  - Redemption at the choice of the holder: Since the issuing entity does not have an unconditional right to avoid delivering cash or another financial asset there is an obligation. The shares are a financial liability.
  - Redemption at the choice of the issuer: The issuing entity has an unconditional right to avoid delivering cash or another financial asset there is no obligation. The shares are equity.
- Irredeemable non-cumulative preference shares should be treated as equity, because the entity has no obligation to the shareholders that the shareholders have any right to enforce.

1.3 Compound instruments

A compound instrument is a financial instrument, issued by a company that cannot be classified as simply a liability or as equity, because it contains elements of both debt and equity. An example of a compound instrument is a convertible bond. The company issues a bond that can be converted into equity in the future or redeemed for cash. Initially, it is a liability, but it has a call option on the company's equity embedded within it.

Typically, a convertible bond pays a rate of interest that is lower than the market rate for a non-convertible bond (a 'straight bond') with the same risk profile. This is because the terms of the conversion normally allow the bondholder to convert the bond into shares at a rate that is lower than the market price.

Split accounting for compound instruments

On initial recognition of compound instrument, the credit entry for the financial instrument must be split into the two component parts, equity and liability.

When convertible bonds are issued they are shown in the statement of financial position partly as debt finance and partly as equity finance. The question is how to determine the amount of the issue price that is debt and the amount that is equity.

The method to use is to calculate the equity element as the residual after determining the present value of the debt element:

- The present value of the interest payments and the redemption value of the convertible is found using a market interest rate for similar debt finance which is not convertible (normally a higher interest rate as there is no conversion element).
- Compare this present value to the proceeds of the bond issue to find the residual equity element.
- Any transaction costs incurred by issuing the instrument should be allocated to each component, the liability and equity, according to the split in value above.

Comment on the measurement of the debt element

The process starts by deriving a fair value for the liability, on the assumption that the bond has no conversion rights, and is a 'straight' fixed rate bond that will be redeemed at par at maturity.

If the company had sold a bond with identical features but with no conversion rights, how much could it have been sold for? To answer this question, it is necessary to recognise that the fair value of a bond is simply the present value of the future cash flows that the bond will generate, discounted at the market rate of interest, which in the following example is 8%.

Example: Convertible bond

A company issues ₦10 million of 6% convertible bonds at par on 1 January 20X1.

The bonds are redeemable at par after four years or can be converted at any time up to that date into shares with a nominal value of ₦2,000,000.

The market rate of interest for similar debt which is not convertible is 8%.

The bonds should be recorded in the statement of financial position at the date of issue as follows:

Step 1: Measure the liability component first by discounting the interest payments and the amount that would be paid on redemption (if not converted) at the prevailing market interest rate of 8%.

31 December	Cash flow	DF (8%)	₦
20X1 to 20X4			
Interest: 10,000,000 × 6%	600,000	3.312	1,987,200
20X4:			
Repayment of principle	10,000,000	0.735	7,350,000
Value of debt element			9,337,200

Step 2: Compare the value of the debt element to the cash raised. The difference is the equity element.

Total proceeds	10,000,000
Value of equity element (residual)	662,800

The initial double entry to recognise the bond would be as follows:

	Dr	Cr
Cash	10,000,000	
Liability		9,337,200
Equity		662,800

The liability component is measured at amortised cost in the usual way at each subsequent reporting date.

Example (continued): Subsequent measurement of the debt element of the convertible bond

	Amortised cost at start of the year	Interest at effective rate (8%)	Cash flow (interest actually paid at 6%)	Amortised cost at year end
20X1	9,337,200	746,976	(600,000)	9,484,176
20X2	9,484,176	758,734	(600,000)	9,642,910
20X3	9,642,910	771,433	(600,000)	9,814,343
20X4	9,814,343	785,557	(600,000)	10,000,000

Note that the final interest expense of ₦785,557 includes a rounding adjustment of ₦510).

There is no guidance on the subsequent accounting treatment of the equity element. One approach would be to retain it as a separate component of equity and then release it to retained earnings when the bond is paid or converted.

Example (continued): Double entry on repayment or conversion of the bond.

At 31 December 20X4 the bond will either be paid or converted. Possible double entries in each case are as follows:

If the bond is repaid

	Dr	Cr
Liability	10,000,000	
Cash		10,000,000
and:		
Equity component	662,800	
Retained earnings		662,800

If the bond is converted:

	Dr	Cr
Liability	10,000,000	
Share capital		2,000,000
Share premium		8,000,000
and:		
Equity component	662,800	
Retained earnings		662,800

Practice question **1**

A company issued a convertible bond for ₦2,000,000 on 1 January 20X5.

The bond is to be redeemed on 31 December 20X7 (3 years after issue). The bond holders can take cash or shares with a nominal value of ₦1,200,000 on this date.

The bond pays interest at 5% but the market rate of interest for similar risk bonds without the conversion feature was 9% at the date of issue.

a) Calculate the liability and equity components of the bond on initial recognition.
b) Construct the necessary journal on initial recognition.
c) Construct an amortisation table to show how the liability component would be measured over the life of the bond.
d) Construct the journal to reflect the possible conversion of the bonds to shares on 31 December 20X7.

1.4 Transactions in own equity

A company may reacquire its own shares. Such shares are called ***treasury shares***. '. The company might then hold on to the shares until it uses them for a particular purpose, such as awarding shares to employees in a share grant scheme. The accounting treatment of treasury shares is that they should be deducted from equity.

Any gain or loss on transactions involving treasury shares is recognised directly in equity, and should not be reported in the statement of profit or loss and other comprehensive income.

IAS 32 requires that the amount of treasury shares held should be disclosed separately, either:

- on the face of the statement of financial position as a deduction from share capital, or
- offset against share capital and disclosed in the notes to the accounts.

1.5 Offsetting

Offsetting an asset and a liability and presenting a net amount on the face of the statement of financial position can result in a loss of information to the users. IAS 1 prohibits offset unless required or permitted by an IFRS.

The idea is that offset should only be allowed if it reflects the substance of the transactions or balances.

IAS 32 adds more detail to this guidance in respect of offsetting financial assets and liabilities.

IAS 32 requires the presentation of financial assets and financial liabilities in a way that reflects the company's future cash flows from collecting the cash from the asset and paying the cash on the liability. It limits a company's ability to offset a financial asset and a financial liability to those instances when the cash flows will occur at the same time.

The IAS 32 rule is that a financial asset and a financial liability must be offset and shown net in the statement of financial position when and only when an entity:

- Currently has a legal right to set off the amounts; and
- Intends either to settle the amounts net, or to realise (sell) the asset and settle the liability simultaneously.

In order for a legal right of set off to be current it must not be contingent on a future event. Furthermore it must be legally enforceable in all of the following circumstances:

- The normal course of business;
- The event of default;
- The event of insolvency or bankruptcy of the entity and all of the counterparties

Note: The existence of a legal right to set off a cash balance in one account with an overdraft in another is insufficient for offsetting to be allowed. The company must additionally show **intent** to settle the balances net, and this is likely to be rare in practice. Consequently, cash balances in the bank and bank overdrafts are usually reported separately in the statement of financial position, and not 'netted off' against each other.

Many companies adopting IFRS for the first time find that they have net amounts in the statement of financial position under their old GAAP that have to be shown as a separate financial asset and financial liability under IFRS. The net position is described as being "grossed up".

1.6 Distributable profit

Rules are set out in CAMA 1994 (as amended), paragraphs 379 to 386.

Dividends are declared, in respect of a period, in a general meeting on the recommendation of the directors.

- A company may is allowed to pay interim dividends;
- The general meeting can decrease but not increase the amount of dividend recommended by the directors.

Dividends are payable only out of the distributable profits of the company.

These are:

- profits arising from the use of the company's property although it is a wasting asset;
- revenue reserves;
- realised profit on a fixed asset sold, but where more than one asset is sold, the net realised profit on the assets sold.

A company must not declare or pay dividend if there are reasonable grounds for believing that the company is or would be unable to pay its liabilities as they become due after the payment.

A dividend cannot be paid out of the share premium account or capital redemption reserve though these can be used to fund bonus issues.

Dividends are paid by individual entities. When a group announces that it is paying a dividend it is actually the parent company that is making the payment.

Example: Group distributions

P acquired 80% of S on 1 January 20X1 for ₦230,000.

The retained profits of S were ₦100,000 at that date and are ₦300,000 at the current year end.

P has retained profits of ₦400,000 at the current year end.

The consolidated retained profits are as follows:

Consolidated retained profits:	**₦**
All of P's retained profits	400,000
P's share of the post-acquisition retained profits of S (80% of (300,000 – 100,000))	160,000
	560,000

The maximum distribution that can be made by the group (i.e. as a dividend paid to P's shareholders) is ₦400,000.

The share of post-acquisition retained profits of S are contained in a separate legal entity and are not available for distribution by the parent.

If S were to pay a dividend, 80% would pass to P and hence become available for P to pay out to its owners. (The remaining 20% would be owned by the NCI).

2 IFRS 7: Disclosure

Section overview

- Objectives of IFRS 7
- Statement of financial position disclosures
- Statement of profit or loss disclosures
- Risk disclosures

2.1 Objectives of IFRS 7

All companies are exposed to various types of financial risk. Some risks are obvious from looking at the statement of financial position. For example, a loan requiring repayment in the next year is reported as a current liability, and users of the financial statements can assess the risk that the company will be unable to repay the loan.

However, there are often many other risks that a company faces that are not apparent from the financial statements. For example if a significant volume of a company's sales are made overseas, there is exposure to the risk of exchange rate movements.

Example:

A UK company has an investment of units purchased in a German company's floating rate silver-linked bond. The bond pays interest on the capital, and part of the interest payment represents bonus interest linked to movements in the price of silver.

There are several financial risks that this company faces with respect to this investment.

It is a floating rate bond. So if market interest rates for bonds decrease, the interest income from the bonds will fall.

Interest is paid in euros. For a UK company there is a foreign exchange risk associated with changes in the value of the euro. If the euro falls in value against the British pound, the value of the income to a UK investor will fall.

A bonus is linked to movements in the price of silver. So there is exposure to changes in the price of silver.

There is default risk. The German company may default on payments of interest or on repayment of the principal when the bond reaches its redemption date.

IFRS 7 requires that an entity should disclose information that enables users of the financial statements to 'evaluate the significance of financial instruments' for the entity's financial position and financial performance.

There are two main parts to IFRS 7:

A section on the disclosure of 'the significance of financial instruments' for the entity's financial position and financial performance

A section on disclosures of the nature and extent of risks arising from financial instruments.

2.2 Statement of financial position disclosures

The carrying amounts of financial instruments must be shown, either in the statement of financial position or in a note to the financial statements, for each class of financial instrument:

- financial assets at fair value through profit or loss;
- financial assets at amortised cost;
- financial assets at fair value through other comprehensive income;
- financial liabilities at fair value through profit or loss; and
- financial liabilities measured at amortised cost.

Other disclosures relating to the statement of financial position are also required. These include the following:

- **Collateral**. A note should disclose the amount of financial assets that the entity has pledged as collateral for liabilities or contingent liabilities.
- **Allowance account for credit losses**. When financial assets (such as trade receivables) are impaired by credit losses and the impairment is recorded in a separate account (such as an allowance account for irrecoverable trade receivables), the entity should provide a reconciliation of changes in the account during the period, for each class of financial assets.
- **Defaults and breaches**. For loans **payable**, the entity should disclose details of any defaults during the period in the loan payments, or any other breaches in the loan conditions.

With some exceptions, for each class of financial asset and financial liability, an entity must disclose the fair value of the assets or liabilities in a way that permits the fair value to be compared with the carrying amount for that class. An important exception is where the carrying amount is a reasonable approximation of fair value, which should normally be the case for short-term receivables and payables.

2.3 Statement of profit or loss disclosures

An entity must disclose the following items either in the statement of profit or loss or in notes to the financial statements:

- Net gains or losses on financial assets or financial liabilities at fair value through profit or loss.
- Net gains or losses on financial liabilities measured at amortised cost.
- Net gains or losses on financial assets at fair value through other comprehensive income.
- Net gains or losses on investments in equity instruments designated at fair value through other comprehensive income.
- Total interest income and total interest expense, calculated using the effective interest method, for financial assets or liabilities that are not at fair value through profit or loss.
- Fee income and expenses arising from financial assets or liabilities that are not at fair value through profit or loss.
- The amount of any impairment loss for each class of financial asset.

Other disclosures

IFRS 7 also requires other disclosures. These include the following:

- Information relating to **hedge accounting**, for cash flow hedges, fair value hedges and hedges of net investments in foreign operations. The disclosures should include a description of each type of hedge, a description of the financial instruments designated as hedging instruments and their fair values at the reporting date, and the nature of the risks being hedged.
- With some exceptions, for each class of financial asset and financial liability, an entity must disclose the fair value of the assets or liabilities in a way that permits the fair value to be compared with the carrying amount for that class. An important exception is where the carrying amount is a reasonable approximation of fair value, which should normally be the case for short-term receivables and payables.

2.4 Risk disclosures

IFRS 7 also requires that an entity should disclose information that enables users of its financial statements to evaluate the nature and extent of the risks arising from its financial instruments.

These risks typically include, but are not restricted to:

- Credit risk
- Liquidity risk, and
- Market risk.

For each category of risk, the entity should provide both quantitative and qualitative information about the risks.

- **Qualitative disclosures**. For each type of risk, there should be disclosures of the exposures to risk and how they arise; and the objectives policies and processes for managing the risk and the methods used to measure the risk.
- **Quantitative disclosures**. For each type of risk, the entity should also disclose summary quantitative data about its exposures at the end of the reporting period. This disclosure should be based on information presented to the entity's senior management, such as the board of directors or chief executive officer.

Credit risk

Credit risk is the risk that someone who owes money (a trade receivable, a borrower, a bond issuer, and so on) will not pay. An entity is required to disclose the following information about credit risk exposures:

- A best estimate of the entity's maximum exposure to credit risk at the end of the reporting period and a description of any collateral held.
- For each class of financial assets, a disclosure of assets where payment is 'past due' or the asset has been impaired.

Liquidity risk

Liquidity risk is the risk that the entity will not have access to sufficient cash to meet its payment obligations when these are due. IFRS 7 requires disclosure of:

- A maturity analysis for financial liabilities, showing when the contractual liabilities fall due for payment
- A description of how the entity manages the liquidity risk that arises from this maturity profile of payments.

Market risk

Market risk is the risk of losses that might occur from changes in the value of financial instruments due to changes in:

- Exchange rates,
- Interest rates, or
- Market prices.

An entity should provide a sensitivity analysis for each type of market risk to which it is exposed at the end of the reporting period. The sensitivity analysis should show how profit or loss would have been affected by a change in the market risk variable (interest rate, exchange rate, market price of an item) that might have been reasonably possible at that date.

Alternatively, an entity can provide sensitivity analysis in a different form, where it uses a different model for analysis of sensitivity, such as a value at risk (VaR) model. These models are commonly used by banks.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Distinguish between debt and equity
- Apply split accounting in the books of the issue on the initial recognition of a convertible bond
- Explain the IFRS 7 disclosures in respect of financial instruments in overview

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

a) Split of liability and equity on initial recognition

31st December	Cash (₦)	Discount factor 9%	Present value (₦)
20X5 - interest	100,000	0.9174	91,743
20X6 - interest	100,000	0.8417	84,168
20X7 - interest	100,000	0.7722	77,218
20X7 - principal	2,000,000	0.7722	1,544,367
Fair value of bond			1,797,496
Value of equity (balance)			202,504
Proceeds from issue of bond			2,000,000

b) Journal on initial recognition

	Dr (₦)	Cr (₦)
Cash	2,000,000	
Liability		1,797,496
Equity		202,504

c) Amortisation table

	Liability at start of year	Finance charge at 9%	Interest paid	Liability at end of year
	₦	₦	₦	₦
20X5	1,797,496	161,775	(100,000)	1,859,271
20X6	1,859,271	167,334	(100,000)	1,926,605
20X7	1,926,605	173,395	(100,000)	2,000,000

d) Journal on conversion to shares

	₦	₦
Bond	2,000,000	
Equity - option proceeds	202,504	
Share capital		1,200,000
Share premium		1,002,504

Professional level
Corporate Reporting

CHAPTER 19

Sundry standards

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders			
	1	Performance reporting		
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.	

IAS 26, IAS 41, IFRS 6, IFRS 14, the IFRS for SMEs and SAS 32 are examinable documents.

Exam context

This chapter provides an overview of each of the above standards.

At the end of this chapter, you should be able to:

- Explain the main requirements of IAS 26
- Explain the main requirements of IAS 41
- Explain the main requirements of IFRS 6
- Explain the main requirements of IFRS 14
- Describe, in overview, the IFRS for SMEs
- Describe and explain the main requirements of SAS 32: On accounting for not-for-profit organisations

1 IAS 26: RETIREMENT BENEFIT PLANS

Section overview

- Scope
- Definitions
- Valuation of plan assets
- Defined contribution plans
- Defined benefit plans
- Disclosure

1.1 Scope

IAS 26 complements IAS 19, Employee Benefits which is concerned with the determination of the cost of retirement benefits in the financial statements of employers.

IAS 26 applies to the reports of retirement benefit plans whether they are:

- ❑ defined contribution plans; or
- ❑ defined benefit plans; and
- ❑ regardless of:
  - whether a fund has a separate legal identity; or
  - whether there are trustees.

All other IFRS apply to the reports of retirement benefit plans to the extent that they are not superseded by IAS 26.

Insured benefits

Retirement benefit plans with assets invested with insurance companies are within the scope of IAS 26 unless the contract with the insurance company is in the name of a specified participant or a group of participants and the retirement benefit obligation is solely the responsibility of the insurance company.

Outside scope

IAS 26 does not deal with other forms of employment benefits such as employment termination indemnities, deferred compensation arrangements, long-service leave benefits, special early retirement or redundancy plans, health and welfare plans or bonus plans.

Government social security type arrangements are also excluded from the scope of IAS 26.

1.2 Definitions

Definition

Retirement benefit plans are arrangements whereby an entity provides benefits for its employees on or after termination of service (either in the form of an annual income or as a lump sum) when such benefits, or the employer's contributions towards them, can be determined or estimated in advance of retirement from the provisions of a document or from the entity's practices.

A retirement benefit plan is a reporting entity separate from the employers of the participants in the plan.

Retirement benefit plans are known by a variety of names, for example, pension schemes, superannuation schemes; or retirement benefit schemes'.

Definitions

Defined contribution plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by contributions to a fund together with investment earnings thereon.

Defined benefit plans are retirement benefit plans under which amounts to be paid as retirement benefits are determined by reference to a formula usually based on employees' earnings and/or years of service.

Funding is the transfer of assets to an entity (the fund) separate from the employer's entity to meet future obligations for the payment of retirement benefits.

Participants are the members of a retirement benefit plan and others who are entitled to benefits under the plan.

Net assets available for benefits are the assets of a plan less liabilities other than the actuarial present value of promised retirement benefits.

Actuarial present value of promised retirement benefits is the present value of the expected payments by a retirement benefit plan to existing and past employees, attributable to the service already rendered.

Vested benefits are benefits, the rights to which, under the conditions of a retirement benefit plan, are not conditional on continued employment.

1.3 Valuation of plan assets

Retirement benefit plan investments are carried at fair value.

The fair value of marketable securities is market value.

Where an estimate of fair value is not possible for plan asset the reason why this is the case must be disclosed.

Securities that have a fixed redemption value and that have been acquired to match the obligations of the plan may be carried at amounts based on their ultimate redemption value assuming a constant rate of return to maturity.

1.4 Defined Contribution Plans

Objective of report

The reporting objective is to provide information about the plan and the performance of its investments.

- The participants are interested in
  - the activities of the plan because they directly affect the level of future benefits; and
  - knowing whether contributions have been received and proper control has been exercised to protect the rights of beneficiaries.
- An employer is interested in the efficient and fair operation of the plan.

The reporting objective is usually achieved by providing a report including:

- a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
- statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period; and
- a description of the investment policies.

Requirement

The report of a defined contribution plan must contain:

- a statement of net assets available for benefits; and
- a description of the funding policy.

1.5 Defined Benefit Plans

Objective of report

The reporting objective is to provide information about the financial resources and activities of the plan that is useful in assessing the relationships between the accumulation of resources and plan benefits over time.

This is usually achieved by providing a report including the following:

- a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions;
- statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period;
- actuarial information either as part of the statements or by way of a separate report; and
- a description of the investment policies.

Requirement

The report must contain either:

- ❑ a statement that shows:
  - the net assets available for benefits;
  - the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; and
  - the resulting excess or deficit; or
- ❑ a statement of net assets available for benefits including either:
  - a note disclosing the actuarial present value of promised retirement benefits, distinguishing between vested benefits and non-vested benefits; or
  - a reference to this information in an accompanying actuarial report.

The report should explain:

- ❑ the relationship between the actuarial present value of promised retirement benefits; and the net assets available for benefits; and
- ❑ the policy for the funding of promised benefits.

If an actuarial valuation has not been prepared at the date of the report, the most recent valuation is used as a base and the date of the valuation disclosed.

Actuarial Present Value of Promised Retirement Benefits

The actuarial present value of promised retirement benefits is based on the benefits promised under the terms of the plan on service rendered to date using either:

- ❑ current salary levels; or
- ❑ projected salary levels

1.6 Disclosure

Specific requirement

The report of a retirement benefit plan (defined benefit or defined contribution) must contain the following information:

- ❑ a statement of changes in net assets available for benefits;
- ❑ a summary of significant accounting policies; and
- ❑ a description of the plan and the effect of any changes in the plan during the period.

Guidance

Reports provided by retirement benefit plans include the following, if applicable:

- ❑ a statement of net assets available for benefits disclosing:
  - assets at the end of the period suitably classified;
  - the basis of valuation of assets;
  - details of any single investment exceeding either 5% of the net assets available for benefits or 5% of any class or type of security;
  - details of any investment in the employer; and
  - liabilities other than the actuarial present value of promised retirement benefits;
- ❑ a statement of changes in net assets available for benefits showing the following:
  - employer contributions;
  - employee contributions;
  - investment income such as interest and dividends;
  - other income;
  - benefits paid or payable (analysed, for example, as retirement, death and disability benefits, and lump sum payments);
  - administrative expenses;
  - other expenses;
  - taxes on income;
  - profits and losses on disposal of investments and changes in value of investments; and
  - transfers from and to other plans;
- ❑ a description of the funding policy;

For defined benefit plans:

- ❑ the actuarial present value of promised retirement benefits (which may distinguish between vested benefits and non-vested benefits) based on the benefits promised under the terms of the plan on service rendered to date using either:
  - current salary levels; or
  - projected salary levels;
- ❑ a description of the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits.

This information may be included in an accompanying actuarial report to be read in conjunction with the related financial information.

Description of the plan

A description of the plan must be provided either as part of the financial information or in a separate report.

It may contain the following:

- the names of the employers and the employee groups covered;
- the number of participants receiving benefits and the number of other participants, classified as appropriate;
- the type of plan - defined contribution or defined benefit;
- a note as to whether participants contribute to the plan;
- a description of the retirement benefits promised to participants;
- a description of any plan termination terms; and
- changes in any of the above during the period covered by the report.

It is not uncommon to refer to other documents that are readily available to users and in which the plan is described, and to include only information on subsequent changes in the report.

2 IAS 41: AGRICULTURE

Section overview

- Scope and definitions
- Accounting treatment
- Government grants

2.1 Scope and definitions

Scope

IAS 41 *Agriculture* covers the following **agricultural activities**:

- ❑ biological assets, except for bearer plants;
- ❑ agricultural produce at the point of harvest; and
- ❑ government grants for agriculture (in certain situations).

IAS 41 does not apply to:

- ❑ the harvested agricultural product (IAS 2 *Inventory* applies);
- ❑ land relating to the agricultural activity (IAS 16 or IAS 40 applies);
- ❑ bearer plants related to agricultural activity (however, IAS 41 does apply to the produce on those bearer plants).
- ❑ intangible assets related to agricultural activity (IAS 38 *Intangible assets* applies).

Definitions

The following definitions are relevant to IAS 41:

Definitions

Agricultural activities – the management by an entity of the biological transformation of biological assets

a. for sale, or

b. into agricultural produce, or

c. into additional biological assets.

Biological asset – a living animal or plant, such as sheep, cows, rice, wheat, potatoes and so on.

Biological transformation means the processes of growth, production, degeneration and procreation that cause changes in the quality or the quantity of a biological asset

Agricultural produce is the harvested product of the entity's biological assets.

Harvest – the detachment of produce from a biological asset or the cessation of a biological asset's life.

Illustration: Definitions

A farmer has a field of lambs ('**biological** assets').

As the lambs grow they go through **biological transformation**.

As sheep they are able to procreate and lambs will be born (**additional biological assets**) and the wool from the sheep provides a source of revenue for the farmer ('**agricultural produce').**

Once the wool has been sheared from the sheep ('**harvested**'), IAS 2 requires that it be accounted for as regular inventory.

Definitions

A **bearer plant** is a living plant that:

a. is used in the production or supply of agricultural produce;

b. is expected to bear produce for more than one period; and

c. has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

Illustration: Definitions (further examples)

Biological assets	Agricultural produce	Products that result from processiong after harvest
sheep	wool	yarn, carpet etc.
trees in a timber plantation	felled trees	logs, lumber
dairy cattle	milk	cheese
cotton plants	harvested cotton	thread, clothing etc.
sugarcane	harvested cane	sugar
tobacco plants	picked leaves	cured tobacco
tea bushes	picked leaves	tea
fruit tress	picked fruit	processed fruit
oil palm	picked fruit	palm oil
rubber trees	harvested latex	rubber products

Plants such as tea bushes, grape vines, oil palms and rubber trees, usually meet the definition of a bearer plant and are within the scope of IAS 16 *Property, Plant and equipment*. However, the produce growing on bearer plants, for example, tea leaves, grapes, oil palm fruit and latex, is within the scope of IAS 41.

Note that there is no "animal" equivalent of a bearer plant. Thus, cows kept for milk are within the scope of IAS 41.

2.2 Accounting treatment

Recognition of a biological asset or agricultural produce

An entity should recognise a biological asset or agricultural produce when (and only when):

- the entity controls the asset as a result of past events
- it is probable that future benefits will flow from the asset to the entity, and
- the fair value or cost of the asset can be measured reliably.

Measurement

- A **biological asset** should be measured initially and subsequently at the end of each reporting period at its **fair value minus ultimate selling costs** (unless the fair value cannot be measured reliably). The gain or loss arising on initial recognition and subsequent revaluation should be included in profit or loss for the period in which it arises.
- **Agricultural produce** harvested from an entity's biological assets is measured at its **fair value minus estimated ultimate selling costs**. The gain or loss on initial recognition is included in the profit or loss for that period. Ultimate selling costs include commissions to brokers and dealers, levies to regulators, transfer taxes and duties.
- Fair value is the quoted price in an active market. It is presumed that fair values can be measured reliably for biological assets. If this is not so, the biological asset should be measured at its cost minus any accumulated depreciation or impairment.

Example: Accounting treatment

Using the earlier example of a sheep farmer, lambs should initially be measured when they are born at their fair value minus costs to sell.

As they grow and their value changes, this gain or loss should be reflected in the biological asset value and also in profit and loss.

The sheep may be used for obtaining wool. Once the wool has been sheared from the sheep, as an agricultural produce the wool should be valued at fair value minus costs to sell.

If the wool is then turned into yarn or carpet its value is then transferred to inventory and IAS 2 will provide any further accounting rules.

2.3 Government grants

Agricultural entities (for example, farms) often benefit from government grants in the form of cash payments. An unconditional grant relating to a biological asset that is being measured at fair value should be recognised as income when the grant becomes receivable.

A grant may be dependent on certain conditions being met. For example, the entity may be asked not to engage in a specific agricultural activity. In such cases, the grant should be recognised only when the conditions are met.

If the biological asset has been measured at cost because fair value could not be measured reliably, then the requirements of IAS 20 *Accounting for government grants* should be applied.

3 IFRS 6: EXPLORATION FOR AND EVALUATION OF MINERAL RESOURCES

Section overview

- Background
- Selection of accounting policies
- Initial recognition and measurement
- Subsequent measurement
- Presentation
- Impairment
- Disclosure

3.1 Background

The group accounts of listed entities in the EU had to be prepared according to IFRS for all accounting periods beginning on or after 1 January 2005. This regulation applied to some very large insurance companies in the EU.

In the run up to conversion, it was noted that there was no IFRS that dealt with this area, but there were significant entities which engaged in such activities.

There were different views held globally on the accounting solution and this led to a number of different accounting treatments.

IFRS 6

IFRS 6 specifies the Financial Reporting for the exploration for and evaluation of mineral resources. IFRS 6 applies to expenditure incurred on exploration for and evaluation of mineral resources but not to those expenditures incurred:

- before the exploration for and evaluation of mineral resources (e.g. expenditures incurred before the entity has obtained the legal rights to explore a specific area); or
- after the technical feasibility and commercial viability of extraction are demonstrable.

Definitions

Exploration and evaluation assets are exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy.

Exploration and evaluation expenditures are expenditures incurred by an entity in connection with the expenditures for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

3.2 Selection of accounting policies

IAS 8 sets out criteria which must be applied by a company when needs to develop an accounting policy for a transaction not covered by a specific IFRS.

IFRS 6 exempts companies from applying these criteria in developing an accounting policy for the recognition and measurement of exploration and evaluation assets.

In other words, companies are free to develop an accounting policy (within the broader guidance of IFRS6) without reference to other parts of IFRS. This is particularly useful when a company involved in this industry adopts IFRS because they may be able to carry on using their pre IFRS accounting policy.

Changes in accounting policies

An entity is allowed to change accounting policies for exploration and evaluation expenditures when the change makes information used as a basis of decision making:

- more relevant and no less reliable; or
- more reliable and no less relevant.

To justify a change, The company must demonstrate that the change brings the financial statements closer to meeting the IAS 8 criteria but the change need not achieve full compliance with those criteria.

3.3 Initial recognition and measurement

Exploration and evaluation assets are measured at cost. A company must determine a policy of specifying which expenditures are recognised as exploration and evaluation assets and apply this policy consistently in doing this.

Expenditures which might be specified include:

- acquisition of exploration rights;
- topographical, geological, geochemical and geophysical studies;
- exploratory drilling;
- trenching;
- sampling; and
- activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

Expenditures related to the development of mineral resources must not be recognised as exploration and evaluation assets. *The Conceptual Framework* and *IAS 38 Intangible Assets* provide guidance on the recognition of assets arising from development.

IAS 37 applies to the recognition of any obligations for removal and restoration that are incurred as a consequence of exploration for and evaluation of mineral resources.

3.4 Subsequent measurement

A company must apply one of the following to exploration and evaluation assets:

- cost model; or
- revaluation model.

If the revaluation model is applied (IAS 16 or IAS 38 model), it must be consistent with the classification of the expenditure as tangible or intangible.

This means that a revaluation model for expenditure classified as an intangible is only possible if there is a fair value that can be measured with reference to an active market.

3.5 Presentation

Exploration and evaluation assets must be classified according to the nature of the assets acquired as:

- tangible (e.g. vehicles and drilling rigs); or
- intangible (e.g. drilling rights).

The classification must be applied consistently.

An exploration and evaluation asset is reclassified from this category when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. In such cases they must be assessed for impairment before reclassification.

3.6 Impairment

Exploration and evaluation assets must be:

- allocated to cash-generating units (CGUs) or groups of CGUs for the purpose of assessing such assets for impairment (the CGU; and
- assessed for impairment when there are indications that the carrying amount may exceed recoverable amount.

Exploration and evaluation assets are unlikely to generate cash flows independently from other assets so as such they are similar to goodwill. Therefore IFRS 6 requires them to be allocated to CGUs groups for the purpose of impairment testing. They are not tested individually for impairment.

Indicators of impairment include (the list is not exhaustive):

- expiry of the period of the exploration right without expectation of renewal;
- expenditure on further exploration/evaluation in the specific area is not budgeted/planned;
- non discovery of commercially viable quantities of mineral resources;
- a decision to discontinue activities in the specific area; and
- indication that the carrying amount of the exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

3.7 Disclosure

Entities must disclose information that identifies and explains the amounts recognised arising from the exploration and evaluation of mineral resources.

- accounting policies for exploration and evaluation expenditures, and recognition as assets;
- amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources; and
- Exploration and evaluation assets must be treated as a separate class of assets (IAS 16 or IAS 38 disclosures apply depending on classification).

4 IFRS 14: REGULATORY DEFERRAL ACCOUNTS

Section overview

- Introduction
- Overview of requirements

4.1 Introduction

Some countries regulate prices that can be charged for certain goods and services. Such goods and services are said to be "rate regulated".

Definitions

Rate-regulated activities: An entity's activities that are subject to rate regulation.

Rate regulation: A framework for establishing the prices that can be charged to customers for goods or services and that framework is subject to oversight and/or approval by a rate regulator.

Regulatory deferral account balance: The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.

In the absence of an accounting standard on a topic, entities that adopt IFRS must formulate an accounting policy in accordance with guidance given in IAS 8. This has led to divergence in practice.

The IASB are engaged in a project on this area but in the meantime have issued IFRS 14 as an interim measure.

4.2 Overview of requirements

IFRS 14 permits a first-time adopter within its scope to continue to account for regulatory deferral account balances in its first IFRS financial statements in accordance with its previous GAAP when it adopts IFRS.

However, IFRS 14 introduces limited changes to some previous GAAP accounting practices for regulatory deferral account balances, which are primarily related to the presentation of these accounts. It requires entities to present regulatory deferral account balances as separate line items in the statement of financial position and to present movements in those account balances as separate line items in the statement of profit or loss and other comprehensive income.

IFRS 14 also requires specific disclosures to identify the nature of, and risks associated with, the rate regulation that has resulted in the recognition of regulatory deferral account balances.

5 IFRS FOR SMALL AND MEDIUM-SIZED ENTITIES (SMES)

Section overview

- Introduction
- IFRS for SMEs
- IFRS for SMEs section by section

5.1 Introduction

International accounting standards are written to meet the needs of investors in international capital markets. Most companies adopting IFRSs are large listed entities. The IASB has not stated that IFRSs are only aimed at quoted companies, but certainly the majority of adopters are large entities. In many countries IFRSs are used as national GAAP which means that unquoted small and medium-sized entities (SMEs) have to apply them.

There is an argument that all entities should apply the same accounting standards in order to give a fair presentation of the affairs of the entity. However in some cases, many of the IFRSs are complex and can be difficult for SMEs to apply, particularly in areas such as financial instruments. Additionally, not all the information required by IFRSs for disclosure is needed by the users of the SME's financial statements.

Some commentators therefore suggest that SMEs and public entities should be allowed to use simplified or differing standards as the nature of their business is different from large quoted entities.

The users of financial statements of SMEs are different from the users of the financial statements of quoted companies. The only 'user groups' that use the financial statements of an SME are normally:

- its shareholders/owners;
- senior management; and
- possibly, government departments and agencies.

A SME is often owned and managed by a small number of entrepreneurs, and may be a family-owned and family-run business. Large companies, in contrast, are run by professional boards of directors, who must be held accountable to their shareholders.

Because there are big differences between SMEs and large quoted companies, it is not clear whether there is any reason why SMEs should comply with IFRSs. There are arguments in favour of using IFRSs for SMEs, and arguments against.

Arguments against the use of IFRSs by SMEs

There are several reasons why SMEs **should not** adopt IFRSs for the preparation of their financial statements.

- Some IFRSs deal with subjects that are of little or no relevance to SMEs, such as accounting standards on consolidation, associates, joint ventures, deferred tax, construction contracts and standards that deal with complex issues of fair value measurement.
- The costs of complying with IFRSs can be high. Large companies are able to bear the cost, which might not be significant relative to their size. For SMEs, the cost is proportionately much higher, and it is doubtful whether the benefits of complying with IFRSs would justify the costs.
- There are not many users of financial statements of SMEs, and they use the financial statements for a smaller range of decisions, compared to investors in international capital markets. So would it be a waste of time (as well as cost) to comply with IFRSs?

Arguments in favour of the use of IFRSs by SMEs

There are also reasons why SMEs **should** adopt IFRSs for the preparation of their financial statements.

- If SMEs use different accounting rules and requirements to prepare their financial statements, there will be a 'two-tier' system of accounting. This could make it difficult to compare results of larger and smaller companies, should the need arise. Confidence in the quality of Financial Reporting might be affected adversely.
- If SMEs prepared financial statements in accordance with their national GAAP, it will be impossible to compare financial statements of companies in different countries. If SMEs grow in size and eventually obtain a stock market quotation, they will have some difficulty in the transition from national GAAP to IFRSs.
- It has also been argued that full statutory accounts for SMEs would be in the public interest, and might help to protect other stakeholders in the company (such as suppliers, customers, lenders and employees).

Considerations in developing standards for SMEs

The aim of developing a set of accounting standards for SMEs is that they allow information to be presented that is relevant, reliable, comparable and understandable. The information presented should be suitable for the uses of the managers and directors and any other interested parties of the SME.

Additionally, many of the detailed disclosures within full IFRSs are not relevant and the accounting standards should be modified for this. The difficulty is getting the right balance of modification, too much and the financial statements will lose their focus and will not be helpful to users.

5.2 IFRS for SMEs

The standard consists of 230 pages of text, arranged into 35 sections that cover all of the recognition, measurement, presentation and disclosure requirements for SMEs. There is no cross reference to other IFRS (with one exception relating to financial instruments).

The IFRS for SMEs imposes a lesser burden on SMEs due to:

- some topics in IFRSs being omitted because they are not relevant to typical SMEs;
- the simplification of many of the recognition and measurement requirements available in full IFRSs; and
- substantially fewer disclosures.

The IFRS for SMEs does not address the following topics:

- earnings per share (i.e. there is no equivalent to IAS 33);
- interim accounting (i.e. there is no equivalent to IAS 34);
- segment reporting (i.e. there is no equivalent to IFRS 8);
- special accounting for assets held for sale (i.e. there is no equivalent to IFRS 5).

The omission of equivalent rules to those in IAS 33, IAS 34 and IFRS 8 is not surprising as they are relevant to listed entities. As the next section explains, such entities cannot be SMEs.

Stand-alone document

The IFRS for SMEs is a stand-alone document. This means that it contains all of the rules to be followed by SMEs without referring to other IFRSs. For example it sets out rules for property, plant and equipment without specifying that the rules are similar or dissimilar to those found in IAS 16.

In the following pages we provide an overview of the sections of the IFRS for SMEs and often refer to similarity or difference to equivalent other IFRSs. This is not what the IFRS for SMEs does but we adopt the approach to make it easier for you to gain an understanding of the main features of the standard.

The IFRS for SMEs is derived from rules in other IFRS. You will note that it uses the same terminology and that many of the rules are identical. However, in several cases the rules in other IFRSs from which the IFRS for SMEs derives have been changed whereas the equivalent rules in this standard have not been changed. For example the rules on joint ventures are based on the standard (IAS 31) that preceded IFRS 11 which you covered earlier. You should not interpret this as meaning that the standard is out of date. It simply means that there is a difference between the rules for SMEs and those followed by other entities. Changes to the main body of standards will not necessarily result in a revision to the IFRS for SMEs.

5.3 IFRS for SMEs section by section

Section 1: Small and medium-sized entities

Definition

Small and medium-sized entities are entities that:

a. do not have public accountability, and

b. publish general purpose financial statements for external users. Examples of external users include owners who are not involved in managing the business, existing and potential creditors, and credit rating agencies.

An entity has **public accountability** if:

a. its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments; or

b. it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (e.g. banks and insurance companies).

The decision as to which entities are required or permitted to apply the standard will lie with the regulatory and legislative authorities in each jurisdiction.

Section 2: Concepts and pervasive principles

This section is drawn from the *IASB Framework for the preparation and presentation of financial statements*. This was the document that preceded the *IASB Conceptual Framework* with which you are already familiar.

The section states that the objective of financial statements of a small or medium-sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Financial statements also show the results of the stewardship of management (the accountability of management for the resources entrusted to it).

The section lists the following qualitative characteristics of information in financial statements:

- ❑ understandability;
- ❑ relevance;
- ❑ materiality;
- ❑ reliability;
- ❑ substance over form;
- ❑ prudence;
- ❑ completeness;
- ❑ comparability; and
- ❑ timeliness.

The section contains guidance on financial position (including the definitions of assets, liabilities and equity) and on financial performance (including the definitions of income and expenses) which is the same as in the conceptual framework. The recognition criteria are also the same.

The IFRS for SMEs contains guidance on measurement that is not found in either the original or the new frameworks.

An entity must measure assets and liabilities at historical cost unless another section in the IFRS for SMEs requires initial measurement on another basis such as fair value.

Most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases. For example:

- property, plant and equipment is measured at the lower of depreciated cost and recoverable amount;
- inventories are measured at the lower of cost and net realizable value (selling price less costs to complete and sell); and
- an entity recognises an impairment loss relating to non-financial assets that are in use or held for sale.

This guidance is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.

Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.

Assets and liabilities, or income and expenses, must not be offset unless required or permitted by another section in the IFRS for SMEs.

Section 3: Financial statement presentation

Financial statements must present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in *Section 2 Concepts and Pervasive Principles*.

The application of the IFRS for SMEs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation of the financial position, financial performance and cash flows of SMEs.

Application of the IFRS for SMEs by an entity with public accountability cannot result in a fair presentation in accordance with this IFRS.

An entity whose financial statements comply with the IFRS for SMEs must make an explicit and unreserved statement of such compliance in the notes. Financial statements must not be described as complying with the IFRS for SMEs unless they comply with all the requirements of this IFRS.

A complete set of financial statements of an entity reporting under the IFRS for SMEs is similar to that required by full IFRS and comprises:

- a statement of financial position;
- either a single statement of profit or loss and other comprehensive income, or a separate statement of profit or loss and a separate statement of other comprehensive income;
- a statement of changes in equity (or a statement of income and retained earnings);
- a statement of cash flows;
- notes including a summary of significant accounting policies; and
- comparative information.

Section 4: Statement of financial position

The rules in IFRS for SMEs on statements of financial position are very similar to those found in IAS 1.

One difference is that line items required for assets held for sale or liabilities of disposal groups held for sale are not required.

Section 5: Statement of comprehensive income and income statement

The rules in IFRS for SMEs on statements of financial performance are very similar to those found in IAS 1.

An entity must present its total comprehensive income either:

- ❑ in a single statement; or
- ❑ in two statements.

An entity must present its total comprehensive income for a period either:

- ❑ in a single statement of comprehensive income, in which case the statement of comprehensive income presents all items of income and expense recognised in the period, or
- ❑ in two statements (an income statement and a statement of comprehensive income) in which case the income statement presents all items of income and expense recognised in the period except the following three categories of gain or loss that must be recognised in total comprehensive income in accordance with the IFRS for SMEs:
  - gains and losses arising on translating the financial statements of a foreign operation (*Section 30: Foreign currency translation*).
  - some actuarial gains and losses (*Section 28: Employee benefits*).
  - some changes in fair values of hedging instruments (*Section 12: Other financial instruments*).

An income statement is what the IFRS for SMEs calls a statement of profit or loss.

Section 6: Statement of changes in equity and statement of income and retained earnings

An SME must present either:

- ❑ a statement of changes in equity (SOCIE); or
- ❑ a statement of income and retained earnings (if the only changes in equity in the period arise from profit or loss, dividends paid, corrections of errors and changes in accounting policy).

The statement of income and retained earnings is an income statement with a closing section which shows the following:

- ❑ retained earnings at the beginning of the reporting period;
- ❑ dividends declared and paid or payable during the period;
- ❑ restatements of retained earnings for corrections of prior period errors;
- ❑ restatements of retained earnings for changes in accounting policy; and
- ❑ retained earnings at the end of the reporting period.

Section 7: Statement of cash flows

There are no significant differences between the rules in section 7 and those in IAS 7.

Section 8: Notes to the financial statements

There are no significant differences between the IFRS for SMEs rules on notes to the financial statements and those found in IAS 1.

Section 9: Consolidated and separate financial statements

This section derives from the standards that were replaced by the project that led to the publication of IFRS 10. However, there are no significant, practical differences between the IFRS for SMEs rules on subsidiaries and consolidation and those found in the other IFRS.

Each set of rules would result in the recognition of the same entities as subsidiaries and result in the same consolidated financial statements in most (but not all) cases. It is possible that the more detailed guidance on control in IFRS 10 would lead to the consolidation of some entities that might not be considered as subsidiaries according to the IFRS for SMEs rules. However, most SMEs are unlikely to be involved in the sort of investment that IFRS 10 would further identify.

Section 10: Accounting policies, estimates and errors

The rules in IFRS for SMEs on accounting policies, estimates and errors are very similar to those found in IAS 8. However, there is no requirement to disclose the impact of a new standard in issue but not yet effective.

Sections 11 and 12: Introduction to IFRS for SMEs in respect of financial instruments

Section 11 and Section 12 together deal with recognising, derecognising, measuring and disclosing financial instruments (financial assets and financial liabilities).

Section 11 applies to basic financial instruments and is relevant to all entities.

Section 12 applies to other, more complex financial instruments and transactions.

An entity must apply either:

- the provisions of both Section 11 and Section 12 in full, or
- the recognition and measurement provisions of IFRS 9.

Section 11: Basic financial instruments

This section applies to all entities.

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

An entity must recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

Measurement of financial assets and liabilities on initial recognition is at the transaction price (including transaction costs) with the following exceptions:

- financial assets and liabilities that are measured at fair value through profit or loss) are measured at their fair value (which is usually the transaction price) with transaction costs expensed to profit or loss;
- financing transactions (for example in connection with the sale of goods if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate) where the financial asset or financial liability is measured at the present value of the future payments.

Subsequent measurement at the end of each reporting period is as follows:

- Debt instruments are measured at amortised cost using the effective interest method with the following exceptions:
  - Debt instruments that are classified as current assets or current liabilities are measured at the undiscounted amount;
  - If an arrangement constitutes a financing transaction, the debt instrument is measured at the present value of the future payments.
- Investments in shares must be measured at fair value with all gains and losses recognised through profit or loss.

Section 12: Other financial instruments issues

This section applies to only to those entities which have complex financial instruments. This includes derivatives and any instrument with an embedded derivative.

An entity must recognise a financial asset or a financial liability only when the entity becomes a party to the contractual provisions of the instrument.

When a financial asset or financial liability is recognised initially, an entity must measure it at its fair value, which is normally the transaction price.

At the end of each reporting period, an entity must measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss.

This section includes a simplified hedge accounting regime which can only be used to account for hedges of the following risks:

- interest rate risk of a debt instrument measured at amortised cost;
- foreign exchange or interest rate risk in a firm commitment or a highly probable forecast transaction;
- price risk of a commodity that it holds or in a firm commitment or highly probable forecast transaction to purchase or sell a commodity;
- foreign exchange risk in a net investment in a foreign operation.

Section 13: Inventories

There are no significant differences between the IFRS for SMEs rules on accounting for inventory and those found in IAS 2.

Section 14: Investments in associates

The section 14 rules on identifying investments in associates are very similar to those found in IAS 28.

Section 14 allows an entity to account for all of its associates using one of the following:

- cost model;
- equity method; or
- fair value model.

Section 15: Investments in joint ventures

Definition

A **joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

Joint control is the contractually agreed sharing of control over an economic entity.

Joint control only exists when the strategic financial and operating decisions relating to the economic activity require the unanimous consent of the entities sharing control (the joint venturers).

Joint control is the key factor in deciding whether a joint venture exists. The following characteristics are common to all types of joint venture:

- two or more joint venturers are bound by a contractual arrangement (usually in writing); and
- the contractual arrangement establishes joint control.

The IFRS for SMEs identifies three broad types of joint venture:

- jointly-controlled operations
- jointly-controlled assets
- jointly-controlled entities.

An entity with a jointly-controlled operation must recognise:

- the assets that it controls and the liabilities that it incurs, and
- the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture.

An entity with an interest in jointly-controlled assets must recognise:

- its share of the jointly controlled assets, classified according to the nature of the assets;
- any liabilities that it has incurred;

- its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;
- any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and
- any expenses that it has incurred in respect of its interest in the joint venture.

An entity with an interest in jointly-controlled entity must account for all of its jointly-controlled entities using one of the following:

- cost model;
- equity method; or
- fair value model.

Section 16: Investment property

The section 14 rules on identifying investment properties are very similar to those found in IAS 40.

Section 14 requires that investment properties must be measured at fair value (cost model not allowed, unless fair value cannot be measured reliably without undue cost or effort).

Section 17: Property, plant and equipment

This section applies to accounting for property, plant and equipment and investment property whose fair value cannot be measured reliably without undue cost or effort.

Most of the section 17 rules are similar to the IAS 16 rules. However, there are some differences. For example, residual value, useful life and depreciation need to be reviewed only if there is an indication they may have changed since the most recent annual reporting date. (IAS 16 requires an annual review).

Section 18: Intangible assets other than goodwill

The section 18 rules on accounting for intangible assets are similar to the IAS 38 rules. However, there are some differences.

- All assets within the scope of this section must be measured subsequently using the cost model. Revaluation is not allowed.
- All research and development costs must be expensed as incurred. There is no capitalisation of internally generated intangible assets.

All intangible assets must be amortised over their estimated useful lives. If this cannot be estimated a useful life of 10 years is assumed. This means that there is no requirement to test unamortised intangibles for impairment on an annual basis.

Section 19: Business combinations and goodwill

The section 19 rules on accounting for business combinations and goodwill are similar to the IFRS 3 rules. However, there are some differences.

- Acquisition costs are capitalised under this standard whereas they must be expensed under IFRS 3.
- Goodwill is amortised over its estimated useful life. If this cannot be estimated a useful life of 10 years is assumed. This means that there is no requirement to test goodwill for impairment on an annual basis.

Section 20: Leases

Lessee accounting is different to that required under IFRS 16. The IFRS for SMEs requires both lessees and lessors to identify operating leases and finance leases. The lessee must recognise a leased asset and lease liability only for finance leases.

Section 21: Provisions and contingencies

There are no significant differences between the IFRS for SMEs rules on provisions and contingencies and those found in IAS 37.

Section 22: Liabilities and equity

The section 22 rules on equity and liabilities are similar to the IAS 32 rules though IAS 32 does envisage more complex scenarios. Both sets of rules would lead to the same classification of an instrument as debt or equity and both sets of rules require split accounting (into debt and equity components) on the initial recognition of an issue of convertible debt.

Both sets of rules require that any gain or loss on transactions involving an entity's own equity must be recognised as a movement in equity. Section 22 applies the same rational to transactions involving a parent's controlling interest in a subsidiary that do not result in a loss of control. The carrying amount of the non-controlling interest is adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between the amount by which the non-controlling interest is so adjusted and the fair value of the consideration paid or received, if any, shall be recognised directly in equity and attributed to equity holders of the parent.

Section 23: Revenue

IFRS 15 has replaced IAS 18 *Revenue* and IAS 11 *Construction contracts* but the revenue recognition rules for SMEs continue to be based on the rules in these superseded standards.

The rules cover revenue from:

- sale of goods;
- the rendering of services;
- construction contracts; and
- the use of an entity's assets by others (yielding interest, royalties or dividends).

Revenue is measured at the fair value of consideration received or receivable.

Revenue from the sale of goods is recognised when **all** of the following conditions have been met:

- The entity has transferred to the buyer the 'significant risks and rewards of ownership of the goods'. This normally occurs when legal title to the goods or possession of the goods passes to the buyer.
- The entity does not retain effective control over the goods sold, or retain a continuing management involvement to the degree usually associated with ownership.
- The amount of revenue can be measured reliably.
- It is probable that economic benefits associated with the transaction will flow to the entity.
- The costs incurred (or to be incurred) for the transaction can be measured reliably.

Revenue from rendering a service is recognised with reference to the stage of completion at the reporting date as long as the outcome of the contract can be estimated reliably. This is when **all** of the following conditions are met:

- The amount of revenue can be measured reliably.
- It is probable that the economic benefits associated with the transaction will flow to the service provider.
- The stage of completion of the transaction as at the end of the reporting period can be measured reliably.
- The costs already incurred for the transaction and the costs that will be incurred to complete the transaction can be measured reliably.

When these conditions are not met, revenue should be recognised only to the extent of the expenses recognised that are recoverable.

Revenue from construction contracts is measured in a similar way.

Revenue from interest, royalties and dividends is recognised when it is probable that the benefits will flow to the entity and the amount of the revenue can be measured reliably. The following approaches are used:

- **Interest**. Interest income should be recognised on a time proportion basis that takes into account the effective yield on the interest-earning asset.
- **Royalties**. Revenue from royalties should be recognised on an accruals basis, in accordance with the terms of the royalty agreement.
- **Dividends**. Revenue from dividends should be recognised when the right to receive the dividend is established.

Section 24: Government grants

The section 24 rules on accounting for government grants are similar to the IAS 20 rules. However, section 24 does not seem to allow deduction of a capital grant from the asset to which it relates.

Section 25: Borrowing costs

Borrowing costs must be recognised as expenses and cannot be capitalised as required by IAS 23.

Section 26: Share-based payment

The section 26 rules on accounting for share-based payment are similar to the IFRS 2 rules.

One difference is that section 26 allows the directors to make an estimate of the fair value of equity instruments granted when there is no observable market price and a reliable measure of fair value is impracticable.

Section 27: Impairment of assets

The section 27 rules on impairment of assets are similar to those in IAS 2 for inventories and those in IAS 36 for impairment of other non-financial assets.

Section 28: Employee benefits

The section 28 rules on accounting for employee benefits are very similar to those found in IAS 19 with no significant differences worth mentioning.

Section 29: Income tax

The section 29 rules on accounting for income tax are similar to the IAS 12 rules.

Section 30: Foreign currency translation

The section 30 rules on foreign currency translation are similar to the IAS 21 rules.

One difference is that section 30 does not permit recycling of the cumulative translation difference in respect of an investment in a foreign entity when that entity is disposed of.

Section 31: Hyperinflation

The section 31 rules on hyperinflation are very similar to the IAS 21 rules.

This is not relevant to Nigerian companies.

Section 32: Events after the end of the reporting period

There are no significant differences between the IFRS for SMEs rules on events after the end of the reporting period and those found in IAS 10.

Section 33: Related party disclosures

There are no significant differences between the IFRS for SMEs rules for related parties and those found in IAS 24.

Section 34: Specialised activities

IFRS for SMEs provides guidance on:

- Agriculture (drawn from IAS 41);
- Extractive industries (refers back to the property, plant and equipment, intangibles other than goodwill, and provisions sections of the IFRS);
- Service concession arrangements (drawn from, but much simplified, IFRIC 12).

Section 35: Transition to the IFRS for SMEs

The guidance is similar to that provided by IFRS 1 for first time adoption of full IFRS. These rules are not described further in this chapter.

6 SAS 32: ON ACCOUNTING FOR NOT-FOR-PROFIT ORGANISATIONS

Section overview

- Introduction
- Contributions
- Financial Reporting – background
- Financial Reporting – accounting methods
- SAS 32 requirements

6.1 Introduction

SAS 32 establishes measurement and recognition presentation and disclosure standards for financial statements of not for profit organisations.

SAS 32 was published with the aim of developing a uniform and consistent basis of providing financial information for not-for-profit organisations in order to enable meaningful assessment of their performance.

Not-for-profit organisations

Definition: Not-for-profit organisation

A not-for-profit organisation is an entity, normally without transferable ownership interests, organised and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose. Its members, contributors and other resource providers do not, in such capacity, expect pecuniary return directly from the organisation.

Not for profit organisations exist for the benefit of the community at large or for a particular section of that community. Not for profit organisations include political or social and educational, scientific, charitable and religious entities among others.

Types of not-for-profit organisations

Not for profit organisations are basically of two types:

- public sector not for profit organisations; and
- private sector not for profit organisations.

SAS 32 applies only to private sector not for profit organisations.

6.2 Contributions

Not for profit organisations obtain most of their resources from members of the public, organisations and governments that identify with their mission rather than by commercial transactions.

Definition: Contributions

A contribution is a voluntary non-reciprocal transfer to a not-for-profit organisation of cash or other assets or a non-reciprocal settlement or cancellation of its liabilities.

Government funding provided to a not-for-profit organisation for example is considered to be a contribution.

Contributions are a type of revenue unique to not for profit organisations. The main feature that sets it apart from revenue is the non-reciprocal nature of the transfer. This means that the contributor does not expect to receive anything, and that the not for profit recipient does not need to provide anything to the contributor, in exchange for the contribution.

Types of contribution

There are (broadly speaking) three types of contribution that a not for profit organisation might receive:

- an unrestricted contribution;
- a restricted contribution; and
- an endowment contribution.

Restricted contributions

A not for profit organisation might have multiple goals and a supporter of the organisation might chose to support one or another of these goals. Such a supporter might make a contribution and specify that it is to be used for a specific purpose.

In other words, some contributions are restricted as to their use.

Definition: Restricted contributions

A restricted contribution is a contribution subject to externally imposed stipulations that specify the purpose for which the contributed asset is to be used. A contribution restricted for the purchase of a capital asset or a contribution of the capital asset itself is a type of restricted contribution.

Accepting a restricted contribution places an obligation on the not-for-profit organisation to respect the restriction and use the cash received only in accordance with the wishes of the donor.

Example: Restriction on use of a contribution

A health charity has the objective of improving the health of the population in remote, rural areas.

The charity operates educational programmes, an inoculation programme, a neo-natal and post-natal care programme.

The charity requests and receives funding from the WHO of a contribution of $1,000,000 to fund the inoculation programme over the next 3 years. This amount can only be used on the inoculation programme.

Endowment contributions

Definition: Endowment contributions

An endowment contribution is a type of restricted contribution subject to externally imposed stipulations specifying that the resources contributed be maintained permanently, although the constituent assets may change from time to time.

Example: Endowment contributions

A very wealthy individual might leave ₦10,000,000 to a health charity stipulating that the money be invested to earn income that must be applied in supporting students through their medical training.

Note that an organisation might also place a voluntary restriction on the use of resources, setting funds aside for a particular purpose. The difference between internal and external restrictions is that the organisation could change its mind about internally restricted resources and apply them in any way it wishes.

6.3 Financial Reporting - background

Stakeholders

Stakeholders of not for profit organisations include:

- contributors:
  - organisations;
  - governments; and
  - members of the public;
- beneficiaries of the service of the organisation;
- the government (who might have granted tax exemption to the activities of the organisation);
- regulators; and
- others (suppliers/employees etc.).

Each of the above might have differing informational needs but these will include both financial and non-financial information.

Financial Reporting issues

The main objective of Financial Reporting of companies subject to IFRS is to provide information that is useful for decision making purposes.

The objective of Financial Reporting by not-for-profit organisations should have a similar aim. In particular, contributors will want to judge whether the contributions provided have been applied in the way expected to the service activities of the organisation.

Statement of financial position

The primary purpose of a statement of financial position is to present the organisation's economic resources, obligations and net assets as at the reporting date.

The statement of financial position, together with the other statements and the notes, provide useful information for assessing whether the organisation will continue to provide services, achieve its objectives and meet its obligations.

Total net assets represent the organisation's residual interest in its assets after deducting its liabilities. The net assets balance therefore provides information about the net resources the organisation has available for carrying out its service delivery activities in the future. Net assets are also referred to as fund balances or as accumulated surplus or deficit.

Restrictions on net assets are externally or internally imposed. To fully understand the nature of the organisation's net assets balance, financial statement users require information about the portions of net assets attributable to endowments, capital assets and other restrictions, none of which can readily be used for other purposes.

Statement of activities

The statement of activities is the not-for-profit version of the statement of financial performance and is also known as the statement of income and expenditure.

The primary purpose of a statement of activities is to communicate information about changes in the organisations economic resources for the period. Specifically this statement provides information about the costs of the organisation’s service delivery activities for the period and the extent to which these expenses were financed all funded by contributions and other revenue.

The information provided is useful in evaluating the organisations performance during the period, including its ability to continue to provide services, and in assessing how the organisations management has discharged its stewardship responsibilities.

Closing comment

Financial reports need to take account of the peculiar nature of the “revenue stream” of not-for-profit organisations and the possible existence of restrictions on how some assets can be used by the organisation. The following section explains certain accounting methods that can be applied in achieving this aim. The subsequent section then specifies the treatment required by SAS 32.

6.4 Financial Reporting - accounting methods

Fund accounting

SAS 32 defines fund accounting as follows:

Definition: Fund accounting

Accounting procedures in which a self-balancing group of accounts is provided for each fund established by legal, contractual or voluntary action, especially in governmental units and not for profit organisations.

In essence, the statement of financial position comprises a series of separate funds each with net assets balancing against a fund balance.

Example: Fund accounting

Statements of financial position for a not-for-profit organisation as at 31 December 20X1:

	Fund1	Fund 2	Fund 3	Total
	₦m	₦m	₦m	₦m
Current assets	200	300		500
Non-current assets			400	400-
Total assets	200	300	400	900
Current liabilites	80	90		170
Non-current liabilities		200		200
Fund balances	120	10	400	530
	200	300	400	900

The statement of activities (being the not-for-profit version of the statement of financial performance) is structured in a similar way to show revenue, expenses and surplus relating to each fund in the period.

An organisation that uses fund accounting in its financial statements usually provides a brief description of the purpose of each fund reported.

Recognition of contributions: Restricted fund method

Fund accounting can be used to highlight resources subject to different restrictions and those which are unrestricted.

SAS 32 defines the restricted fund method as follows:

Definition: Restricted fund method

Restricted fund method is a specialized type of fund accounting which involves the reporting of details of financial statement elements by fund in such a way that the organisation reports total general funds, one or more restricted funds, and an endowment fund, if applicable.

One of the funds might be specified as a fund relating to capital assets. These assets are not available. Net assets invested in capital assets represent an amount of net assets that is not available for other purposes.

Contributions are recognised as follows when using restricted fund accounting:

- Unrestricted contributions: Recognise as revenue relating to the general fund in the period.
- Restricted contributions: Recognise as revenue relating to appropriate fund in the period.
- Endowment contributions: Recognise as revenue relating to the endowment fund in the period.

Recognition of contributions: Deferral method

SAS 32 defines the deferral method as follows:

Definition: Deferral method

Deferral method is a way of capturing matching concepts by relating revenues with expenses

The deferral method may be used with or without fund accounting.

Contributions are recognised as follows when using fund accounting:

- Unrestricted contributions:
- Restricted contributions:
  - recognise as deferred contribution in net assets; then
  - recognise as revenue when the conditions of the contribution are met.
- Endowment contributions: Recognise directly in the endowment fund.

Summary of contribution double entry

Type of contribution	Restricted fund method	Deferral method
Unrestricted contribution	Dr Cash/receivables Cr Revenue When received	Dr Cash/receivables Cr Revenue When received
Restricted contribution	Dr Cash/receivables Cr Revenue When received	Dr Cash/receivables Cr Deferred contribution When received and Dr Deferred contribution Cr Revenue When condition is met
Endowment contribution	Dr Cash/receivables Cr Revenue When received	Dr Cash/receivables Cr Endowment fund When received

6.5 SAS 32 requirements

Financial statements for a not-for-profit organisation must include:

- ❑ statement of accounting policies (as a prominent single section);
- ❑ statement of financial position;
- ❑ statement of activities;
- ❑ statement of changes in net assets;
- ❑ statement of cash flows; and
- ❑ notes to the accounts.

General disclosures

The following must be disclosed:

- ❑ the name of the organisation;
- ❑ the period of time covered;
- ❑ a brief, clear and concise description of its purpose and all activities; and
- ❑ its legal form and legal form of other related entities that are expected to register by legislation.

A not-for-profit organisation that uses fund accounting must provide a brief description of the purpose of each fund reported.

Basis of preparation

Where separate funds are reported, contributions may be recognised using either the deferral method or the restricted fund method.

Where separate funds are not reported only the deferral method may be used.

Example: Financial statements: Restricted fund accounting

Statement of financial position

	Unrestricted fund	Capital assets	Restricted fund	Endowment fund	Total
Current assets	2		3	4	9
Investments	5		6	7	18
Non-current assets		8			8
	7	8	9	11	35
Current liabilities	1		1	1	3
Non-current liabilities	2	1	2	2	7
Unrestricted fund	4				4
Capital fund		7			7
Restricted fund			6		6
Endowment fund				8	8
	7	8	9	11	35

Statement of activities

Revenue	6		3	5	14
Expenses	3		2	0	5
Surplus	3		1	5	9

Statement of changes in net assets

Surplus in the year	3		1	5	9
Transfer	-1	1			
Net assets at start	2	6	5	3	16
Net assets at end	4	7	6	8	25

Notes:

Capital assets have been puchased in the year out of the unrestricted fund. This is shown as a transfer in the statement of changes in net assets.

An endowment contribution of 5 has been received and this has been recognised in revenue.

Restricted funds of 3 have been received and recognised in revenue.

The restricted fund balance at the year end is 6.

Example: Financial statements: Deferral method

Statement of financial position

	Unrestricted fund	Capital assets	Restricted fund	Endowment fund	Total
Current assets	2		3	4	9
Investments	5		6	7	18
Non-current assets		8			8
	7	8	9	11	35
Current liabilities	1		1	1	3
Non-current liabilities	2	1	2	2	7
Deferred contribution			6		6
Unrestricted fund	4				4
Capital fund		7			7
Restricted fund			0		0
Endowment fund				8	8
	7	8	9	11	35

Statement of activities

Revenue	6		2		8
Expenses	3		2		5
Surplus	3		0		3

Statement of changes in net assets

Surplus in the year	3		0		3
Transfer	-1	1			
Contribution				5	5
Net assets at start	2	6	0	3	11
Net assets at end	4	7	0	8	19

Notes:

Capital assets have been puchased in the year out of the unrestricted fund. This is shown as a transfer in the statement of changes in net assets.

An endowment contribution of 5 has been received and this has been recognised directly in the endowment fund.

Restricted funds of 2 have been received and recognised in revenue.

There is a balance of 6 recognised as a deferred contribution (the amount recognised in the restricted fund in the previous example).

7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the main requirements of IAS 26
- Explain the main requirements of IAS 41
- Explain the main requirements of IFRS 6
- Explain the main requirements of IFRS 14
- Describe, in overview, the IFRS for SMEs
- SAS 32: On accounting for not-for-profit organisations

Professional level
Corporate Reporting

CHAPTER 20

Business combinations and consolidation

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

C	Group financial statements		
	1	Introduction to consolidating complex group structure	
		a	Identify and discuss complex group relationships including the criteria used to identify a subsidiary and an associate.
		b	Identify and discuss the circumstances in which a group is required to prepare group financial statements and when an exemption can be granted.
		c	Identify and discuss the criteria used to determine how different types of investments are recognised and measured.
		d	Discuss and apply the treatment given to a subsidiary acquired exclusively with a view to its subsequent disposal.
		e	Discuss why directors may not wish to consolidate a subsidiary and when this will be permitted.
	2	Preparation of group financial statement of a complex group	
		a	Apply the provisions of relevant standards in determining the cost of acquisition in business combination under different scenarios.
		b	Determine and apply appropriate procedures to be used in preparing group financial statements.
		c	Determine, apply and disclose from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of acquisitions achieved one time or in stages involving subsidiaries, associates and joint ventures.
		h	Prepare group financial statements where necessary in (c) to (g) above.

This chapter does not cover the above competencies in their entirety. It covers that part of the above competencies that involve new and existing investments in subsidiaries.

IFRS 3 and IFRS 10 are examinable documents.

Exam context

This chapter explains the provisions of these standards and allows you to revise consolidated statements of financial position. It includes more detail impairment testing of goodwill than you will have seen before.

The content of this chapter is a vital foundation for understanding more complex areas of consolidation for example disposals of a subsidiary and the consolidation of subsidiaries the

functional currency of which differs from that presentation currency of the consolidated financial statements.

At the end of this chapter, you should be able to:

- Explain and discuss in detail the requirements of IFRS 3 with regard to the calculation of goodwill;
- Define using examples subsidiary, parent and control;
- Explain the concept of control as set out in IFRS 10;
- Describe situations when control is presumed to exist;
- Identify and describe the circumstances in which an entity is required to prepare and present consolidated financial statements;
- Prepare a consolidated statement of financial position including the fair value exercise and the elimination of inter-company balances and accounting for unrealised profit;
- Account for goodwill including impairment testing; and
- Account for gain on a bargain purchase (negative goodwill).

1 THE NATURE OF A GROUP AND CONSOLIDATED ACCOUNTS

Section overview

- International accounting standards and group accounts
- Location of accounting rules
- The nature and purpose of consolidated financial statements

1.1 International accounting standards and group accounts

The following standards relate to accounting for investments:

- IFRS 10 *Consolidated financial statements;*
- IAS 27 *Separate financial statements;*
- IAS 28 *Investments in associates and joint ventures;*
- IFRS 11 *Joint Arrangements; and*
- IFRS 3 *Business combina*tions.

IAS 1 and group accounts

IAS 1 requires that financial statements distinguish between:

- profit or loss for the period;
- other comprehensive income, which consists of gains or losses that are not reported in profit or loss – such as gains on asset revaluations;
- transactions between the entity and its owners in their capacity as owners, which are called 'equity transactions' and reported in the statement of changes in equity.

This applies to consolidated accounts (group accounts).

1.2 Location of accounting rules

IFRS 3 defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses.

IFRS 10 explains that a business under the control of another is a subsidiary and the controlling entity is the parent.

IFRS 10 defines consolidated financial statements as the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. This means that groups must present their financial statements in the form of consolidated accounts.

Guidance on the process of consolidation is set out in two standards, IFRS 3 *Business Combinations* and IFRS 10 *Consolidated Financial Statements*.

IFRS 3 is largely about the initial accounting for a new investment, setting out the rules on the calculation of goodwill.

IFRS 10 covers the on-going rules related to consolidation. It is IFRS 10 that requires:

- that the financial statements of P and S be prepared using uniform accounting policies;
- the consolidated assets, liabilities, income and expenses are those of the parent and its subsidiaries added on a line by line basis;
- the elimination of unrealised profit on intra group transactions; and
- the cancellation of intra group balances.

Changes of ownership

IFRS 3 explains how to account for further investments in a subsidiary after control has been achieved. This is called step acquisitions were control already exist.

IFRS 10 explains how to account for disposals where control is retained or lost.

1.3 The nature and purpose of consolidated financial statements

A subsidiary is usually acquired through the purchase of a controlling interest in its equity. The parent makes a long-term investment in the subsidiary. In the statement of financial position of the parent, there is a non-current asset: 'Investment in subsidiary, at cost'

Sometimes, a parent company has no assets at all except shares in the subsidiaries in the group. A parent whose main assets (or only assets) are shares in subsidiaries is sometimes called a **holding company**.

When a large part of the assets of a parent company consists of investments in subsidiaries, it is difficult for the users of the financial statements of the parent to understand anything about its financial position or financial performance. To find out meaningful information about their investment, users of the parent's financial statements need to know about the financial position and performance of the operating subsidiaries.

The purpose of consolidated accounts is to provide financial statements that have meaning and relevance to users.

When a parent acquires a subsidiary, both the parent and the subsidiary remain legally separate entities. However, in practice they operate as if they were one organisation. Consolidated financial statements reflect the reality (or substance) of the situation: the group is a single economic unit.

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

2 IFRS 10: CONSOLIDATED FINANCIAL STATEMENTS

Section overview

- Introduction to IFRS 10
- Situations where control exists
- The requirement to prepare consolidated accounts
- Investment entities exemption

2.1 Introduction to IFRS 10

IFRS 10 establishes principles for the presentation of consolidated financial statements when an entity controls one or more other entities

Definitions: Group, parent and subsidiary

Group: A parent and its subsidiaries

Parent: An entity that controls one or more entities.

Subsidiary: An entity that is controlled by another entity.

A group consists of a parent entity and one or more entities that it has control over. These are called subsidiaries.

The entity that ultimately controls all the entities in the group is called the parent.

Some parent companies have no assets at all except shares in the subsidiaries of the group. A parent whose main assets (or only assets) are shares in subsidiaries is sometimes called a **holding company**.

Control

An entity is a subsidiary of another entity if it is controlled by that other entity.

IFRS 10 contains a principles based definition of control.

Definition: Control

An investor controls an investee when:

a. it is exposed, or has rights, to variable returns from its involvement with the investee; and

b. it has the ability to affect those returns through its power over the investee.

In other words an investor controls an investee, if and only if, it has all the following:

- ❑ power over the investee;
- ❑ exposure, or rights, to variable returns from its involvement with the investee; and
- ❑ ability to use its power over the investee to affect the amount of its returns.

2.2 Situations where control exists

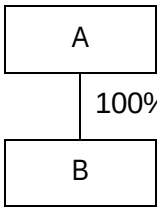
The above definition of control is quite complicated.

In practice, the vast majority of cases involve a company achieving control of another through buying a controlling interest in its shares.

Furthermore, in the vast majority of cases obtaining a controlling interest means buying shares which give the holder more than 50% of the voting rights in the other company.

Illustration: Wholly owned subsidiary

A owns 100% of B's voting share capital.



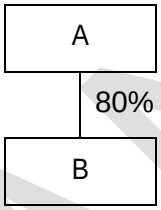
This 100% holding is described as a controlling interest and gives A complete control of B.

B would be described as a wholly owned subsidiary.

A company does not have to own all of the shares in another company in order to control it.

Illustration: Partly owned subsidiary

A owns 80% of B's voting share capital.



This 80% holding is described as a controlling interest and gives A complete control of B.

B would be described as a partly owned subsidiary.

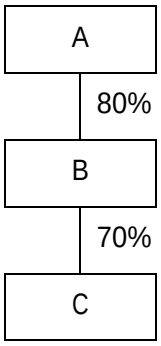
Other parties own the remaining 20% of the shares. They have an ownership interest in B but do not have control.

This is described as a non-controlling interest.

Non-controlling interest (NCI) is defined by IFRS 10 as: "the equity in a subsidiary not attributable … to a parent."

Control is assumed to exist when the parent owns directly, or indirectly through other subsidiaries, more than half of the voting power of the entity, unless in exceptional circumstances it can be clearly demonstrated that such control does not exist.

Illustration:



A owns a controlling interest in B.

B owns a controlling interest in C.

Therefore, A controls C indirectly through its ownership of B.

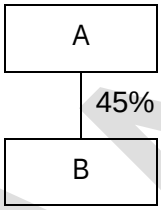
C is described as being a sub-subsidiary of A.

In certain circumstances, a company might control another company even if it owns shares which give it less than half of the voting rights. Such a company is said to have ***de facto*** control over the other company. (***De facto*** is a Latin phrase which translates as ***of fact***. It is used to mean **in reality** or to refer to a position held in fact if not by legal right).

Illustration: Wholly owned subsidiary

A owns 45% of B's voting share capital.

The other shares are held by a large number of unrelated investors none of whom individually own more than 1% of B.



This 45% holding probably gives A complete control of B.

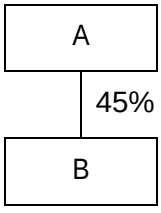
It would be unlikely that a sufficient number of the other shareholders would vote together to stop A directing the company as it wishes.

A company might control another company even if it owns shares which give it less than half of the voting rights because it has an agreement with other shareholders which allow it to exercise control.

Illustration: Wholly owned subsidiary

A owns 45% of B's voting share capital.

A further 10% is held by A's bank who have agreed to use their vote as directed by A.



This 45% holding together with its power to use the votes attached to the banks shares gives A complete control of B.

It was stated above but is worth emphasising that in the vast majority of cases control is achieved through the purchase of shares that give the holder more than 50% of the voting rights in a company.

Two or more investors collectively control an investee when they must act together to direct the relevant activities. If this is the case, no investor can direct the activities without the co-operation of the others so no investor individually controls the investee and it is not a subsidiary. Each investor must account for its interest in accordance with the relevant IFRSs, such as IFRS 11 Joint Arrangements, IAS 28 Investments in Associates and Joint Ventures or IFRS 9 Financial Instruments.

Power

An investor has power over an investee when it has existing rights that give it the current ability to direct the relevant activities (the activities that significantly affect the investee's returns). This power does not necessarily have to be exercised. As long as the rights exist, all other things being equal, the investee is a subsidiary.

Power arises from rights.

- Assessing power is often straightforward – for example when power arises through holding more than 50% of voting rights; or
- Assessing power might be more complex, for example:
  - when power results from one or more contractual arrangements; or
  - when power is due to a dominant but not majority shareholding.

Only substantive rights are taken into account. Substantive rights are rights that an investor has the *practical ability* to exercise. Usually such rights must be currently exercisable so that the entity is in a position to direct the relevant activities of the entity. However sometimes rights might be substantive, even though they are not currently exercisable.

Example: Substantive rights

S Inc. is an investee company.

Policies over the relevant activities can be changed only at special or scheduled shareholders' meetings. This includes the approval of material sales of assets as well as the making or disposing of significant investments.

S Inc. holds annual shareholder meetings at which decisions to direct the relevant activities are made. The next scheduled shareholders' meeting is in eight months.

Shareholders that individually or collectively hold at least 5% of the voting rights can call a special meeting to change the existing policies over the relevant activities with 30 days' notice.

X Plc holds a majority of the voting rights in S Inc. Are these rights substantive?

Answer

The rights are substantive and S Inc. is a subsidiary of X Plc.

X plc is able to make decisions about the direction of the relevant activities when they need to be made. The fact that it takes 30 days before it can exercise its voting rights does not stop it from having the current ability to direct the relevant activities.

Example: Substantive rights

B Inc. is an investee company (with the same fact pattern as for S Inc. above).

A Plc holds an option, which if exercised, would give it ownership of shares with more than 50% of the voting rights of B Inc. This option is exercisable in 25 days and is deeply in the money.

Is B Inc. a subsidiary of A Plc?

Answer

The option contract is a substantive right that gives A Plc the current ability to direct the relevant activities of B Inc.

A plc has rights that are essentially equivalent to those of a majority shareholder in that it can make decisions about the direction of the relevant activities when they need to be made.

The fact that it takes 30 days before it can exercise its votes does not stop it from having the current ability to direct the relevant activities.

B Inc. is a subsidiary of A Plc.

2.3 The requirement to prepare consolidated accounts

Definition

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

All parents?

An entity that is a parent must present consolidated financial statements.

There is an exception to this rule. A parent need not present consolidated financial statements if (and only if) it meets all of the following conditions:

- The parent itself (X) is a wholly-owned subsidiary, with its own parent (Y).
- Alternatively, the parent (X) is a partially-owned subsidiary, with its own parent (Y), and the other owners of X are prepared to allow it to avoid preparing consolidated financial statements.
- The parent's debt or equity instruments are not traded in a public market.
- The parent does not file its financial statements with a securities commission for the purpose of issuing financial instruments in a public market.
- The parent's own parent, or the ultimate parent company (for example, the parent of the parent's parent), **does** produce consolidated financial statements for public use that comply with International Financial Reporting Standards.

All subsidiaries?

Consolidated financial statements should include all the subsidiaries of the parent from the date at which control is achieved to the date upon which control is lost.

A question might explain that a parent does not wish to consolidate a subsidiary but it would usually have to do so. The following might be given as spurious justification for failing to consolidate a particular subsidiary:

- The subsidiary's activities are dissimilar from those of the parent, so that the consolidated financial statements might not present the group's financial performance and position fairly;
- Obtaining the information needed would be expensive and time-consuming and might delay the preparation of the consolidated financial statements; and
- The subsidiary operates under severe long term restrictions, so that the parent is unable to manage it properly. For example, a subsidiary might be located in a country badly disrupted by a war or a revolution. However, note that if the parent loses control then the investee is no longer a subsidiary and should not be consolidated.

Sometimes a group is acquired and the new parent intends to sell one of the new subsidiaries. In this case the subsidiary is accounted for as discontinued operation according to the rules in IFRS 5. This means that all of its assets and all of its liabilities are included as separate lines on the face of the statement of financial position and the group share of its profit (or loss) is shown as a separate line on the face of the statement of profit or loss.

2.4 Investment entities exemption

Under normal rules a parent must consolidate all controlled entities.

There is an exemption that applies to investment entities. These are entities whose business activity is primarily investing activity for example, venture capitalists, unit trusts and mutual funds.

An investment entity might take shares in say, a brewer, in order to make gains through dividends or capital appreciation, not to become involved in brewing.

Furthermore, an investment entity might hold shares in a diverse range of businesses in very different sectors. The investment may result in the investment entity gaining control of the investee.

The usefulness of investment entities consolidating such investments has been called into doubt.

Definition of 'investment entity'

An investment entity is an entity that:

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

An investment entity has the following typical characteristics:

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

A parent must determine whether it meets the investment entity definition by considering whether it demonstrates the above characteristics. However, the absence of any of the typical characteristics may not necessarily disqualify an entity from being classified as an investment entity. Each case should be judged on its merit.

The exemption

An entity that is an investment entity (as defined) must not consolidate investments over which it has control but must measure these at fair value through profit or loss in accordance with IFRS 9: *Financial Instruments*.

This does not apply to a subsidiary of an investment entity that provides services related to the investment entities activities; such a subsidiary must be consolidated.

Note that this exemption only applies to an investment entity itself. If an investment entity is itself a subsidiary, the ultimate parent would consolidate the investment entity and the entities that the investment entity controls in the usual way.

3 IFRS 3: BUSINESS COMBINATIONS

Section overview

- Introduction to IFRS 3
- Acquisition method
- Goodwill
- Cost (consideration transferred)
- Acquisition date amounts of assets acquired and liabilities assumed

3.1 Introduction to IFRS 3

Definitions

A **business combination** is a transaction or other event in which an acquirer obtains control of one or more businesses.

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

Objective of IFRS 3

The objective of IFRS 3 is to improve the relevance, reliability and comparability of information reported about business combinations and their effects.

It establishes principles and requirements for:

- ❑ the recognition and measurement of identifiable assets acquired, liabilities assumed and non-controlling interest in the acquiree;
- ❑ the recognition and measurement of goodwill (or a gain from a bargain purchase); and
- ❑ disclosures that enable users to evaluate the nature and financial effects of a business combination.

Transactions under common control are not within the scope of IFRS 3.This means that transfers of ownership of a subsidiary within a group (for example in group reconstructions) are not subject to the rules in this standard. Companies engaging in such transactions must develop accounting policies in accordance with the guidance given in IAS 8.

3.2 Acquisition method

All business combinations are accounted for by the acquisition method which involves:

- ❑ identifying the acquirer;
- ❑ determining the acquisition date;
- ❑ recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree; and
- ❑ recognising and measuring goodwill or a gain from a bargain purchase.

Identifying the acquirer

It might be difficult to identify an acquirer:

- The acquirer is usually the combining entity whose relative size is significantly greater than that of the other(s).
- In a business combination affected by transferring cash (other assets) or by incurring liabilities the acquirer is usually the entity that makes the transfer or incurs the liabilities.
- In a business combinations affected by exchange of equity interests the acquirer is usually the entity that issues equity (however, in a "reverse acquisition" the issuing entity is the acquiree).

Also note that the acquirer is usually the entity:

- whose owners have the largest portion of the voting rights in the combined entity;
- whose owners have the ability determine the composition of the governing body of the combined entity;
- whose (former) management dominates the management of the combined entity;
- that pays a premium over the pre-combination fair value of the equity interests of the others.

Determining the acquisition date

Acquisition date is the date on which the acquirer effectively obtains control of the acquiree.

This generally the closing date (date of transfer of consideration and when net assets are acquired) but might be before or after this date depending on circumstances.

3.3 Goodwill

IFRS 3 is largely about the calculation of goodwill.

Definition: Goodwill

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

IFRS 3 sets out the calculation of goodwill as follows:

Illustration: Goodwill

N.B. All balances are as at the date of acquisition.

	₦
Consideration transferred (cost of the business combination)	X
Non-controlling interest	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3)	X
Goodwill recognised	X

The non-controlling interest may be stated as either:

- a proportionate share of the identifiable assets acquired and liabilities assumed; or
- at fair value as at the date of acquisition.

Issues to address:

IFRS 3 gives guidance on:

- cost of a business combination;
- recognition and measurement of identifiable assets and liabilities assumed; and
- accounting for goodwill.

3.4 Cost (consideration transferred)

IFRS 3 states that the purchase consideration for an acquisition (business combination) is the sum of:

- the fair values, at the acquisition date, of the assets transferred by the acquirer, such as cash;
- the liabilities incurred by the acquirer to the former owners of the acquire; and
- equity instruments issued by the acquirer in exchange for control of the acquiree.

The purchase consideration may include some deferred and contingent considerations.

When the acquirer issues shares as part of the purchase consideration and the shares are quoted equity instruments, they are normally valued at their market price at the acquisition date for the purpose of measuring the consideration/acquisition cost.

If the consideration includes assets or liabilities of the acquirer carried at amounts that differ from their fair values at the acquisition date, these are revalued with gains and losses taken to P&L.

Consideration includes any asset or liability resulting from a contingent consideration arrangement:

- recognised at acquisition-date the fair value if it is given at that date, but if it is given at a future date, determine the present value and unwind the interest; and
- classified as a liability or equity on the basis of guidance in IAS 32 or other applicable IFRSs.

A right to the return of previously transferred consideration is classified as an asset if specified conditions are met.

Costs of acquisition: transaction costs

Transaction costs incurred in making an acquisition, such as the cost of the fees of advisers and lawyers, must not be included in the cost of the acquisition. These costs must be treated as an expense as incurred and written off to profit or loss.

The amount of transaction costs associated with an acquisition and written off during the period to profit or loss must be disclosed in a note to the financial statements.

Example: Cost of acquisition

Company P acquired 80% of the shares of Company S when the fair value of the net assets of S was ₦800,000.

The purchase price was ₦300,000 in cash plus 10,000 new shares in Company P.

The new shares were to be issued 1 month after the date of acquisition.

The market value of P's shares at the date of acquisition was ₦40 each. One month later the market value had increased to ₦45.

The costs of making the acquisition were ₦80,000.
₦700,000. The share price at the date of acquisition is used not that at the date of issue.

The costs of making the acquisition should be written off to profit or loss.

		N
Cost of investment (Cash Consideration)		300
Share exchange consideration		400
Total consideration		700
Parent share of net asset at acquisition	800 x 80%	(640)
Positive Goodwill at acquisition		60

Note Parent control subsidiary by 80%, therefore shares 80% of subsidiary net asset at the date of acquisition.

However, if an entity borrows money to finance an acquisition, the costs associated with arranging the borrowing are treated in accordance with the rules of IFRS 9. These costs are deducted from the value of the debt and amortised over the term of the debt using the effective rate of interest (i.e. the amortised cost method).

Deferred consideration

Sometimes all or part of the cost of an acquisition is deferred and does not become payable until a later date.

The amount of any deferred consideration (the amount not payable immediately) is discounted to its present value at the acquisition date and subsequently unwind by charging the interest (finance cost) against earnings.

Contingent consideration

Sometimes the final cost of the combination is contingent on (depends on) a future event. For example, an acquirer could agree to pay an additional amount if the acquired subsidiary's profits exceed a certain level within three years of the acquisition.

In a situation such as this, the contingent payment should be included in the cost of the combination (discounted to present value if the payment will occur more than 12 months in the future).

Under the rules of IFRS 3, contingent consideration must be recognised at fair value at acquisition, even if it is not probable that the consideration will actually have to be paid.

Example: Contingent consideration

Company X purchased 100% of the issued capital of Company S on 1 January Year 4.

The purchase agreement required Company X to pay ₦300,000 in cash immediately and an additional sum of ₦100,000 on 31 December Year 6 if the earnings of Company S increase at an annual rate of 25% per year in each of the three years following the acquisition.

How should the contingent payment be recognised in calculating the goodwill arising at the date of acquisition?

Answer

The contingent consideration should be included in the cost of investment (the purchase consideration) whether or not it is probable that it will have to be paid. The contingent consideration of ₦100,000 should be measured at fair value.

If it is fairly certain that the contingent consideration will have to be paid, an appropriate measure of fair value might be the present value of the future payment, discounted at an appropriate cost of capital. The purchase consideration is therefore ₦300,000 plus the present value of the contingent (deferred) consideration.

If there is still contingent consideration at the end of an accounting period, it might be necessary to re-measure it.

If the contingent consideration will be payable in cash, it should be re-measured

to fair value at the end of the reporting period. Any gain or loss on re-measurement should be taken to profit or loss.

If the contingent consideration will take the form of debt, the amount of the debt is re-measured at fair value at the end of the reporting period and the change in value is recognised in profit or loss in the period.

If the contingent consideration will take the form of equity, it is not re-measured at the end of the reporting period. The eventual settlement of the payment will be accounted for as an equity transaction (i.e. a transaction between the entity and owners of the group in their capacity as owners).

A reason for re-measuring the contingent consideration is that the amount payable might depend on the performance of the subsidiary after its acquisition.

If the profits are higher than expected, the contingent consideration might be re-measured to a higher value, increasing the liability (the contingent payment) and reducing the reported profit for the period.

Similarly if the profits are lower than expected, the contingent consideration might be re-measured to a lower value, reducing the liability (the contingent payment) and increasing the reported profit for the period.

(Note: Under the previous accounting rules, before the introduction of IFRS 3, any increase in the value of contingent consideration was charged to goodwill.).

Share options given to the previous owners

When an entity acquires a subsidiary that was previously managed by its owners, the previous owners might be given share options in the entity as an incentive to stay on and work for the subsidiary after it has been acquired. IFRS 3 states that the award of share options in these circumstances is not a part of the purchase consideration. The options are post-acquisition employment expenses and should be accounted for as share-based payments in accordance with IFRS 2.

3.5 Acquisition date, amounts of assets acquired and liabilities assumed

Core principle

An acquirer of a business must recognise assets acquired and liabilities assumed at their acquisition date fair values and disclose information that enables users to evaluate the nature and financial effects of the acquisition.

To support this IFRS 3R sets out:

- a recognition principle;
- classification guidance; with
- a measurement principle.

There are specified exceptions to each of these.

Any asset acquired or liability assumed is subsequently measured in accordance with applicable IFRS. There are also exceptions to this rule.

Recognition principle

An acquirer must recognise (separately from goodwill), identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree as of the acquisition date.

To qualify for recognition identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities set out in *The Conceptual Framework* as at the acquisition date.

This might result in recognition of assets and liabilities not previously recognised by the acquiree.

When a company acquires a subsidiary, it may identify intangible assets of the acquired subsidiary, which are not included in the subsidiary's statement of financial position. If these assets are separately identifiable and can be measured reliably, they should be included in the consolidated statement of financial position as intangible assets, and accounted for as such.

This can result in the recognition of assets and liabilities not previously recognised by the acquiree.

Illustration: Identifiable asset on acquisition

If a company bought 100% of the Coca-Cola Corporation, they would be buying a lot of assets but part (perhaps the largest part) of the purchase consideration would be to buy the Coca Cola brand.

Coca Cola does not recognise its own brand in its own financial statements because companies are not allowed to recognised internally generated brands.

However, as far as the company buying the Coca-Cola Corporation is concerned the brand is a purchased asset. It would be recognised in the consolidated financial statements and would be taken into account in the goodwill calculation.

Contingent liabilities

Many acquired businesses will contain contingent liabilities such as contingent liabilities for the settlement of legal disputes or for warranty liabilities. IFRS 3 states that contingent liabilities should be recognised at acquisition 'even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.'

The contingent liabilities should be measured at fair value at the acquisition date. (Contingent assets are not recognised).

Restructuring costs

An acquirer should not recognise a liability for the cost of restructuring a subsidiary or for any other costs expected to be incurred as a result of the acquisition (including future losses).

This is because a plan to restructure a subsidiary after an acquisition cannot be a liability at the acquisition date. For there to be a liability (and for a provision to be recognised) there must have been a past obligating event. This can only be the case if the subsidiary was already committed to the restructuring before the acquisition.

This means that the acquirer cannot recognise a provision for restructuring or reorganisation at acquisition and then release it to profit and loss in order to 'smooth profits' or reduce losses after the acquisition.

Measurement principle

Identifiable assets acquired and the liabilities assumed are measured at their acquisition date fair values.

Definition: Fair value

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.

The net assets of a newly acquired business are subject to a fair valuation exercise.

The table below shows how different types of asset and liability should be valued.

Item	Fair value
Marketable investments	Current market value
Non-marketable investments	Estimated values that take into consideration features such as: (a) price earnings ratios (b) dividend yield (c) expected growth rates of comparable investments
Trade and other receivables	Present values of the amounts to be received. This is normally the same as the book value. Discounting is not usually required because amounts are expected to be received within a few months.
Inventories: finished goods	Selling price less the sum of: (a) the costs of disposal, and (b) a reasonable profit allowance for the selling effort of the acquirer based on profit for similar finished goods.
Inventories: work in progress	Selling price of finished goods less the sum of: (a) costs to complete, (b) costs of disposal, and (c) a reasonable profit for the completing and selling effort based on profit for similar finished goods.
Inventories: raw materials	Current replacement costs
Land and buildings	Market value
Plant and equipment	Normally market value. Use depreciated replacement cost if market value cannot be used (e.g., because of the specialised nature of the plant and equipment or because the items are rarely sold, except as part of a continuing business).
Intangible assets	Described later.
Trade and other payables; long-term debt and other liabilities.	Present values of amounts to be disbursed in meeting the liability determined at appropriate current interest rates. For current liabilities this is normally the same as book value.

Exceptions

Note that this table only shows the exceptions to the above principles and guidance.

Topic	Recognition principle	Measurement at acquisition	Measurement at later dates
Contingent liability	Defined by IAS 37 and not recognised. Contingent liability due to a present obligation is recognised	Fair value	At the higher of the original amount and the amount that would be reported under IAS 37.
Income taxes	IAS 12 applies	IAS 12 applies	IAS 12 applies
Employee benefits	IAS 19 applies	IAS 19 applies	IAS 19 applies
Indemnification assets	This is a right to be compensated by the seller if a defined contingency occurs Recognition of the asset mirrors the recognition of the liability	Measurement of the asset mirrors the recognition of the liability	Measurement of the asset mirrors the recognition of the liability
Reacquired rights		Recognised as an intangible asset and measured on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value	The asset recognised is amortised over the over the remaining contractual period of the contract in which the right was granted.
Share based payments		IFRS 2 applies	
Assets held for sale		IFRS 5 applies	

Deferred tax

Deferred income tax assets and liabilities are recognised and measured in accordance with IAS 12 *Income Taxes*, rather than at their acquisition-date fair values.

Measurement period

Initial accounting for goodwill may be determined on a provisional basis and must be finalised by the end of a measurement period.

This ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed at the acquisition date but must not exceed one year from the acquisition date.

During the measurement period new information obtained about facts and circumstances that existed at the acquisition date might lead to the adjustment of provisional amounts or recognition of additional assets or liabilities with a corresponding change to goodwill.

Any adjustment restates the figures as if the accounting for the business combination had been completed at the acquisition date.

Classification guidance

Identifiable assets acquired and liabilities assumed must be classified (designated) as necessary at the acquisition date so as to allow subsequent application of appropriate IFRS.

The classification is based on relevant circumstances as at the acquisition date with two exceptions:

- classification of a lease contract in accordance with IFRS 16 *Leases*; and
- classification of a contract as an insurance contract in accordance with IFRS 17 *Insurance Contracts*.

Classification in these cases is based on circumstances at the inception of the contract or date of a later modification that would change the classification.

4 CONSOLIDATION TECHNIQUE

Section overview

- The basic approach
- Practice questions

4.1 The basic approach

Suggested step by step approach to the preparation of consolidated statements of financial position

To prepare a consolidated statement of financial position as at the acquisition date, the following steps should be taken.

Step 1: Establish the group share (parent company share) in the subsidiary and the percentage owned by non-controlling interests.

Step 2: Perform double entry to record any individual company adjustments that might be necessary. Mark these in the face of the question. The information can be lifted into workings later so that the marker can understand what you have done.

Step 3: Set out a pro-forma (skeleton) statement of financial position and fill in the easy numbers (for example those assets and liabilities that are a straight cross cast and the share capital)

Step 4: Calculate the net assets of the subsidiary S at the acquisition date and at the end of the reporting period taking into account information about the fair value of assets at the acquisition date and the existence of any assets not recognised by the subsidiary that might need to capitalise for consolidation purposes.

Step 5: Calculate the goodwill

Illustration: Goodwill (Full goodwill or FV method)

	₦
Consideration transferred (cost of the business combination)	X
Non-controlling interest	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed (measured in accordance with IFRS 3)	X
Goodwill or Gain on Bargain purchase recognised	X

Step 6: Calculate the non-controlling interest.

Illustration: Consolidated retained earnings

	₦
NCI at the date of acquisition	X
NCI's share of the post-acquisition retained earnings of S	X
NCI's share of each other post-acquisition reserves of S (if any)	X
NCI at the date of consolidation	X

Step 7: Calculate consolidated retained earnings.

Possible complications

You should be familiar with the following of possible complications that you may need to take into account when answering questions:

- ❑ Before consolidation
  - Measuring the cost of acquisition
  - Identifying assets not recognised by the subsidiary which need to be included for consolidation purposes
  - Performing the fair value exercise

Construct a net assets summary of each subsidiary showing net assets at the date of acquisition and at the reporting date.

- ❑ During consolidation
  - Mid-year acquisition – consolidation must be from the date of acquisition so you may need to construct a net assets total for a subsidiary at a point during the previous year.
  - Elimination of inter-company balances
  - Elimination of unrealised profit.
- ❑ After consolidation
  - Impairment testing goodwill
  - Accounting for a gain on a bargain purchase.

4.2 Practice questions

Practice question **1**

P acquired 70% of S on 1 January 20X1 for ₦450,000

The retained earnings of S were ₦50,000 at that date.

It is P's policy to recognise non-controlling interest at the date of acquisition as a proportionate share of net assets.

The statements of financial position P and S as at 31 December 20X1 were as follows:

Assets:	P (₦)	S(₦)
Investment in S, at cost	450,000	-
Other assets	500,000	350,000
	950,000	350,000
Equity		
Share capital	100,000	100,000
Retained earnings	650,000	100,000
	750,000	200,000
Current liabilities	200,000	150,000
	950,000	350,000

x

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **2**

P acquired 70% of S on 1 January 20X1 for ₦450,000

The retained earnings of S were ₦50,000 at that date.

It is P's policy to recognise non-controlling interest at the date of acquisition at fair value.

The fair value of the non-controlling interest at the date of acquisition was ₦75,000.

The statements of financial position P and S as at 31 December 20X1 were as follows:

Assets:	P (₦)	S(₦)
Investment in S, at cost	450,000	-
Other assets	500,000	350,000
	950,000	350,000
Equity		
Share capital	100,000	100,000
Retained earnings	650,000	100,000
	750,000	200,000
Current liabilities	200,000	150,000
	950,000	350,000

x

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **3**

P bought 80% of S 2 years ago.

At the date of acquisition S's retained earnings stood at ₦600,000. The fair value of its net assets was not materially different from the book value except for the fact that it had a brand which was not recognised in S's accounts. This had a fair value of 100,000 at this date and an estimated useful life of 20 years.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P	S
	₦	₦
PP and E	1,800,000	1,000,000
Investment in S	1,000,000	
Other assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Liabilities	200,000	200,000
	3,200,000	1,300,000

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **4**

P bought 80% of S 2 years ago.

At the date of acquisition S's retained earnings stood at ₦600,000 and the fair value of its net assets were ₦1,000,000. This was ₦300,000 above the book value of the net assets at this date.

The revaluation was due to an asset that had a remaining useful economic life of 10 years as at the date of acquisition.

The statements of financial position P and S as at 31 December 20X1 were as follows:

	P	S
	₦	₦
PP and E	1,800,000	1,000,000
Investment in S	1,000,000	
Other assets	400,000	300,000
	3,200,000	1,300,000
Share capital	100,000	100,000
Retained earnings	2,900,000	1,000,000
Liabilities	200,000	200,000
	3,200,000	1,300,000

Prepare a consolidated statement of financial position as at 31 December 20X1.

Practice question **5**

P acquired 70% of S on 1 January 20X1 for ₦1,000,000

The retained earnings of S were ₦50,000 at that date.

Also, at the date of acquisition S held an item of plant with a carrying amount of 250,000 less than its fair value. This asset had a remaining useful life of 10 years as from that date.

It is P's policy to recognise non-controlling interest at the date of acquisition as a proportionate share of net assets.

The statements of financial position of P and S as at 31 December 20X1 were as follows:

	P (₦)	S(₦)
Assets:		
Investment in S, at cost	1,000,000	-
Other non-current assets	400,000	200,000
Current assets	500,000	350,000
	1,900,000	550,000
Equity		
Share capital	100,000	100,000
Retained earnings	1,600,000	300,000
	1,700,000	400,000
Current liabilities	200,000	150,000
	1,900,000	550,000

Prepare a consolidated statement of financial position as at 31 December 20X1.

5 ACCOUNTING FOR GOODWILL

Section overview

- Accounting for goodwill
- Impairment testing of goodwill
- Negative goodwill and bargain purchases

5.1 Accounting for goodwill

Positive goodwill - Excess of cost of combination over share of net assets

After initial recognition goodwill is measured at cost less any accumulated impairment losses.

- Goodwill acquired in a business combination is not amortised.
- It is tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired, in accordance with *IAS 36, Impairment of Assets*.

Gain from a bargain purchase ("Negative goodwill")

A bargain purchase is a business combination in which the calculation of goodwill leads to a negative figure.

When this happens the acquirer must reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and must recognise any additional assets or liabilities that are identified in that review.

The acquirer must then review the procedures used to measure the amounts this IFRS requires to be recognised at the acquisition date for all of the following:

- the identifiable assets acquired and liabilities assumed;
- the non-controlling interest in the acquiree (if any); and
- the consideration transferred.

Any amount remaining after applying the above requirements is recognised as a gain in profit or loss on the acquisition date.

5.2 Impairment testing of goodwill

Purchased goodwill is not amortised, but must be tested for impairment on an annual basis. It cannot be tested for impairment directly. It is allocated to one or more cash generating unit (IAS 36) and then the carrying amount of the cash generating unit is compared to its recoverable amount.

The following discussion and examples assume that the subsidiary in question is a cash generating unit (CGU).

Partial goodwill method (NCI at acquisition measured as a proportionate share of subsidiary's net assets

Recoverable amount of the CGU is based on the cash flows that its assets are expected to generate (either through use or sale of the unit). These cash flows will be a function of all of the assets of the unit including the NCI's share of the goodwill but this latter figure has not been recognised.

The carrying amount of the NCI is made up of:

- the total net assets of the unit (parent's interest and NCI's); and
- the parent's interest in goodwill.

Any comparison of carrying amount to recoverable amount should compare like to like but the cash flows from the NCI's goodwill contribute to the recoverable amount but this goodwill is not in the carrying amount. IAS 36 requires a working that grosses up the carrying amount of the CGU's assets by the NCI share of goodwill. Note that this is only in a working; it is not part of the double entry.

This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.

Any impairment is charged against the goodwill in the first instance with any balance writing down other assets in the unit.

Only that part of any impairment loss attributable to the parent is recognised by the entity as a goodwill impairment loss.

Example: Impairment of goodwill

X plc paid ₦1,600 for an 80% interest in Y plc on 01/01/X1.

On this date Y had identifiable net assets with a fair value of ₦1,500.

Goodwill on acquisition:	₦
Cost of acquisition	1,600
Share of net assets (80% × ₦1,500)	(1,200)
Goodwill	400

The following amounts are recognised in the consolidated financial statements at the date of acquisition:

	₦
Goodwill	400
Asset	1,500
NCI (20% × 1,500)	300

This cash-generating unit includes goodwill within its carrying amount, so it must be tested for impairment annually (or more frequently if there is an indication that it may be impaired).

31/12/X1 – Impairment test

X plc estimates that the recoverable amount of Y plc is ₦1,400.

The net assets of Y plc (after fair value adjustments) were still ₦1,520.

Carrying amount of Y plc:	Goodwill	Asset	Total
As at 01/01/X1	400	1,500	1,900
Notional grossing up of goodwill 400 × $^{20}/_{80}$	100	-	100
	500	1,500	2,000
Recoverable amount			(1,520)
Impairment loss			480

The whole loss (480) is covered by the goodwill of 500 but only 80% of this is in the financial statements. Therefore only 80% of the loss is recognised

Allocation of impairment loss	**Notional write off**	**X plc share**	**X plc write off**
Goodwill (notional)	480	80%	384

Allocation of impairment loss	**Goodwill**	**Asset**	**Total**
As at 31/12/X1	400	1,500	1,900
Impairment loss	(384)		(384)
	16	1,500	1,516

Full goodwill method (NCI at acquisition measured at fair value

This is more straightforward.

If there is a NCI in a cash-generating unit to which goodwill has been allocated, the carrying amount of that unit is made up of:

- both the parent's interest and the NCI in the net assets of the unit; and
- both the parent's interest in goodwill and the NCI's interest in goodwill.

When non-controlling interests are valued by the fair value method, any impairment in the total goodwill after acquisition should be shared between the parent company shareholders and the NCI.

It is tempting to allocate the write off of goodwill between the parent and NCI in proportion to the goodwill attributable to each. However, para C6, Appendix C to IAS 36 says that the impairment should be "allocated between the parent and the NCI on the same basis as that on which profit or loss is allocated".

Example: Impairment of goodwill

S has 10 million shares of ₦1 each in issue. H acquired 80% of these shares at a price of ₦11.6 million when the net assets of S were ₦10 million. Prior to the acquisition, the shares of S had been trading in the stock market at ₦1.20 per share.

Suppose that subsequently goodwill is impaired in value by ₦1.5 million, so that it is now valued at just ₦2,500,000.

The impairment in the goodwill must be attributed to the parent company and the NCI in the according to the proportions used to allocate profit or loss (80:20).

Goodwill

	Total	Parent	NCI
	₦000	₦000	₦000
Purchase consideration	11,600	11,600	
Non-controlling interest (2m shares @ ₦1.2)	2,400		2,400
	14,000		
Fair value of net assets of subsidiary at acquisition	(10,000)	(8,000)	(2,000)
Goodwill	4,000	3,600	400
Impairment of goodwill:	(1,500)	(1,200)	(300)
	2,500	2,400	100

Note that the impairment is allocated 80:20 not 3,600:400 which might have been expected.

5.3 Negative goodwill and bargain purchases

A bargain purchase is a business combination in which the calculation of goodwill leads to a negative figure.

When this happens the acquirer must then review the procedures used to measure the amounts recognised at the acquisition date for all of the following:

- The identifiable assets acquired and liabilities assumed;
- The non-controlling interest in the acquiree (if any); and
- The consideration transferred.

Any amount remaining after applying the above requirements is recognised as a gain in profit or loss on the acquisition date and share between the parent and the NCI in their percentage holdings where the gain on bargain purchase is arrived based on the Full Goodwill method otherwise it is charged to the parent alone.

This means that in most cases when a bargain purchase occurs, the 'negative goodwill' should be added to the consolidated profit for the group for the year.

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you know how to:

- Explain and discuss in detail the requirements of IFRS 3 with regard to the calculation of goodwill
- Define using examples subsidiary, parent and control
- Explain the concept of control as set out in IFRS 10
- Describe situations when control is presumed to exist
- Identify and describe the circumstances in which an entity is required to prepare and present consolidated financial statements
- Prepare a consolidated statement of financial position including the fair value exercise and the elimination of inter-company balances and accounting for unrealised profit
- Account for goodwill including impairment testing
- Account for gain on a bargain purchase (negative goodwill)

SOLUTIONS TO PRACTICE QUESTIONS

Solution (continued) **1**

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post acq^{n}
Share capital	100,000	100,000	
Retained earnings	100,000	50,000	50,000
Net assets	200,000*	150,000	

W2 Non-controlling interest

	₦
NCI's share of net assets at the date of acquisition (30% × 150,000 (W1))	45,000
NCI's share of the post-acquisition retained earnings of S (30% of 50,000 (W1))	15,000
NCI's share of net assets at the date of consolidation	60,000

Alternative working

NCI's share of net assets at the date of consolidation (30% × 200,000*)	60,000

W3 Goodwill

	₦
Cost of investment	450,000
Non-controlling interest at acquisition (see W2)	45,000
	495,000
Net assets at acquisition (W1)	(150,000)
	345,000

W4 Consolidated retained profits:

	₦
All of P's retained earnings	650,000
P's share of the post-acquisition retained earnings of S (70% of 50,000 (W1))	35,000
	685,000

Solution **2**

P Group: Consolidated statement of financial position at 31 December 20X1

	₦
Assets	
Goodwill (W3)	375,000
Other assets (500 + 350)	850,000
Total assets	1,225,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	685,000
	785,000
Non-controlling interest (W2)	90,000
	875,000
Current liabilities (200 + 150)	350,000
Total equity and liabilities	1,225,000

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post acqn
Share capital	100,000	100,000	
Retained earnings	100,000	50,000	50,000
Net assets	200,000*	150,000	

W2 Non-controlling interest

	₦
Fair value of NCI at the date of acquisition	75,000
NCI's share of the post-acquisition retained earnings of S (30% of 50,000 (W1))	15,000
NCI's share of net assets at the date of consolidation	90,000

W3 Goodwill

	₦
Cost of investment	450,000
Non-controlling interest at acquisition (given)	75,000
	525,000
Net assets at acquisition (W1)	(150,000)
	375,000

W4 Consolidated retained profits:

	₦
All of P's retained earnings	650,000
P's share of the post-acquisition retained earnings of S (70% of 50,000 (W1))	35,000
	685,000

Solution **3**

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

P Group: Consolidated statement of financial position at 31 December 20X1

	₦
Assets	
Brand (see working)	90,000
Goodwill (see working)	360,000
Property, plant and equipment (1,800 + 1000)	2,800,000
Other assets (400 + 300)	700,000
Total assets	3,950,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (see working)	3,212,000
	3,312,000
Non-controlling interest	238,000
	3,550,000
Current liabilities (200 + 200)	400,000
Total equity and liabilities	3,950,000

Workings:

Net assets summary of S

	At date of consolidation	At date of acquisition	Post acq^{n}
Share capital	100,000	100,000	
Retained earnings			
Given in the question	1,000,000	600,000	
Extra depreciation on brand ($100{,}000 \times {}^{2\text{ years}}/_{20\text{ years}}$)	(10,000)	–	
	990,000	600,000	390,000
Consolidation reserve on recognition of the brand	100,000	100,000	
Net assets	1,190,000	800,000	

Non-controlling interest	₦
NCI's share of net assets at the date of acquisition (20% × 800,000)	160,000
NCI's share of the post-acquisition retained earnings of S (20% of 390,000 (see above))	78,000
NCI's share of net assets at the date of consolidation	238,000

Solution (continued) **3**

Goodwill	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (20% × 800,000)	160,000
	1,160,000
Net assets at acquisition (see above)	(800,000)
	360,000

Consolidated retained profits:	₦
All of P's retained earnings	2,900,000
P's share of the post-acquisition retained earnings of S (80% of 390,000 (see above))	312,000
	3,212,000

Brand	₦
On initial recognition	100,000
Amortization since acquisition (100,000 × $^{2\text{ years}}/_{20\text{ years}}$)	(10,000)
	90,000

Solution **4**

P Group: Consolidated statement of financial position at 31 December 20X1

	₦
Assets	
Goodwill (see working)	200,000
PP and E (see working)	3,040,000
Other assets (400,000 + 300,000)	700,000
Total assets	3,940,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (see working)	3,172,000
	3,272,000
Non-controlling interest	268,000
	3,540,000
Current liabilities (200 + 200)	400,000
Total equity and liabilities	3,940,000

Solution (continued) **4**

	At date of consolidation	At date of acquisition	Post acqn
Share capital	100,000	100,000	
Retained earnings			
Given in the question	1,000,000	600,000	
Extra depreciation on fair value adjustment (300 × 2 years/10 years) – *see explanation on next page*	(60,000)	–	
	940,000	600,000	340,000
Fair value reserve	300,000	300,000	
Net assets	1,340,000	1,000,000	

Non-controlling interest	₦
NCI's share of net assets at the date of acquisition (20% × 1,000)	200,000
NCI's share of the post-acquisition retained earnings of S (20% of 340 (see above))	68,000
NCI's share of net assets at the date of consolidation	268,000

Goodwill	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (20% × 1,000)	200,000
	1,200,000
Net assets at acquisition (see above)	(1,000,000)
	200,000

Consolidated retained profits:	₦
All of P's retained earnings	2,900,000
P's share of the post-acquisition retained earnings of S (80% of 340 (see above))	272,000
	3,172,000

Solution (continued) **4**

Property plant and equipment	₦
Parent's	1,800
Subsidiary's	
Given in question	1,000
Fair value adjustment	300
Extra depreciation on fair value adjustment ($300 \times {}^{2\text{ years}}/_{10\text{ years}}$)	(60)
	1,240
To statement of financial position	3,040

Solution **5**

P Group: Consolidated statement of financial position at 31 December 20X1

Assets	₦
Goodwill (W3)	720,000
Other non-current assets (400 + (200 + 250 – 25))	825,000
Other assets (500 + 350)	850,000
Total assets	2,395,000
Equity	
Share capital (P only)	100,000
Consolidated retained earnings (W4)	1,757,500
	1,857,500
Non-controlling interest (W2)	187,500
	2,045,000
Current liabilities (200 + 150)	350,000
Total equity and liabilities	2,395,000

Solution **5**

Workings:

W1 Net assets summary

	At date of consolidation	At date of acquisition	Post acq^{n}
Share capital	100,000	100,000	
Retained earnings			
Given in the question	300,000	50,000	
Extra depreciation on fair value adjustment (250 × $^{1\ years}/_{10\ years}$)	(25,000)	–	
	275,000	50,000	225,000
Fair value reserve	250,000	250,000	
Net assets	625,000	400,000	

W2 Non-controlling interest

	₦
NCI's share of net assets at the date of acquisition (30% × 400)	120,000
NCI's share of the post-acquisition retained earnings of S (30% of 225 (W1))	67,500
NCI's share of net assets at the date of consolidation	187,500

W3 Goodwill

	₦
Cost of investment	1,000,000
Non-controlling interest at acquisition (W2)	120,000
	1,120,000
Net assets at acquisition (see above)	(400,000)
	720,000

W4 Consolidated retained profits:

	₦
All of P's retained earnings	1,600,000
P's share of the post-acquisition retained earnings of S (70% of 225 (W1))	157,500
	1,757,500

CHAPTER 21

Consolidated statements of profit or loss and other comprehensive income

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

C	Group financial statements		
	2	Preparation of group financial statement of a complex group	
		b	Determine and apply appropriate procedures to be used in preparing group financial statements.
		c	Determine, apply and disclose from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of acquisitions achieved one time or in stages involving subsidiaries, associates and joint ventures.
		h	Prepare group financial statements where necessary in (c) to (g) above.

This chapter does not cover the above competencies in their entirety. It covers that part of the above competencies that involve new and existing investments in subsidiaries.

IFRS 3 and IFRS 10 are examinable documents.

Exam context

This chapter allows you to revise consolidated statements of profit or loss and other comprehensive income. The content of this chapter is a vital foundation for understanding more complex areas of consolidation for example disposals of a subsidiary and the consolidation of subsidiaries the functional currency of which differs from that presentation currency of the consolidated financial statements.

At the end of this chapter, you should be able to:

- Prepare a consolidated statement of comprehensive income;
- Eliminate the results of inter-company transactions on consolidation;
- Eliminate unrealised profit on consolidation; and
- Incorporate fair value adjustments during consolidation.

1 CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Section overview

- Consolidated statement of profit or loss: the basic rules
- Inter-company items
- Other adjustments
- Pre- and post-acquisition profits

1.1 Consolidated statement of profit or loss: the basic rules

A consolidated statement of profit or loss brings together the sales revenue, income and expenses of the parent and the sales revenue, income and expenses of its subsidiaries.

Similarly a consolidated statement of other comprehensive income brings together the gains and losses of the parent and the gains and losses of its subsidiaries.

In the consolidated statements, all items of income, expenses, gains and losses are a straight cross cast of equivalent items in the individual financial statements of the members of the group.

Non-controlling interest

Consolidated financial statements must also disclose the profit or loss for the period and the total comprehensive income for the period attributable to:

- owners of the parent company; and
- non-controlling interests.

The figure for NCI is simply their share of the subsidiary's profit for the year that has been included in the consolidated statement of comprehensive income.

The amounts attributable to the owners of the parent and the non-controlling interest are shown as a metric (small table) immediately below the statement of comprehensive income.

Illustration: Amounts attributable to the owners of the parent and the non-controlling interest

Total comprehensive income attributable to:	₦
Owners of the parent (balancing figure)	X
Non-controlling interests (x% of y)	X
	X

Where: x% is the NCI ownership interest

y is the subsidiary's profit for the year that has been included in the consolidated statement of comprehensive income

1.2 Inter-company items

Consolidated statements of profit or loss are prepared by combining the information given in the statements of profit or loss of the individual companies.

It is usually necessary to make adjustments to eliminate the results of inter-company trading. This includes adjustments to cancel out inter-company trading balances and unrealised profit.

Inter-company trading

Inter-company trading will be included in revenue of one group company and purchases of another. These are cancelled on consolidation.

Illustration:

	Debit	Credit
Revenue	X	
Cost of sales (actually purchases within cost of sales)		X

Unrealised profits on trading

If any items sold by one group company to another are included in inventory (i.e. have not been sold on outside the group by the year end), their value must be adjusted to lower of cost and net realisable value from the group viewpoint (as for the consolidated statement of financial position).

This is an inventory valuation adjustment made in the consolidated financial statements.

Illustration:

	Debit	Credit
Closing inventory – Statement of comprehensive income	X	
Closing inventory – Statement of financial position		X

The adjustment in the statement of comprehensive income reduces gross profit and hence profit for the year. The NCI share in this reduced figure and the balance is added to retained earnings. Thus, the adjustment is shared between both ownership interests.

If the sale is from S to P the unrealised profit adjustment must be shared with the NCI.

Inter-company management fees and interest

All other inter-company amounts must also be cancelled.

Where a group company charges another group company, management fees/interest, there is no external group income or external group expense and they are cancelled one against the other like inter-company sales and cost of sales.

Illustration:

	Debit	Credit
Income (management fees)	X	
Expense (management charges)		X

Inter-company dividends

The parent may have accounted for dividend income from a subsidiary. This is cancelled on consolidation.

Dividends received from a subsidiary are ignored in the consolidation of the statement of comprehensive income because the profit out of which they are paid has already been consolidated.

1.3 Other adjustments

Fair value adjustments

Depreciation is charged on the carrying amount of assets.

If a depreciable asset is revalued on consolidation the depreciation stream that relates to that asset will also need to be revalued.

This adjustment is carried out in the financial statements of the subsidiary. It will affect the subsidiary's profit after tax figure and therefore will affect the NCI.

Accounting for Impairment of goodwill

When purchased goodwill is impaired, the impairment does not affect the individual financial statements of the parent company or the subsidiary. The effect of the impairment applies exclusively to the consolidated statement of financial position and the consolidated income statement.

If goodwill is impaired:

- It is written down in value in the consolidated statement of financial position, and
- The amount of the write-down is charged as an expense in the consolidated income statement (normally in administrative expenses).

Practice question **1**

P acquired 80% of S 3 years ago. Goodwill on acquisition was 80,000. The recoverable amount of goodwill at the year-end was estimated to be 65,000. This was the first time that the recoverable amount of goodwill had fallen below the amount at initial recognition.

S sells goods to P. The total sales in the year were 100,000. At the year-end P retains inventory from S which had cost S 30,000 but was in P's books at 35,000.

It is the policy of P to include in the distribution costs of S depreciation of an asset which had been subject to a fair value increase of 100,000 on acquisition. This asset is being written off on a straight line basis over 10 years.

The statements of profit or loss for the year to 31 December 20X1 are as follows:

	P	S
	₦(000)	₦(000)
Revenue	1,000	800
Cost of sales	(400)	(250)
Gross profit	600	550
Distribution costs	(120)	(75)
Administrative expenses	(80)	(20)
	400	455
Dividend from S	80	-
Finance cost	(25)	(15)
Profit before tax	455	440
Tax	(45)	(40)
Profit for the period	410	400

Prepare the consolidated income statement for the year ended 31 December.

1.4 Pre- and post-acquisition profits

A change in ownership in the period will have an impact on the consolidated statement of profit or loss and other comprehensive income.

The financial statements of a subsidiary must be consolidated from the date control is achieved until the date that control is lost. In other words, the pattern of ownership must be reflected in the statement of profit or loss and other comprehensive income.

- All of an entity's results are consolidated if it is controlled for the whole year
- If an entity is controlled for only part of the year, only those results that relate to that part of the year are consolidated.

For example, if a parent acquires a subsidiary **during** a financial year, the profits of the subsidiary have to be divided into pre-acquisition and post-acquisition and only post acquisition profits are consolidated.

The following straightforward example is of a type that you have seen in previous papers. Later chapters on step acquisitions and disposals will show more complex applications of the principle.

Example: Consolidated statement of profit or loss (mid-year acquisition)

Entity P acquired 80% of S on 1 October 20X1.

The statements of profit or loss for the year to 31 December 20X1 are as follows:

	P	S
	₦	₦
Revenue	400,000	260,000
Cost of sales	(200,000)	(60,000)
Gross profit	200,000	200,000
Other income	20,000	-
Distribution costs	(50,000)	(30,000)
Administrative expenses	(90,000)	(95,000)
Profit before tax	80,000	75,000
Income tax expense	(30,000)	(15,000)
Profit for the period	50,000	60,000

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	P	S ($^{3}/_{12}$)	Consolidated
	₦	₦	₦
Revenue	400,000	65,000	465,000
Cost of sales	(200,000)	(15,000)	(215,000)
Gross profit	200,000	50,000	250,000
Other income	20,000	–	20,000
Distribution costs	(50,000)	(7,500)	(57,500)
Administrative expenses	(90,000)	(23,750)	(113,750)
Profit before tax	80,000	18,750	98,750
Income tax expense	(30,000)	(3,750)	(33,750)
Profit for the period	50,000	15,000	65,000

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	62,000
Non-controlling interests (20% of 15,000)	3,000
	65,000

2 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Prepare a basic consolidated statement of comprehensive income

SOLUTIONS TO PRACTICE QUESTIONS

Solutions **1**

Consolidated statement of comprehensive income for the year ended 31 December.

	Workings				
	P	**S**	**Dr**	**Cr**	**Consol.**
	₦(000)	₦(000)	₦(000)	₦(000)	₦(000)
Revenue	1,000	800	(100)		1,700
Cost of sales	(400)	(250)	[3](5)	100	(555)
Gross profit	600	550	(105)	100	1,145
Distribution costs	(120)	(75)			
Fair value adjustment		[1](10)			
	(120)	(85)			(205)
Administrative expenses	(80)	(20)	[2](15)		(115)
	400	445			
Dividend from S	80	-	(80)		
Finance cost	(25)	(15)			(40)
Profit before tax	455	430			785
Tax	(45)	(40)			(85)
Profit for the period	410	390	(200)	100	700

Total comprehensive income attributable to:	₦(000)
Owners of the parent (balancing figure)	633
Non-controlling interests (20% of 390,000) – (20% of [3]5,000)	77
	700

Notes:

1: Extra depreciation on fair value adjustment ($^{100}/_{10\text{ years}}$)

2: Goodwill impairment

3: Unrealised profit

Alternative approach to determine the NCI post acquisition profit.

S Post acq profit	390,000
Unrealized profit	(5,000)
Adjusted post acq. profit	385,000
NCI's share of post acq.profit	20% of 385,000=77,000.

Professional level
Corporate Reporting

CHAPTER 22

Associates and joint ventures

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

C	Group financial statements		
	1	**Introduction to consolidating complex group structure**	
		a	Identify and discuss complex group relationships including the criteria used to identify a subsidiary and an associate.
		c	Identify and discuss the criteria used to determine how different types of investments are recognised and measured.
		f	Outline and apply the key definitions and accounting methods relating to interests in associates and joint arrangements.
	2	**Preparation of group financial statement of a complex group**	
		c	Determine, apply and disclose from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of acquisitions achieved one time or in stages involving subsidiaries, associates and joint ventures.
		h	Prepare group financial statements where necessary in (c) to (g) above.

Competencies

C **Preparation and presentation**

1 **Preparing and reporting information for financial statements and notes:**

1(a) Prepare and present extracts from the financial statements of a single entity undertaking a variety of transactions on the basis of chosen accounting policies and in accordance with IFRS and local regulations.

1(b) Identify from a given scenario a subsidiary, associate or joint venture according to international standards and local regulation.

1(c) Calculate from given data and information the amounts to be included in an entity's consolidated financial statements arising from existing, new or discontinuing activities or interests (excluding any part disposal) in subsidiaries, associates or joint ventures in accordance with IFRS and local regulations.

This chapter does not cover the above competencies in their entirety. It covers that part o the above competencies that involve associates and joint ventures and transactions involving associates and joint ventures.

IAS 28 and IFRS 11 are examinable documents.

Exam context

This chapter explains the accounting rules for joint operations, joint ventures and associates.

At the end of this chapter, you should be able to:

- Define and explain the differences between a joint operation, a joint ventures and an associate;
- Account for joint operations;
- Explain equity accounting;
- Measure investment in an associate or joint venture for inclusion in the statement of financial position using equity accounting;
- Measure share of profit of an associate or joint venture for inclusion in the statement of comprehensive income; and
- Account for unrealised profit on transactions between an associate or joint venture and its parent or a member of the parent's group.

1 IFRS 11: JOINT ARRANGEMENTS

Section overview

- Introduction
- Joint arrangements
- Types of joint arrangements
- Accounting for joint operations and joint ventures

1.1 Introduction

A controlling interest in an investee results in an investment (a subsidiary) which is consolidated.

An interest in the equity shares of another company that gives no influence is accounted for as follows:

- The shares are shown in the statement of financial position as long-term assets (an investment) and valued in accordance with IFRS 9; and
- Any dividends received for the shares are included in profit or loss for the year as other income.

Other investments might result in joint control or significant influence. The rules for accounting for these are given in:

- ***IFRS 11 Joint Arrangements***: and
- ***IAS 28 Investments in Associates and Joint ventures***.

This session introduces the rules on accounting for joint arrangements.

1.2 Joint arrangements

Definition

A **joint arrangement** is an arrangement of which two or more parties have joint control.

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

A joint arrangement has the following characteristics:

- The parties are bound by a contractual arrangement; and
- The contractual arrangement gives two or more of those parties joint control of the arrangement.

Definition

A **party to a joint arrangement** is an entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

Contractual arrangement

Any contractual arrangement will usually be evidenced in writing, usually in the form of a contract or documented discussions between the parties.

A joint arrangement might be structured through a separate vehicle in which case some aspects of the contractual arrangement might be incorporated in its articles, charter or by-laws.

Any contractual arrangement sets out the terms upon which the parties participate in the activity that is the subject of the arrangement and would generally deal with such matters as:

- the purpose, activity and duration of the joint arrangement;
- how the members of the board of directors, or equivalent governing body, of the joint arrangement, are appointed;
- the decision-making process (the matters requiring decisions from the parties, the voting rights of the parties and the required level of support for those matters);
- the capital or other contributions required of the parties; and
- how the parties share assets, liabilities, revenues, expenses or profit or loss relating to the joint arrangement.

Joint control

IFRS 11 states that decisions about the relevant activities require unanimous consent of all parties that collectively control the arrangement. It is not necessary for every party to the arrangement to agree in order for unanimous consent to exist. This requires agreement by only those parties that collectively control the arrangement.

Day to day decision making might be delegated to a manager or to one of the parties to the arrangement. In such cases, the situation would need to be analysed to decide whether, in fact, decisions require the unanimous agreement of the interested parties. Such an arrangement is still a joint arrangement when the manager executes the policy decisions that have been agreed unanimously by the investors.

Example: Joint control

In each of the following scenarios three entities A, B and C establish an arrangement.

Decisions about relevant activities	Scenario 1 Require the unanimous consent of A, B and C	Scenario 2 Require at least 75% of voting rights	Scenario 3 Require at least 75% of voting rights
Ownership interest			
A	50%	50%	50%
B	30%	30%	25%
C	20%	20%	25%

Required

For each scenario, analyse whether a joint arrangement exists and which parties have joint control.

Answer

Scenario 1

A, B and C have joint control of the arrangement and each must account for its investment according to IFRS 11.

Scenario 2

Although A can block any decision, it does not control the arrangement because it needs the agreement of B.

A and B have joint control of the arrangement. The terms of their contractual arrangement requiring at least 75% of the voting rights to make decisions about the relevant activities imply that A and B have joint control of the arrangement because decisions about the relevant activities of the arrangement cannot be made without both A and B agreeing.

A and B must each account for its investment according to IFRS 11.

C is a party to a joint arrangement but has no control.

Scenario 3

The arrangement can be controlled by A with B or by A with C. This means that no party can be said to have joint control.

In order for this to be a joint arrangement the contractual terms would have to specify which combination of parties is required to agree about the relevant activities.

IFRS 11 does not apply to this investment.

1.3 Types of joint arrangements

There are two types of joint arrangement. A joint arrangement is either a joint operation or a joint venture.

Definition

A **joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.

A joint venture is a joint arrangement where the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers.

This classification depends on the rights and obligations of the parties to the arrangement.

Investors may or may not establish a joint arrangement as a separate vehicle.

Definition

A **separate vehicle** is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

The application guidance to IFRS 11 says that if a joint arrangement **is not** structured through a separate vehicle it must be a joint operation.

If a joint arrangement **is** structured through a separate vehicle it could be a joint operation or a joint venture.

For a joint arrangement to be a joint venture it is the separate vehicle that must have the rights to the assets and the obligations to the liabilities with the investor only having an interest in the net assets of the entity. If an investor has a direct interest in specific assets and direct obligation for specific liabilities of the separate vehicle then the joint arrangement is a joint operation.

1.4 Accounting for joint operations and joint ventures

The method of accounting for an interest in a joint arrangement depends on what type of joint arrangement it is.

Joint operations

A joint operator must recognise the following in its own financial statements:

- its assets, including its share of any assets held jointly;
- its liabilities, including its share of any liabilities incurred jointly;
- its revenue from the sale of its share of the output arising from the joint operation;
- its share of the revenue from the sale of the output by the joint operation; and
- its expenses, including its share of any expenses incurred jointly.

If an entity participates in, but does not have joint control of a joint operation but has rights to the assets, and obligations for the liabilities, relating to the joint operation it must also apply the above accounting treatment.

If an entity participates in, but does not have joint control of a joint operation and also does not have rights to the assets, and obligations for the liabilities, relating to the joint operation it must account for its interest in the joint operation in accordance with the IFRSs applicable to that interest.

When an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes a business (as defined in IFRS 3), it must apply the principles on business combinations accounting in IFRS 3.

This applies to the acquisition of both the initial interest and additional interests in a joint operation.

The principles on business combinations include:

- the measurement of identifiable assets and liabilities at fair value;
- expensing acquisition-related costs;
- recognising goodwill; and
- impairment testing goodwill.

Joint ventures

A joint venturer must recognise its interest in a joint venture as an investment and account for it using the equity method in accordance with IAS 28 *Investments in*

Associates and Joint Ventures unless the entity is exempted from applying the equity method as specified in that standard.

If an entity participates in, but does not have joint control of a joint operation it must account for its interest in the arrangement in accordance with IFRS 9 Financial Instruments, unless it has significant influence over the joint venture, in which case it must account for it in accordance with IAS 28.

Example – Accounting for a joint operation

On 1 January 20X7, X and Y entered into a joint operation to purchase and operate an oil pipeline.

Both entities contributed equally to the purchase cost of ₦20 million and this was financed by a joint loan of ₦20,000,000.

Contract terms

Y carries out all maintenance work on the pipeline but maintenance expenses are shared between B and C in the ratio 40%: 60%.

Both entities use the pipeline for their own operations and share any income from third parties 50%: 50%. Sales to third parties are invoiced by Y.

The full interest on the loan is initially paid by X but the expense is to be shared equally.

During the year ended 31 December 20X7

Y carried out maintenance at a cost of ₦1,200,000.

Income from third parties was ₦900,000, all paid to Y.

Interest of ₦1,500,000 was paid for the year on 31 December by X.

Required

Show the relevant figures that would be recognised in the financial statements of X and Y for the year to 31 December 20X7.

Answer

	Total amount	In X financial statements	In Y financial statements
Statement of financial position	₦	₦	₦
Jointly-controlled assets			
Property, plant and equipment			
Cost	20,000,000	10,000,000	10,000,000
Share of liabilities incurred			
Bank loan	20,000,000	10,000,000	10,000,000
Current: account with Y (owed by Y) – see workings		720,000	
Current: account with X (owed to X) – see workings			720,000
Share of revenue			
Income from third parties (50:50)	900,000	450,000	450,000
Share of expenses			
Maintenance costs (40:60)	1,200,000	480,000	720,000
Interest on loan (50:50)	1,500,000	750,000	750,000
	2,700,000	1,230,000	1,470,000
Workings			
Statement of profit or loss			
Income from third parties (50:50)	900,000	450,000	450,000
Maintenance costs (40:60)	1,200,000	480,000	720,000
Interest on loan (50:50)	1,500,000	750,000	750,000
	(2,700,000)	(1,230,000)	(1,470.000)
	(1,800,000)	(780,000)	(1,020.000)
Cash expense		(1,500,000)	(1,200,000)
Cash collected			900,000
Net cash expense		(1,500,000)	(300,000)
Cash due to X from Y		720,000	(720,000)

2 IAS 28: INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

Section overview

- Associates and joint ventures
- Accounting for associates and joint ventures
- Trading with an associate or joint venture

2.1 Associates and joint ventures

Definition

An **associate** is an entity over which the investor has significant influence.

Significant influence

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control of those policies.

- IAS 28 states that if an entity holds 20% or more of the voting power (equity) of another entity, it is presumed that significant influence exists, and the investment should be treated as an associate.
- If an entity owns less than 20% of the equity of another entity, the normal presumption is that significant influence does not exist.

Holding 20% to 50% of the equity of another entity therefore means as a general rule that significant influence exists, but not control; therefore the investment is treated as an associate, provided that it is not a joint venture.

The '20% or more' rule is a general guideline, however, and IAS 28 states more specifically how significant influence arises. The existence of significant influence is usually evidenced in one or more of the following ways:

- Representation on the board of directors;
- Participation in policy-making processes, including participation in decisions about distributions (dividends);
- Material transactions between the two entities;
- An interchange of management personnel between the two entities; or
- The provision of essential technical information by one entity to the other.

2.2 Accounting for associates and joint ventures

IAS 28 states that associates and joint ventures must be accounted for using the equity method.

The **equity method** is defined as a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets.

The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.

Statement of financial position: investment in the associate

In the statement of financial position of the reporting entity (the investor), an investment in an associate is measured at:

Illustration: Equity method

	₦
Cost of investment	X
Plus/(Minus): Parent's share of profits (losses) of the associate (or JV) since acquisition	X
Plus/(Minus): Parent's share of OCI of the associate (or JV) since acquisition	X
Minus any impairment of the investment recognised	(X)
	X

There is no goodwill-recognised for an investment in an associate.

The accumulated profits of the reporting entity (or the consolidated accumulated reserves when consolidated accounts are prepared) should include the investor's share of the post-acquisition retained profits of the associate (or JV), (**minus** any impairment in the value of the investment since acquisition). This completes the other side of the entry when the investment is remeasured.

Similarly any other reserve of the reporting entity (or any other consolidated reserves when consolidated accounts are prepared) should include the investor's share of the post-acquisition movement in the reserve of the associate (or JV).

Statement of profit or loss and other comprehensive income

In the statement of profit or loss and other comprehensive income, there should be separate lines for:

- 'Share of profits of associate (or JV)' in the profit and loss section of the statement; and
- 'Share of other comprehensive income of associate (or JV)' in the 'other comprehensive income' section of the statement.

Example: Equity method

Entity P acquired 30% of the equity shares in Entity A during Year 1 at a cost of ₦147,000 when the fair value of the net assets of Entity A was ₦350,000.

Entity P is able to exercise significant influence over Entity A.

At 31 December Year 5, the net assets of Entity A were ₦600,000.

In the year to 31 December Year 5, the profits of Entity A after tax were ₦80,000.

The figures that must be included to account for the associate in the financial statements of Entity P for the year to 31 December Year 5 are as follows:

Statement of financial position:

The investment in the associate is as follows:

	₦
Investment at cost	147,000
Investor's share of post-acquisition profits of A (**W1)**	75,000
Investment in the associate	222,000

W1 Retained post-acquisition profits of Entity A	₦
Net assets of the associate at 31 December Year 5	600,000
Net assets of Entity A at date of acquisition of shares	(350,000)
Retained post-acquisition profits of Entity A	250,000
Entity P's share of A	30%
Entity P's share of A's profits since the date of acquisition	₦75,000

Note: ₦75,000 will be included in the accumulated profits of Entity P

The journal to achieve the re-measurement is

Dr Cost ₦75,000 and Cr Accumulated profits ₦75,000

Statement of profit or loss

The share of the associate's after-tax profit for the year is shown on a separate line as:

Share of profits of associate (30% × ₦80,000): ₦24,000.

Practice question **1**

Entity P acquired 40% of the equity shares in Entity A during Year 1 at a cost of ₦128,000 when the fair value of the net assets of Entity A was ₦250,000.

Since that time, the investment in the associate has been impaired by ₦8,000.

Since acquisition of the investment, there has been no change in the issued share capital of Entity A, nor in its share premium reserve or revaluation reserve.

On 31 December Year 5, the net assets of Entity A were ₦400,000.

In the year to 31 December Year 5, the profits of Entity A after tax were ₦50,000.

What figures would be included for the associate in the financial statements of Entity P for the year to 31 December Year 5?

2.3 Trading with an associate or joint venture

There might be trading between a parent and an associate (or JV). If in addition to the associate (or JV) the parent holds investments in subsidiaries there might also be trading between other members of the group and the associate (or JV).

In such cases there might be:

- Inter-company balances (amounts owed between the parent (or group) and the associate (or JV) in either direction); and
- Unrealised profit on inter-company transactions.

The accounting rules for dealing with these items for associate (or JVs) are different from the rules for subsidiaries.

Inter-company balances

Inter-company balances between the members of a group (parent and subsidiaries) are cancelled out on consolidation.

Inter-company balances between the members of a group (parent and subsidiaries) and associates (or JVs) ***are not cancelled out*** on consolidation. An associate (or JV) is not a member of the group but is rather an investment made by the group. This means that it is entirely appropriate that consolidated financial statements show amounts owed by the external party as an asset and amount owed to the external party as a liability.

This is also the case if a parent has an associate (or JV) and no subsidiaries. The parent must equity account for the investment. Once again, it is entirely appropriate that consolidated financial statements show amounts owed by the external party as an asset and amount owed to the external party as a liability.

Unrealised inter-group profit

Unrealised inter-company (intra-group) profit between a parent and a member of a group must be eliminated in full on consolidation.

For unrealised profit arising on trade between a parent and associate (or JV***)*** ***only the parent's share*** of the unrealised profit is eliminated.

IAS 28 does not specify the double entry to achieve this.

The following are often used in practice

Parent sells to associate (or JV):

- The unrealised profit is held in inventory of the associate (or JV). The investment in the associate (or JV) should be reduced by the parent's share of the unrealised profit.
- The other side of the entry increases cost of sales

Illustration: Unrealised profit double entry when parent sells to associate

	Debit	Credit
Cost of sales/Retained earning	X	
Investment in associate		X

Associate (or JV) sells to parent:

- The unrealised profit is held in inventory of the parent and this should be reduced in value by the parent's share of the unrealised profit.
- The other side of the entry reduces the parent's share of the profit of the associate (or JV).

Illustration: Unrealised profit double entry when associate sells to parent

	Debit	Credit
Share of profit of associate	X	
Inventory		X

In both cases, there will also be a reduction in the post-acquisition profits of the associate (or JV), and the investor entity's share of those profits (as reported in profit or loss). This will reduce the accumulated profits in the statement of financial position.

Example: Unrealised profit

Entity P acquired 40% of the equity shares of Entity A several years ago. The cost of the investment was ₦205,000.

As at 31 December Year 6 Entity A had made profits of ₦275,000 since the date of acquisition.

In the year to 31 December Year 6, Entity P sold goods to Entity A at a sales price of ₦200,000 at a mark-up of 100% on cost.

Goods which had cost Entity A ₦30,000 were still held as inventory by Entity A at the year-end.

The necessary adjustments for unrealised profit, and the double entries are as follows:

Unrealised profit adjustment	₦
Inventory sold by P to A	200,000
Profit on the sale (× 100%/200%)	100,000
Unrealised profit (× ₦30,000x100/200	15,000
Entity P's share (40%)	6,000

Double entries:	Dr(₦)	Cr(₦)
Investment in associate	110,000	
Accumulated profits		110,000
Being: Share of post-acquisition profits (40% of ₦275,000)		

	Dr(₦)	Cr(₦)
Cost of sales (hence accumulated profit)	6,000	
Investment in associate		6,000
Being: Elimination of share of unrealised profit (see above)		

Investment in associate (see above for adjustments)	₦
Cost of the investment	205,000
Entity P's share of post-acquisition profits of Entity A	110,000
Minus: Entity P's share of unrealised profit in inventory	(6,000)
	309,000

Practice question **2**

Entity P acquired 30% of the equity shares of Entity A several years ago at a cost of ₦275,000.

As at 31 December Year 6 Entity A had made profits of ₦380,000 since the date of acquisition.

In the year to 31 December Year 6, the reported profits after tax of Entity A were ₦100,000.

In the year to 31 December Year 6, Entity P sold goods to Entity A for ₦180,000 at a mark-up of 20% on cost.

Goods which had cost Entity A ₦60,000 were still held as inventory by Entity A at the year-end.

a) Calculate the unrealised profit adjustment and state the double entry.

b) Calculate the investment in associate balance that would be included in Entity P's statement of fiancial position as at 31 December Year 6.

c) Calculate the amount that would appear as a share of profit of associate in Entity P's statement of profit or loss for the year ending 31 December Year 6.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define and explain the differences between a joint operation, a joint ventures and an associate;
- Account for joint operations;
- Explain equity accounting;
- Measure investment in an associate or joint venture for inclusion in the statement of financial position using equity accounting;
- Measure share of profit of an associate or joint venture for inclusion in the statement of comprehensive income; and
- Account for unrealised profit on transactions between an associate or joint venture and its parent or a member of the parent's group.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

The figures that must be included to account for the associate in the financial statements of Entity P for the year to 31 December Year 5 are as follows:

Statement of financial position:

The investment in the associate is as follows:

	₦
Investment at cost	128,000
Investor's share of post-acquisition profits of A (**W1)**	60,000
Minus: Accumulated impairment in the investment	(8,000)
Investment in the associate	180,000

W1 Retained post-acquisition profits of Entity A	₦
Net assets of the associate at 31 December Year 5	400,000
Net assets of Entity A at date of acquisition of shares	(250,000)
Retained post-acquisition profits of Entity A	150,000
Entity P's share of A	40%
Entity P's share of A's profits since the date of acquisition	₦60,000

Statement of profit or loss

The share of the associate's after-tax profit for the year is shown on a separate line as:

Share of profits of associate (40% × ₦50,000): ₦20,000.

Solution **2**

a) **Unrealised profit adjustment**

	₦
Inventory sold by P to A	180,000
Profit on the sale (× 20%/120%)	30,000
Unrealised profit (× ₦60,000/₦180,000)	10,000
Entity P's share (30%)	3,000

Double entry	Dr(₦)	Cr(₦)
Cost of sales (hence accumulated profit)	3,000	
Investment in associate		3,000

Being: Elimination of share of unrealised profit (see above)

b) **Investment in associate (see above for adjustments)**

	₦
Cost of the investment	275,000
Entity P's share of post-acquisition profits of Entity A (30% of ₦380,000)	114,000
Minus: Entity P's share of unrealised profit in inventory	(3,000)
	386,000

c) **Statement of profit or loss**

The share of the associate's after-tax profit for the year is shown on a separate line as:

Share of profits of associate (30% × ₦100,000): ₦30,000.

CHAPTER 23

Business combinations achieved in stages

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

C	Group financial statements		
	2	Preparation of group financial statement of a complex group	
		c	Determine, apply and disclose from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of acquisitions achieved one time or in stages involving subsidiaries, associates and joint ventures.
		h	Prepare group financial statements where necessary in (c) to (g) above.

Exam context

This chapter explains how an entity should account for an acquisition achieved in stage.

It also explains how an entity should account for purchase of further interests in a subsidiary after control has been achieved.

At the end of this chapter, you should be able to:

- Explain and apply the requirements of IFRS 3 with regard to the calculation of goodwill when a control of an entity is achieved by more than one purchase of shares; and
- Explain and apply the requirements of IFRS 10 on how to account for a purchase of a further interest in a subsidiary once control has been achieved.

1 ACQUISITIONS ACHIEVED IN STAGES

Section overview

- Acquisitions achieved in stages
- Purchase of additional equity interest after control is achieved

1.1 Acquisitions achieved in stages

As well as being achieved in a single transaction control might be achieved through a series of transactions. (These are known as step acquisitions, successive share purchases or piecemeal acquisitions).

Example: Step acquisition

A company may purchase a 35% stake, and then a year later, purchase a further 40%.

When the second purchase is made the company's interest in the subsidiary increases from 35% to 75%.

This is a controlling interest.

In other words control is achieved at the date of the second acquisition.

This is the date of acquisition.

Consolidation is from the acquisition date which is the date that control is achieved. Goodwill is calculated at the acquisition date with reference to the fair value of the consideration.

IFRS 3 requires that, for a business combination achieved in stages, the parent must remeasure any previously held equity interest in the new subsidiary to its fair value at the date that control is achieved. This is added to the cost of the investment that resulted in control. This figure is used to calculate goodwill.

Goodwill is measured as follows:

Illustration: Goodwill

	₦
Consideration transferred (cost of the business combination)	X
The acquisition-date fair value of the acquirer's previously held equity interest in the entity	X
Non-controlling interest	X
	X
The net of the acquisition date amounts of identifiable assets acquired and liabilities assumed	X
Goodwill recognised	X

The resulting gain or loss on the remeasurement of the previously held equity interest is recognized in profit or loss or other comprehensive income, as appropriate; that is accumulated in OCI and subsequently reclassified to Retained earnings if it was earlier classified as available for sales investment.

Example: Step acquisition

H bought 10% of S 2 years ago for ₦45m. The balance on S's retained earnings was ₦150m at this date.

H bought 60% of S 1 year ago for ₦540m. The balance on S's retained earnings was ₦300m at this date and S held a non-current asset with a fair value of ₦150m more than its carrying amount.

The fair value of the original investment (10%) in S was ₦60m at this date.

Statements of financial position for H and S as at 31 December 20X1:

	H	S
Assets:	₦m	₦m
Investment in S:		-
First holding (10%)	45	-
Second holding (60%)	540	-
	585	-
Other assets	2,500	650
	3,085	650
Equity		
Share capital	100	100
Retained earnings	2,485	500
	2,585	600
Current liabilities	500	50
	3,085	650

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

H Group: Consolidated statement of financial position at 31 December 20X1

	₦m
Assets	
Goodwill (see working)	215
Other assets (2,500 + (650 + 150))	3,300
Total assets	3,515
Equity	
Share capital (P only)	100
Consolidated retained earnings (see working)	2,640
	2,740
Non-controlling interest (see working)	225
	2,965
Current liabilities (500 + 50)	550
Total equity and liabilities	3,515

Example (continued): Net assets summary of S

	At date of Consolidation	At date of acquisition	Post acqn
Share capital	100	100	
Retained earnings	500	300	200
Fair value reserve	150	150	
Net assets	750	550	

Non-controlling interest	**₦m**
NCI's share of net assets at the date of acquisition (30% × 550)	165
NCI's share of the post-acquisition retained earnings of S (30% of 200 (see above))	60
NCI's share of net assets at the date of consolidation (30% × 550)	225

Goodwill	**₦m**
Cost of investment	
Cost of second purchase (60%)	540
Fair value of first purchase (10%) – (45 + 15)	60
	600
Non-controlling interest at acquisition	165
	765
Net assets at acquisition (see above)	(550)
	215

Consolidated retained profits:	**₦m**
H's retained earnings	
Per the question	2,485
Gain on remeasurement of previously held equity interest in S (60 – 45)	15
	2,500
H's share of the post-acquisition retained earnings of S (70% of 200 (see above))	140
	2,640

Practice question **1**

Company P bought shares in Company T as follows:

		Cost	Retained profits
		₦	₦
1 January Year 1	40,000 shares	180,000	500,000
30 June Year 4	120,000 shares	780,000	800,000

No fair value adjustments arose on the acquisitions.

Company T had issued share capital of 200,000 ₦1 ordinary shares and retained profits at 31 December Year 4 were ₦900,000. The fair value of its initial investment in 40,000 shares of T was ₦250,000 at 30 June Year 4.

What is the value goodwill on acquisition.

Practice question **2**

Company P bought shares in Company T as follows:

		Cost	Retained profits
		₦	₦
1 January Year 1	40,000 shares	180,000	500,000
30 June Year 4	120,000 shares	780,000	800,000

No fair value adjustments arose on the acquisition. Between 1 January Year 1 and 30 June Year 4, Company T was treated as an associate and the investment in T was accounted for by the equity method. There was no impairment in the investment.

Company T had issued share capital of 200,000 ₦1 ordinary shares. The fair value of its initial investment in 40,000 shares of T was ₦250,000 at 30 June Year 4.

What gain or loss should be recognised on 30 June Year 4 on the initial investment in 40,000 shares of Company T?

1.2 Purchase of additional equity interest after control is achieved

A company may make a further purchase of shares after control has been achieved.

This is a transaction between the owners of the subsidiary (the controlling interest and the non-controlling interest) which will cause the non-controlling interest to change.

Any difference between the purchase consideration and the change in the non-controlling interest is recognised directly in equity.

The equity adjustment

Illustration: Equity adjustment

	₦
Consideration paid	X
Reduction in non-controlling interest at the date of the purchase	(X)
Equity adjustment	X

The reduction in non-controlling interest at the date of the purchase is the share of net assets given up by the non-controlling interest at that date. This requires a working to show the net assets of the subsidiary at that date.

This is very similar to the goodwill working but this figure is not goodwill. Goodwill arises at the acquisition date (the date at which control is achieved).

Non-controlling interest (NCI)

The NCI in the statement of financial position at the reporting date is based on the percentage holdings at that date.

Group policy might be to measure NCI as a proportionate share of net assets at the acquisition date. In this case the NCI at the reporting date can be easily measured as the NCI share of assets at that date.

If group policy is to measure NCI at fair value at the acquisition date the calculation can be quite tricky. In this case, you have to start with the NCI at the acquisition date and adjust it by the appropriate NCI share of profits since that date. This must be adjusted by NCI share of profits sold at the date of the second purchase by the parent.

Illustration: Non-controlling interest (NCI)

	₦
NCI at the date of acquisition (Original NCI % × Net assets at that date)	X
NCI's share of retained earnings of S from the acquisition date to the date of the second purchase (based on original NCI %)	X
NCI's share of retained earnings of S from the date of the second purchase to the reporting date (based on the new NCI %)	X
Share of profits disposed of at date of second purchase	
NCI at the date of consolidation	X

This is best demonstrated using figures and is shown in the following example.

Consolidated retained earnings

This must be calculated in the usual way by adding the parent's share of the subsidiary's post acquisition retained profits to those of the parent but remembering to make the equity adjustment.

The parent's share of the subsidiary's post acquisition retained profits must be measured as two figures.

Illustration: parent's share of the subsidiary's post acquisition retained profits

	₦
Parent's share of retained earnings of S from the acquisition date to the date of consolidation (Original % held)	X
Parent's share of retained earnings of S from date of second purchase to the date of consolidation (Incremental NCI% held)	X
Equity adjustment	X/(X)
	X

Again this is best demonstrated using figures and is shown in the following example. Work through it carefully.

Example: Purchase of additional equity interest after control is achieved

H bought 60% of S 2 years ago for ₦540m. The balance on S's retained earnings was ₦150m.

H bought 10% of S 1 year ago for ₦45m. The balance on S's retained earnings was ₦300m at this date.

Statements of financial position H and S as at 31 December 20X1:

	H	S
Assets:	₦m	₦m
Investment in S:	585	-
Other assets	2,500	650
	3,085	650
Equity		
Share capital	100	100
Retained earnings	2,485	500
	2,585	600
Current liabilities	500	50
	3,085	650

The NCI was 40% at the date of the first acquisition and remained the same until the date of the second purchase at which time it changed to 30%;

Example (continued): Purchase of additional equity interest after control is achieved

A consolidated statement of financial position as at 31 December 20X1 can be prepared as follows:

H Group: Consolidated statement of financial position at 31 December 20X1

	₦m
Assets	
Goodwill (**W3**)	390
Other assets (2,500 + 650)	3,150
Total assets	3,540
Equity	
Share capital (P only)	100
Consolidated retained earnings (see working)	2,710
	2,810
Non-controlling interest (see working)	180
	2,990
Current liabilities (500 + 50)	550
Total equity and liabilities	3,540

W1: Net assets summary of S

	At date of consolidation	1 year ago	2 years ago
Share capital	100	100	100
Retained earnings	500	300	150
Net assets	600	400	250

W2: Non-controlling interest	**₦m**
NCI's share of net assets at the date of consolidation (30% of 600 **W1**)	180

A proof of this figure is shown at the end of the example

Example (continued): Purchase of additional equity interest after control is achieved

W3: Goodwill	**₦m**
Cost of investment	540
Non-controlling interest at acquisition (40% of 250)	100
	640
Net assets at acquisition (see above)	(250)
	390

W4: Equity adjustment	**₦m**
Cost of investment	45
Non-controlling interest sold (10% of 400)	(40)
	5

Consolidated retained profits:	**₦m**
H's retained earnings	2,485
Equity adjustment **W4**	(5)
H's share of the post-acquisition retained earnings of S	
(60% of (500 – 150) **W1**	210
(10% of (500 – 300) **W1**	20
	2,710

Non-controlling interest (Proof)	**₦m**
NCI's share of net assets at the date of acquisition (40% × 250)	100
NCI's share of the post-acquisition retained earnings of S from date of acquisition to the date of the later purchase ((40% of 300 – 150) **W1**))	60
	160
Less movement in NCI at date of second purchase(10% of 400)	(40)
NCI's share of the post-acquisition retained earnings of S from date of second purchase to the date of consolidation ((30% of 500 – 300) **W1**))	60
NCI's share of net assets at the date of consolidation (30% of 600) **W1**	180

Practice question **3**

Company H bought shares in Company S as follows:

		Cost	Retained profits
		₦	₦
1 January Year 1	120,000 shares	600,000	500,000
30 June Year 4	40,000 shares	270,000	800,000

No fair value adjustments arose on the acquisition.

Company S has issued share capital of 200,000 ₦1 ordinary shares.

What was the goodwill arising on the acquisition?

Practice question **4**

Company H bought shares in Company S as follows:

		Cost	Retained profits
		₦	₦
1 January Year 1	120,000 shares	600,000	500,000
30 June Year 4	40,000 shares	270,000	800,000

No fair value adjustments arose on the acquisition. There has been no impairment of goodwill since the acquisition. No goodwill is attributed to non-controlling interests.

Company S has issued share capital of 200,000 ₦1 ordinary shares.

What journal is required on the acquisition of the 40,000 shares in Company S on 30 June Year 4?

2 PATTERN OF OWNERSHIP IN THE CONSOLIDATED STATEMENT OF PROFIT OR LOSS

Section overview

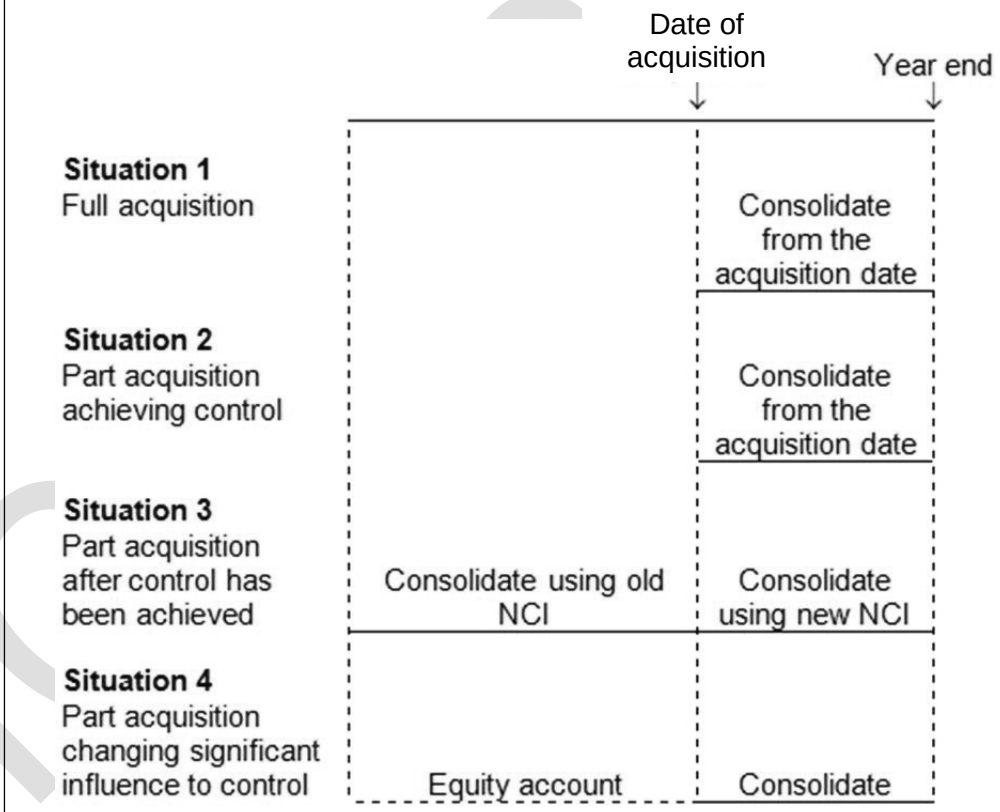
- Introduction
- Step acquisition
- Purchase of additional equity interest after control is achieved
- Purchase turning significant influence into control

2.1 Introduction

The pattern of ownership must be reflected in the statement of profit or loss and other comprehensive income.

A change in ownership in the period will have an impact on the consolidated statement of profit or loss and other comprehensive income.

Illustration: Pattern of ownership



Situation 1 is the basic situation which you will have seen before. The results must be consolidated from the date that control is achieved.

Situations 2 to 4 are explained in more detail in the following sections

2.2 Step acquisition

Situation 2: In this case the parent had a previously held equity interest. This gave the parent no influence. Control was achieved by the second acquisition and consolidation commences from that point.

Example: Step acquisition

H has owned 10% of S for several years

H bought a further 60% of S on 30th September 20X1.

Statements of profit or loss for the year ended 31 December 20X1:

	H	S
	₦m	₦m
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)
Gross profit	3,000	1,200
Expenses	(1,000)	(300)
Profit before tax	2,000	900
Income tax	(500)	(160)
Profit after tax	1,500	740

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	H	S (3/12)	Consolidated
	₦	₦	₦
Revenue	10,000	1,500	11,500
Cost of sales	(7,000)	(1,200)	(8,200)
Gross profit	3,000	300	3,300
Expenses	(1,000)	(75)	(1,075)
Profit before tax			2,225
Income tax expense	(500)	(40)	(540)
Profit for the period	1,500	185	1,685
Total comprehensive income attributable to:			
Owners of the parent (balancing figure)			1,629
Non-controlling interests (30% of 185)			56
			1,685

2.3 Purchase of additional equity interest after control is achieved

Situation 3: In this case the parent has a subsidiary for the whole year. Therefore the results of that subsidiary must be consolidated for the whole year. However, the pattern of ownership changes during the year. The pattern of ownership is reflected in the statement of profit or loss by applying the appropriate NCI to the results for that part of the year in which that NCI was valid.

Example:

H has owned 60% of S for several years

H bought a further 10% of S on 30th September 20X1.

Statements of profit or loss for the year ended 31 December 20X1:

	H	S
	₦m	₦m
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)
Gross profit	3,000	1,200
Expenses	(1,000)	(300)
Profit before tax	2,000	900
Income tax	(500)	(160)
Profit after tax	1,500	740

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	H	S	Consolidated
	₦	₦	₦
Revenue	10,000	6,000	16,000
Cost of sales	(7,000)	(4,800)	(11,800)
Gross profit	3,000	1,200	4,200
Expenses	(1,000)	(300)	(1,300)
Profit before tax	2,000	900	2,900
Income tax expense	(500)	(160)	(660)
Profit for the period	1,500	740	2,240

Total comprehensive income attributable to:	
Owners of the parent (balancing figure)	1,962
Non-controlling interests	
40% × 9/12 × 740	222
30% × 3/12 × 740	56
	278
	2,240

2.4 Purchase turning significant influence into control

Situation 4: In this case the parent had significant influence in the first part of the years and then made an acquisition which achieved control. The results for the year must be split into two parts. The results for the period in which the parent had significant influence must be equity accounted. The results for the period in which the parent had control must be consolidated.

Example: Step acquisition (associate to subsidiary)

H has owned 40% of S for several years. This holding gave H significant influence over S.

H bought a further 30% of S on 30th September 20X1.

Statements of profit or loss for the year ended 31 December 20X1:

	H	S
	₦m	₦m
Revenue	10,000	6,000
Cost of sales	(7,000)	(4,800)
Gross profit	3,000	1,200
Expenses	(1,000)	(300)
Profit before tax	2,000	900
Income tax	(500)	(160)
Profit for the period	1,500	740

A consolidated statement of comprehensive income can be prepared as follows:

	Working		
	H	S ($^{3}/_{12}$)	Consolidated
	₦	₦	₦
Revenue	10,000	1,500	11,500
Cost of sales	(7,000)	(1,200)	(8,200)
Gross profit	3,000	300	3,300
Expenses	(1,000)	(75)	(1,075)
Share of profit of associate ($40\% \times {}^{9}/_{12} \times 740$)			222
Profit before tax			2,447
Income tax expense	(500)	(40)	(540)
Profit for the period	1,500	185	1,907

Total comprehensive income attributable to:

Owners of the parent (balancing figure)	1,851
Non-controlling interests (30% of 185)	56
	1,907

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you know how to:

- Explain and apply the requirements of IFRS 3 with regard to the calculation of goodwill when a control of an entity is achieved by more than one purchase of shares.
- Explain and apply the requirements of IFRS 10 on how to account for a purchase of a further interest in a subsidiary once control has been achieved.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

Goodwill is calculated when control is acquired (IFRS 3).

	₦
Fair value of original investment	250,000
Cost of additional shares	780,000
Cost of investment to acquire T	1,030,000
Net assets acquired (160/200 × (800 + 200))	800,000
Goodwill	230,000

Goodwill is calculated when control is acquired (IFRS 3)

Solution **2**

A step acquisition occurs in June Year 4. The original investment is re-valued at fair value.

	₦
Cost of original investment	180,000
Share of retained profits of associate (20% × (800 – 500)	60,000
	240,000
Fair value of original investment	250,000
Gain recognised in profit or loss	10,000

Goodwill is calculated when control is acquired (IFRS 3)

Solution **3**

Goodwill is calculated when control is acquired (IFRS 3). This is on purchase of the first investment.

	₦
Fair value of original investment	600,000
Net assets acquired (120/200 × (500 + 200))	420,000
Goodwill	180,000

Solution **4**

	Dr	Cr
Equity attributable to parent	₦70,000	
Non-controlling interest	₦200,000	
Bank		₦70,000

The acquisition of the extra 40,000 shares does not affect control of Company S, and it is therefore accounted for as an equity transaction between equity owners of the company in their capacity as owners. IAS 27 states that any difference between cash paid and the adjustment made to NCI is attributed to parent equity

CHAPTER 24

Disposal of subsidiaries

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

C	Group financial statements		
	2	Preparation of group financial statement of a complex group	
		b	Determine and apply appropriate procedures to be used in preparing group financial statements.
		d	Calculate, determine and disclose, from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of full or partial disposals involving subsidiaries, associates and joint ventures.
		g	Calculate, determine and disclose, from financial information or other data in a given scenario, the amounts to be included in group financial statements relating to part of a group, the activities of which have been discontinued, or have been acquired or disposed of in the period.
		h	Prepare group financial statements where necessary in (c) to (g) above.

Exam context

This chapter explains how to account for a disposal of a subsidiary including how to deal with a disposal that satisfies the IFRS 5, discontinued operations criteria.

At the end of this chapter, you should be able to:

- Calculate the profit or loss arising on disposal from the group viewpoint;
- Complete a statement of profit or loss for a period in which there has been a disposal of a subsidiary; and
- Complete a statement of profit or loss for a period in which there has been a disposal of a subsidiary and that disposal constitutes a discontinued operation.

1 FULL DISPOSALS

Section overview

- Introduction
- Pattern of ownership
- Profit or loss on disposal
- Step by step approach

1.1 Introduction

A parent company might dispose of a holding in a subsidiary.

IFRS 10 Consolidated Financial Statements contains rules on accounting for disposals of a subsidiary.

Accounting for a disposal is an issue that impacts the statement of profit or loss.

There are two major tasks in constructing a statement of profit or loss for a period during which there has been a disposal of a subsidiary:

- ❑ The statement of profit or loss must reflect the pattern of ownership of subsidiaries in the period.
- ❑ When control is lost, the statement of profit or loss must show the profit or loss on disposal of the subsidiary.

The rules in IFRS 10 cover full disposals and part disposals.

When a parent makes a part disposal of an interest in a subsidiary it will be left with a residual investment. The accounting treatment for a part disposal depends on the nature of the residual investment.

If a part disposal results in loss of control the parent must recognise a profit or loss on disposal in the consolidated statement of profit or loss.

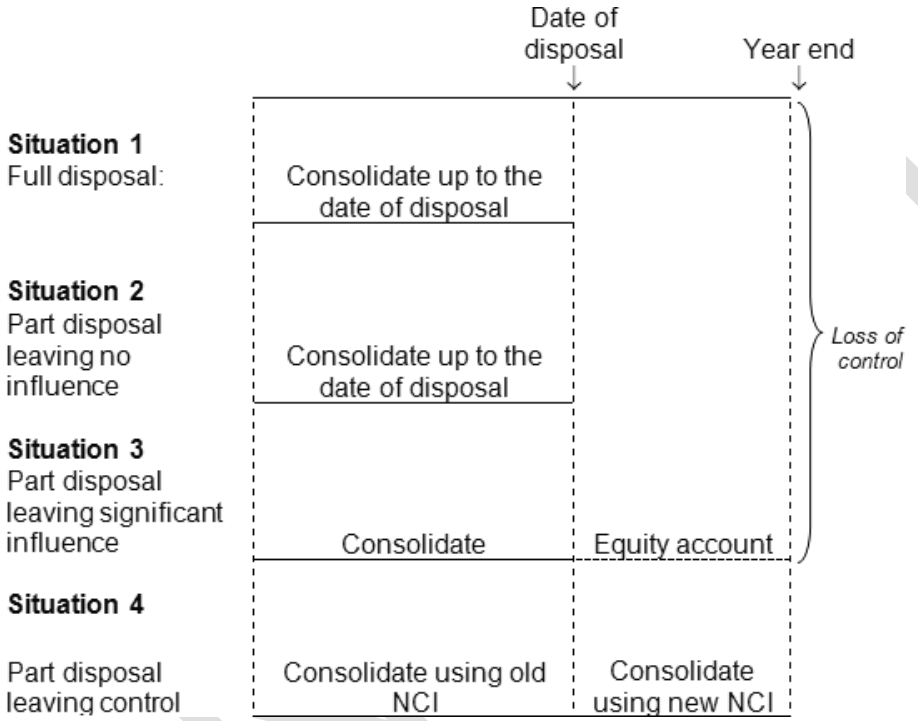
A part disposal which does not result in loss of control is a transaction between the owners of the subsidiary. In this case the parent does not recognise a profit or loss on disposal in the consolidated statement of profit or loss. Instead the parent recognises an equity adjustment.

1.2 Pattern of ownership

The pattern of ownership in a period is always reflected in the consolidated statement of profit or loss.

IFRS 11 requires that an interest in a subsidiary is consolidated from the date of acquisition to the date of disposal.

Illustration: Disposal during the year



An interest in an associate must also be equity accounted from the date that significant influence is achieved to the date that it is lost.

Thus, the figures from the statement of profit or loss and other comprehensive income that relate to the period up to the date of disposal must be identified. In practice, this would normally be achieved by constructing a set of accounts up to the date of disposal. In exam questions we tend to use time apportionment.

There is another reason for consolidating up to the date of disposal. The calculation of the profit on disposal involves comparing the sale proceeds to what leaves the statement of financial positon as at the date of disposal. Therefore, the results of the subsidiary must be consolidated up to the date of disposal in order to establish the correct net assets figure.

1.3 Profit or loss on disposal

IFRS 11 specifies an approach to calculating the profit or loss on disposal.

This approach involves comparing the asset that is recognised as a result of the disposal (i.e. the proceeds of the sale) to the amounts that are derecognised as a result of the disposal.

The calculation is as follows:

Illustration: Profit (loss) on disposal

		₦
Recognise:		
Proceeds		X
Fair value of residual interest (only for part disposals)		X
Total FV of parent share	(A)	X
Derecognise:		
Net assets of subsidiary (including FV adj. and unimpaired G/W on consolidation)		X
Non-controlling interest Share of net assets		(X)
Parent's share of net asset (B)		(X)
		(X)
Disposal gain/(loss) A-B		X

Example: Profit on disposal of a subsidiary

On 1 January Year 9, H plc acquired 90% of the equity shares of S Ltd for ₦120 million.

The fair value of the identifiable net assets in S Ltd at that date was ₦111 million. The fair value of the NCI at 1 January Year 9 was ₦9 million.

H plc uses the full goodwill method for consolidation leading to the recognition of good will of ₦18m ((₦120m + ₦9m – ₦111m).

H plc subsequently sold the shares on 31 December Year 9 for ₦197 million. The carrying value of the net assets of S Ltd at 31 December Year 9 was ₦124 million.

The gain on disposal recognised in profit or loss should be calculated as follows:

		₦ m
Consideration received for shares in S Ltd on 31 December	(A)	197.0
Net assets de-recognised in consolidated accounts		
Net assets + unimpaired Goodwill (124+18)		(142)
Value of NCI at 31 December (10% ×142)million FV method		(14.2)
Net assets sold	(B)	(127.8)
Gain on disposal, reported in profit or loss	(A-B)	(69.2)

The calculation of profit or loss on disposal must be supported by several other calculations. These are:

- the goodwill arising on acquisition, which in turn needs the net assets of the subsidiary at the date of acquisition; and
- the net assets of the subsidiary at the date of disposal, which in turn needs a calculation of the equity reserves at the date of disposal.

Example:

At 1 January Year 9, H plc held 80% of the equity of S Ltd. The carrying value of the net assets of S Ltd at this date was ₦570 million.

There was also goodwill of ₦20 million net of accumulated impairments relating to the investment in S Ltd: all this goodwill is attributable to the equity owners of H plc.

On 1 April Year 9, H plc sold its entire shareholding in S Ltd for ₦575 million in cash.

H plc has a financial year ending 31 December. It was subsequently established that the profit after tax of S Ltd for the year to 31 December Year 9 was ₦120 million.

S Ltd did not make any dividend payment during the year before the disposal of the shares.

How should the disposal of the shares be accounted for? (Ignore deferred taxation).

Answer

In the three months of the year to the date of disposal of the shares in S Ltd, the after-tax profit of S Ltd was ₦30 million (₦120 million × 3/12).

The carrying value of the net assets of S Ltd at the date that control was lost is therefore ₦600 million (₦570 million + ₦30 million).

The gain on disposal of the shares is as follows:

	₦ million
Consideration received from sale of shares	575
Net assets derecognised (including goodwill)	620
NCI removed/derecognized (20% of 600)	(120)
H plc's share of assets derecognised	(500)
Total gain	75

Practice question **1**

P bought 80% of the issued ordinary shares of S twenty five years ago at a cost of ₦330,000 when the net assets of S amounted to ₦280,000.

No goodwill is attributed to the non-controlling interests. Goodwill arising on the acquisition has suffered an impairment of 80% of its original value.

On the final day of the current accounting period P sold its entire shareholding in S for proceeds of ₦460,000. At this date the net assets of S amounted to ₦400,000.

What is the profit or loss on disposal reported in consolidated profit or loss for the current period?

1.4 Step by step approach

The following approach can be used to prepare answers to questions requiring a consolidated statement of profit or loss when there is a disposal of a subsidiary during the year.

Step 1: Reflect the pattern of ownership

Construct a pro-forma answer with columns for the parent, the subsidiary and the consolidated figures.

Enter the figures to be consolidated remembering to prorate the subsidiary's figures up to the date of disposal and add across to give the consolidated figures.

The non-controlling interest can be calculated from the subsidiary's column.

Step 2: Construct the following workings:

- Net assets summary as at the date of disposal and the date of acquisition
- Retained earnings as at the date of disposal (for the above);
- Goodwill arising on acquisition (using the net assets at the date of acquisition from the net assets summary)

Step 3: Calculate the profit or loss on disposal

Step 4: Include the profit or loss on disposal into the consolidated statement of profit or loss and finish it off.

Work through the following example carefully.

Example: Facts

Example: Disposal of subsidiary

The following financial statements are to the year-end 31 December 20X4

	H	S
Statements of profit or loss	₦000	₦000
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400	(2,150)
Profit after tax	7,550	1,650
Statement of changes in equity	₦000	₦000
Retained earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained earnings c/f	11,310	3,500

a. H plc bought 90% of S Ltd 4 years ago for ₦3,750,000 when the retained earnings of S ltd were ₦500,000.

   S Ltd has share capital of ₦3,000,000.

b. H plc sold its entire holding in S Ltd on 30 September 20X4 for ₦9,500,000.

c. S Ltd does not qualify to be treated as a discontinued operation under IFRS5.

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X4.

Step 1: Reflect the pattern of ownership

Answer

	H	S (9/12)	Group
Statements of profit or loss	₦000	₦000	₦000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Profit on disposal (W)			
Profit before tax			
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	
Profit attributable to:			₦000
Owners of the parent			
Non-controlling interest (10% of 1,238)			124
Profit for the year			

Step 2: Key workings

Answer

W1: Net assets summary

	At date of disposal	At date of acquisition
	₦000	₦000
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net assets	6,088	3,500

W2: Retained earnings at date of disposal	₦000
Retained earnings at start of year	1,850
Profit for the period up to the date of disposal (9/12 × 1,650,000)	1,238
NCI's share of net assets at the date of consolidation	3,088

W3: Goodwill	₦000
Cost of investment	3,750
Non-controlling interest at acquisition (10% × 3,500,000 (W1))	350
	4,100
Net assets at acquisition (see above)	(3,500)
	600

Step 3: Profit on disposal

Answer

W4: Profit on disposal	₦000
Sale proceeds	9,500
Derecognise:	
Net assets at date of disposal (W1)	6,088
NCI at date of disposal (10% × 6,088,000 (W1))	(609)
	(5,479)
Goodwill (W3)	(600)
	3,421

Step 4: Complete the answer

Answer

H Plc: Consolidated statement of profit or loss for the year ended 31 December 20X4

	H	S (9/12)	Group
Statements of profit or loss	₦000	₦000	₦000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Profit on disposal (W)			3,421
Profit before tax			19,221
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	12,209

Profit attributable to:	₦000
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% of 1,238)	124
Profit for the year	12,209

2 PART DISPOSALS

Section overview

- Part disposal with loss of control
- Part disposal with no loss of control

2.1 Part disposal with loss of control

As stated previously there are two major tasks in constructing a statement of profit or loss for a period during which there has been a disposal of a subsidiary:

- The statement of profit or loss must reflect the pattern of ownership of subsidiaries in the period.
- When control is lost, the statement of profit or loss must show the profit or loss on disposal of the subsidiary.

When a parent makes a part disposal of an interest in a subsidiary it will be left with a residual investment. The accounting treatment for a part disposal depends on the nature of the residual investment.

If a part disposal results in loss of control the parent must recognise a profit or loss on disposal in the consolidated statement of profit or loss.

The pattern of ownership must reflect the nature of the residual investment.

IFRS calculation of profit on disposal has been shown before but is repeated here for your convenience.

Illustration: Profit (loss) on disposal

	₦
Recognise:	
Proceeds	X
Fair value of residual interest (only for part disposals)	X
Total FV (A)	X
Derecognise:	
Net assets of subsidiary + unimpaired G/W + FV adj.	X
Non-controlling interest Share of net assets	(X)
Parent share of NA (B)	(X)
Disposal gain (A-B)	X

Example: Profit on part disposal of a subsidiary

H plc acquired 90% of the equity shares of S Ltd for ₦120 million.

Goodwill on consolidation was ₦18m

There had been no impairment of goodwill since the date of acquisition.

H plc sold a 50% holding (leaving it with a 40% holding) for ₦100 million. This transaction resulted in H plc losing control of S ltd.

The fair value of the residual investment (i.e. the remaining 40%) was estimated to be ₦70

The carrying value of the net assets of S Ltd at 31 December Year 9 was ₦124 million.

The gain on disposal recognised in profit or loss should be calculated as follows:

Recognised:	₦ m
Consideration received for shares in S Ltd on 31 December	100.0
Fair value of residual investment	70.0
	170.0
Derecognised:	
Net assets de-recognised	124.0
NCI (10% × 124 million)	(12.4)
	111.6
Goodwill derecognized	18.0
Net assets sold	(129.6)
Gain on disposal, reported in profit or loss	40.4

Practice question **2**

Paprika, the holding company of a large group, had bought 90% of the issued capital Saffron several years ago.

Both companies prepare accounts to 31 December each year.

On 31 October Year 5 Paprika sold 50% of its shareholding in Saffron for ₦540,000.

At this date, the carrying value of the net assets of Saffron was ₦800,000 and the carrying value of the goodwill relating to the acquisition of Saffron (all attributable to the parent company) was ₦100,000.

The fair value of the remaining investment in S is estimated at ₦500,000.

What gain or loss should be recognised on the disposal of the shares in Saffron?

The same step by step approach shown earlier can be used to prepare answers to questions requiring a consolidated statement of profit or loss when there is a part disposal of a subsidiary during the year and that part disposal results in a loss of control.

Work through the following example carefully.

Example: Facts

Example: Part disposal (loss of control but leaving significant influence)

The following financial statements are to the year-end 31 December 20X4

	H	S
Statements of profit or loss	₦000	₦000
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400	(2,150)
Profit after tax	7,550	1,650
Statement of changes in equity	₦000	₦000
Retained earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained earnings c/f	11,310	3,500

a. H plc bought 90% of S Ltd 4 years ago for ₦3,750,000 when the retained earnings of S ltd were ₦500,000.
   S Ltd has share capital of ₦3,000,000.
b. H plc sold 50% of S Ltd on 30 September 20X4 for ₦5,000,000.
c. The remaining 40% investment in S Ltd held by H plc resulted in H plc having significant influence over S Ltd. This residual investment was estimated to have a fair value of ₦3,500,000
d. S Ltd does not qualify to be treated as a discontinued operation under IFRS5.

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X4.

Step 1: Reflect the pattern of ownership

Answer

	H	S (9/12)	Group
Statements of profit or loss	₦000	₦000	₦000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Share of profits of associate ($40\% \times {}^{3}/_{12} \times 1{,}650$)			165
Profit on disposal (W)			
Profit before tax			
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	

Profit attributable to:	₦000
Owners of the parent	
Non-controlling interest (10% of 1,238)	124
Profit for the year	

Step 2: Key workings

Answer

W1: Net assets summary

	At date of disposal	At date of acquisition
	₦000	₦000
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net assets	6,088	3,500

W2: Retained earnings at date of disposal	₦000
Retained earnings at start of year	1,850
Profit for the period up to the date of disposal (9/12 × 1,650,000)	1,238
NCI's share of net assets at the date of consolidation	3,088

W3: Goodwill	₦000
Cost of investment	3,750
Non-controlling interest at acquisition (10% × 3,500,000 (W1))	350
	4,100
Net assets at acquisition (see above)	(3,500)
	600

Step 3: Profit on disposal

Answer

W4: Profit on disposal	₦000
Recognise	
Sale proceeds	5,000
Fair value of residual investment	3,500
	8,500
Derecognise:	
Net assets at date of disposal (W1)	6,088
NCI at date of disposal (10% × 6,088,000 (W1))	(609)
	(5,479)
Goodwill (W3)	(600)
	2,421

Step 4: Complete the answer

Answer

H Plc: Consolidated statement of profit or loss for the year ended 31 December 20X4

	H	S (9/12)	Group
Statements of profit or loss	₦000	₦000	₦000
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Share of profits of associate ($40\% \times {}^{3}/_{12} \times 1{,}650$)			165
Profit on disposal (W)			2,421
Profit before tax			18,386
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	11,374

Profit attributable to:	₦000
Owners of the parent (balancing figure)	11,250
Non-controlling interest (10% of 1,238)	124
Profit for the year	11,374

2.2 Part disposal with no loss of control

A part disposal does which does not result in loss of control is a transaction between the owners of the subsidiary. In this case the parent does not recognise a profit or loss on disposal in the consolidated statement of profit or loss. Instead the parent recognises an equity adjustment.

Example: Part disposal with no loss of control

The following financial statements are to the year-end 31 December 20X4

	H	S
Statements of profit or loss	₦000	₦000
Revenue	22,950	8,800
Expenses	(10,000)	(5,000)
Operating profit	12,950	3,800
Tax	(5,400	(2,150)
Profit after tax	7,550	1,650
Statement of changes in equity	₦000	₦000
Retained earnings b/f	3,760	1,850
Profit after tax	7,550	1,650
Retained earnings c/f	11,310	3,500

a. H plc bought 90% of S Ltd 4 years ago for ₦3,750,000 when the retained earnings of S ltd were ₦500,000.

   S Ltd has share capital of ₦3,000,000.

b. H plc sold 10% of S Ltd on 30 September 20X4 for ₦1,000,000.

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X4 and calculate the equity adjustment necessary to reflect the change in ownership.

Step 1: Reflect the pattern of ownership and complete the statement of profit and loss

This is straightforward as the parent has held a subsidiary for the whole year. The only complication is that the results have to be time apportioned so that the relevant NCI can be measured.

Profit on disposal is NOT recognised where there is no loss of control.

Answer

	H	S	Group
Statements of profit or loss	₦000	₦000	₦000
Revenue	22,950	8,800	31,750
Expenses	(10,000)	(5,000)	(15,000)
Profit before tax	12,950	3,800	16,750
Tax	(5,400)	(2,150)	(7,550)
Profit after tax	7,550	1,650	9,200
Profit attributable to:			₦000
Owners of the parent (as a balancing figure)			8,993
Non-controlling interest			
(10% × 1,650 × 9/12)			124
(20% × 1,650 × 3/12)			83
			207
Profit for the year			9,200

Step 2: Key workings

Answer

W1: Net assets summary

	At date of disposal	At date of acquisition
	₦000	₦000
Share capital	3,000	3,000
Retained earnings (W2)	3,088	500
Net assets	6,088	3,500

W2: Retained earnings at date of disposal	₦000
Retained earnings at start of year	1,850
Profit for the period up to the date of disposal (9/12 × 1,650,000)	1,238
NCI's share of net assets at the date of consolidation	3,088

W3: Goodwill	₦000
Cost of investment	3,750
Non-controlling interest at acquisition (10% × 3,500,000 (W1))	350
	4,100
Net assets at acquisition (see above)	(3,500)
	600

Step 3: Equity adjustment

Answer

W4: Profit on disposal	₦000
Sale proceeds	1,000
Net assets sold to the NCI 10% of 6088	(609))
	391

The double entry to record the equity adjustment is as follows:

	Debit	**Credit**
Cash	1,000	
Non-controlling interest		609
OCE		391

3 DISPOSAL OF A SUBSIDIARY WHICH DOES NOT CONTAIN A BUSINESS

Section overview

- Background
- New rules

3.1 Background

This section concerns a situation where a parent loses control of a subsidiary that does not contain a business (as defined in IFRS 3) by selling an interest to an associate (or joint venture) accounted for using the equity method.

Such a transaction is the same as selling an asset to the associate (or joint venture).

Usually, if a parent loses control of a subsidiary, the parent must:

- derecognise the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
- recognise any investment retained in the former subsidiary at its fair value when control is lost; and
- recognise the gain or loss associated with the loss of control in the statement of profit or loss.

In the case of a part disposal, the parent must measure any residual investment at its fair value with any gain or loss being recognised in the statement of profit or loss.

3.2 Rules

If the subsidiary sold does not contain a business (as defined in IFRS 3) by selling an interest to an associate (or joint venture) accounted for using the equity method the gain or loss resulting from the transaction is recognised in the parent's profit or loss only to the extent of the unrelated investors' interests in that associate or joint venture.

The remaining part of the gain is eliminated against the carrying amount of the investment in that associate or joint venture.

Also any residual investment must be revalued to fair value and usually the gain or loss is recognised in profit or loss.

The residual investment might be an associate (or joint venture) accounted for using the equity method. In that case the remeasurement gain or loss is recognised in profit or loss only to the extent of the unrelated investors' interests in the new associate or joint venture.

The remaining part of that gain is eliminated against the carrying amount of the investment retained in the former subsidiary.

Example: Loss of control of a subsidiary (that does not contain a business) by selling it to an associate

H plc owns 100% of S Ltd (a company which does not contain a business). H plc owns 20% of A Ltd.

H Plc sold 70% of S Ltd to A Ltd for ₦210 million.

The fair value of the identifiable net assets in S Ltd at the date of the sale was ₦100 million.

The fair value of the residual investment at the date of disposal was ₦90 million.

The gain on disposal recognised in profit or loss should be calculated as follows:

	₦ m
Consideration received for shares in S Ltd	210.0
Fair value of the residual interest	90.0
	300.0
Net assets de-recognised	(100.0)
Gain on disposal	200.0

H Plc recognises the gain to the extent of the unrelated investors' interests. H Plc's interests and those of unrelated investors after the disposal are as follows:

Interests in A Ltd:	
H Plc	20%
Unrelated investors	80%
Total	100%
Interests in S Ltd:	
H Plc	
Direct interest	30%
Indirect interest (20% of 70%)	14%
	44%
Unrelated investors (80% of 70%)	56%
Total	100%

The gain must be analysed into that part which relates to the actual sale and that part which relates to the revaluation of the residual investment.

	Total	Sale	Revaluation
	₦ m	₦ m	₦ m
Consideration received	210.0	210.0	90.0
Fair value of the residual interest	90.0		
	300.0		
Net assets de-recognised	(100.0)	(70.0)	(30.0)
Gain on disposal	200.0	140.0	60.0

Example (continued): Loss of control of a subsidiary (that does not contain a business) by selling it to an associate

The recognition of the gain is based on the ownership interests.

	Sale	Revaluation
	₦ m	₦ m
Gain on disposal	140.0	60.0
Interests in A Ltd:		
H Plc (20%)	28.0	
Unrelated investors (80%)	112.0	
Interests in S Ltd:		
H Plc (44%)		26.0
Unrelated investors (56%)		34.0

The double entry to account for the disposal may be summarised as:

	Dr (₦ m)	Cr (₦ m)
Cash	210.0	
Net assets		100.0
Investment in S (90 – 26)	64.0	
Investment in A		28.0
Gain on disposal (reported in profit or loss) (112.0 + 34.0)		146.0
	274.0	274.0

4 IFRS 5 AND DISPOSALS

Section overview

- IFRS 5: Discontinued operations
- Presentation of discontinued operations
- Discontinued operations and disposals

4.1 IFRS 5: Discontinued operations

This was covered in an earlier chapter but is repeated here for your convenience.

IFRS 5 *Non-current assets held for sale and discontinued operations* sets out requirements for disclosure of financial information relating to discontinued operations.

A discontinued operation is a disposal group that satisfies extra criteria. (IFRS 5 does not say as much but this is a helpful way to think of it).

Definition

Discontinued operation - A component of an entity that either has been disposed of or is classified as held for sale and:

1. represents a separate major line of business or geographical area of operations,
2. is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or
3. is a subsidiary acquired exclusively with a view to resale.

A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for Financial Reporting purposes, from the rest of the entity.

A disposal group might be, for example, a major business division of a company.

4.2 Presentation of discontinued operations

Presentation in the statement of profit or loss

The following must be disclosed for discontinued operations:

- ❑ a single amount on the face of the statement of profit or loss comprising the total of:
  - the post-tax profit or loss of discontinued operations; and
  - the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

4.3 Discontinued operations and disposals

A disposal might satisfy the discontinued operations criteria.

This will not affect measurement but will affect presentation.

The consolidation of the subsidiary up to the date of disposal is not carried out on a line by line basis. Instead, the profit after tax for this period combined with the profit (loss) on disposal and shown as a single figure.

The answer to the previous example is used below to show the difference.

Example: Disposal of subsidiary – Not a discontinued operation (as seen before)

H Plc: Consolidated statement of profit or loss for the year ended 31 December 20X4

	H	S (9/12)	Group
Statements of profit or loss	₦000	₦000	
Revenue	22,950	6,600	29,550
Expenses	(10,000)	(3,750)	(13,750)
Operating profit	12,950	2,850	15,800
Profit on disposal (W)			3,421
Profit before tax			19,221
Tax	(5,400)	(1,612)	(7,012)
Profit after tax	7,550	1,238	12,209

Profit attributable to:	₦000
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% of 1,238)	124
Profit for the year	12,209

Example: Disposal of subsidiary – As a discontinued operation

H Plc:
Consolidated statement of profit or loss for the year ended 31 December 20X4

	Group
Statements of profit or loss	₦000
Revenue	22,950
Expenses	(10,000)
Profit before tax	12,950
Tax	(5,400)
Profit for the period from continuing operations	7,550
Profit for the year from discontinued operations (1,238 + 3,421)	4,659
Profit for the year	12,209
Profit attributable to:	₦000
Owners of the parent (balancing figure)	12,085
Non-controlling interest (10% of 1,238)	124
Profit for the year	12,209

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Calculate the profit or loss arising on disposal from the group viewpoint
- Complete a statement of profit or loss for a period in which there has been a disposal of a subsidiary
- Complete a statement of profit or loss for a period in which there has been a disposal of a subsidiary and that disposal constitutes a discontinued operation

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

	₦
Proceeds received	460,000
Net assets disposed of at carrying value	400,000
Attributable to non-controlling interests (20%)	(80,000)
Unimpaired goodwill attributable to P	320,000
	21,200
Gain to equity owners of P on disposal of S	341,200
Gain on disposal, reported in profit or loss	118,800

Goodwill on the acquisition attributable to P:
= ₦330,000 - (80% × ₦280,000) = ₦106,000

Goodwill remaining after accumulated impairment (20% × ₦106,000) = ₦21,200.

Solution **2**

	₦
Proceeds received from sale of shares	540,000
Fair value of remaining investment in S	500,000
	1,040,000
Net assets disposed of at carrying value	800,000
Attributable to non-controlling interests (20%)	(80,000)
	720,000
Unimpaired goodwill attributable to P	100,000
Gain to equity owners of P on disposal of S	(820,000)
Gain on disposal, reported in profit or loss	220,000

CHAPTER 25

Other group standards

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

C	Group financial statements		
	2	Preparation of group financial statement of a complex group	
		c	Determine, apply and disclose from financial information or other data in a given scenario, the amounts to be included in group financial statements in respect of acquisitions achieved one time or in stages involving subsidiaries, associates and joint ventures.

IAS 27 and IFRS 12 are examinable documents.

Exam context

This chapter explains the provisions of these standards. This chapter supplements the earlier chapters on accounting for subsidiaries, associates and joint ventures.

At the end of this chapter, you should be able to:

- Describe the IFRS 12 disclosure requirement for investments in subsidiaries, associates and joint ventures;
- Explain the meaning of separate financial statements; and
- Describe the accounting treatment for subsidiaries, associates and joint ventures in separate financial statements.

1 IAS 27 SEPARATE FINANCIAL STATEMENTS

Section overview

- Introduction to IAS 27
- Preparation of separate financial statements
- Disclosure

1.1 Introduction to IAS 27

IAS 27 contains accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements.

IAS 27 requires an entity preparing separate financial statements to account for those investments at cost or in accordance with *IFRS 9: Financial Instruments*.

IAS 27 does say which entities must produce separate financial statements.

Definition

Separate financial statements: Those presented by a parent or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IFRS 9 Financial Instruments

Separate financial statements are those presented in addition to consolidated financial statements or in addition to financial statements in which investments in associates or joint ventures are accounted for using the equity method.

However, if a company is exempt from the need to consolidate or account for an investment using the equity method the separate financial statements are its only financial statements.

1.2 Preparation of separate financial statements

Separate financial statements must be prepared in accordance with all applicable IFRSs.

Investments in subsidiaries, joint ventures and associates must be accounted for in separate financial statements, either:

- ❑ at cost; or
- ❑ in accordance with IFRS 9; or
- ❑ using the equity method.

A company must apply the same accounting for each category of investments.

Investments accounted for at cost are subject to the rules in IFRS 5 when they are classified as held for sale.

IAS 28: Investments in Associates and Joint Ventures allows a company to measure its investments in associates or joint ventures at fair value through profit or loss. Such investments must be accounted for in the same way in its separate financial statements.

Dividends are recognised in profit or loss in separate financial statements when the right to receive the dividend is established.

1.3 Disclosure

All applicable IFRSs apply when providing disclosures in separate financial statements as well as the following requirements.

When a parent prepares separate financial statements, it must disclose:

- ❑ the fact that the financial statements are separate financial statements;
- ❑ a list of significant investments in subsidiaries, joint ventures and associates, including:
  - the name of those investees;
  - the principal place of business (and country of incorporation, if different) of those investees; and
  - its proportion of the ownership interest (and its proportion of the voting rights, if different) held in those investees.
- ❑ a description of the method used to account for the investments listed.

In addition, if a parent is exempt from preparing consolidated financial statements and elects not to do so, and instead prepares separate financial statements, it must disclose:

- ❑ the fact that the financial statements are separate financial statements;
- ❑ that the exemption from consolidation has been used;
- ❑ the name and principal place of business (and country of incorporation, if different) of the entity whose consolidated financial statements that comply with IFRS have been produced for public use; and
- ❑ the address where those consolidated financial statements are obtainable.

2 IFRS 12: DISCLOSURE OF INTERESTS IN OTHER ENTITIES

Section overview

- Introduction to IFRS 12
- Significant judgements and assumptions
- Interests in subsidiaries
- Interests in joint arrangements and associates
- Structured entities

2.1 Introduction to IFRS 12

The objective of IFRS 12 is to require companies to disclose information that enables users of their financial statements to evaluate:

- the nature of, and risks associated with, its interests in other entities; and
- the effects of those interests on its financial position, financial performance and cash flows.

This requires disclosure of:

- the significant judgements and assumptions it has made in determining the nature of its interest in another entity or arrangement, and in determining the type of joint arrangement in which it has an interest; and
- information about its interests in:
  - subsidiaries;
  - joint arrangements and associate); and
  - structured entities that are not controlled by the entity (unconsolidated structured entities).

IFRS 12 sets out required disclosures but disclosure of additional information might be necessary to meet IFRS 12's objective.

IFRS 12 must be applied by a company that has an interest in any of the following:

- subsidiaries;
- joint arrangements (i.e. joint operations or joint ventures);
- associates;
- unconsolidated structured entities.

2.2 Significant judgements and assumptions

A company must disclose information about significant judgements and assumptions it has made (and changes to those judgements and assumptions) in determining:

- ❑ that it has control of another entity;
- ❑ that it has joint control of an arrangement or significant influence over another entity; and
- ❑ the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle.

To comply with the above a company must disclose, for example, significant judgements and assumptions made in determining that:

- ❑ it does not control another entity even though it holds more than half of the voting rights of the other entity;
- ❑ it controls another entity even though it holds less than half of the voting rights of the other entity;
- ❑ it does not have significant influence even though it holds 20% or more of the voting rights of another entity; and
- ❑ it has significant influence even though it holds less than 20% of the voting rights of another entity.

2.3 Interests in subsidiaries

A company must disclose information that enables users of its consolidated financial statements

- ❑ to understand:
  - the composition of the group; and
  - the interest that non-controlling interests have in the group's activities and cash flows; and
- ❑ to evaluate:
  - the nature and extent of significant restrictions on its ability to access or use assets, and settle liabilities, of the group;
  - the nature of, and changes in, the risks associated with its interests in consolidated structured entities;
  - the consequences of changes in its ownership interest in a subsidiary that do not result in a loss of control; and
  - the consequences of losing control of a subsidiary during the reporting period.

When the financial statements of a subsidiary used in the preparation of consolidated financial statements are as of a date or for a period that is different from that of the consolidated financial statements, a company must disclose:

- ❑ the date of the end of the reporting period of the financial statements of that subsidiary; and
- ❑ the reason for using a different date or period.

Non-controlling interests

A company must disclose for each of its subsidiaries that have non-controlling interests that are material to the reporting entity:

- ❑ the name of the subsidiary;
- ❑ the principal place of business (and country of incorporation if different) of the subsidiary;
- ❑ the proportion of ownership interests held by non-controlling interests;
- ❑ the proportion of voting rights held by non-controlling interests, if different from the proportion of ownership interests held;
- ❑ the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period;
- ❑ accumulated non-controlling interests of the subsidiary at the end of the reporting period; and
- ❑ summarised financial information about the subsidiary.

The nature and extent of significant restrictions

A company must disclose:

- ❑ any significant restrictions on its ability to access or use the assets and settle the liabilities of the group, such as:
  - those that restrict the ability of a parent or its subsidiaries to transfer cash or other assets to (or from) other entities within the group;
  - guarantees or other requirements that may restrict dividends and other capital distributions being paid, or loans and advances being made or repaid, to (or from) other entities within the group; and
- ❑ the carrying amounts in the consolidated financial statements of the assets and liabilities to which those restrictions apply.

Consequences of losing control of a subsidiary during the reporting period

A company must disclose the gain or loss arising on the loss of control of a subsidiary during the period together with the line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately).

2.4 Interests in joint arrangements and associates

A company must disclose information that enables users of its financial statements to evaluate:

- the nature, extent and financial effects of its interests in joint arrangements and associates, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements and associates; and
- the nature of, and changes in, the risks associated with its interests in joint ventures and associates.

Nature, extent and financial effects of interests in joint arrangements and associates

A company must disclose:

- for each material joint arrangement and associate:
  - the name of the joint arrangement or associate;
  - the nature of the entity's relationship with the joint arrangement or associate;
  - the principal place of business (and country of incorporation, if applicable and different from the principal place of business) of the joint arrangement or associate; and
  - the proportion of ownership interest or participating share held by the entity and, if different, the proportion of voting rights held (if applicable).
- for each material joint venture and associate that is material to the reporting entity:
  - whether the investment in the joint venture or associate is measured using the equity method or at fair value.
  - summarised financial information about the joint venture or associate.
  - if the joint venture or associate is accounted for using the equity method, the fair value of its investment in the joint venture or associate, if there is a quoted market price for the investment.
- financial information about the entity's investments in joint ventures and associates that are not individually material:
  - in aggregate for all individually immaterial joint ventures and, separately,
  - in aggregate for all individually immaterial associates.

A company must also disclose:

- the nature and extent of any significant restrictions on the ability of joint ventures or associates to transfer funds to the entity in the form of cash dividends, or to repay loans or advances made by the entity.
- when the financial statements used in applying the equity method are as of a date or for a period that is different from that of the entity:
  - the date of the end of the reporting period of the financial statements of that joint venture or associate; and
  - the reason for using a different date or period.

- the unrecognised share of losses of a joint venture or associate, both for the reporting period and cumulatively, if the entity has stopped recognising its share of losses of the joint venture or associate when applying the equity method.

Risks associated with an entity's interests in joint ventures and associates

A company must disclose:

- commitments that it has relating to its joint ventures separately from the amount of other commitments
- contingent liabilities incurred relating to its interests in joint ventures or associates (unless the probability of loss is remote).

2.5 Structured entities

Definition

Structured entity: An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

A structured entity might be consolidated or unconsolidated depending on the results of the analysis of whether control exists.

Consolidated structured entities

A company must disclose the terms of any contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity.

A company must also disclose any support given where there is no contractual obligation and any intention to provide financial or other support to a consolidated structured entity.

Unconsolidated structured entities

A company must disclose information that enables users of its financial statements:

- to understand the nature and extent of its interests in unconsolidated structured entities; and
- to evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe the IFRS 12 disclosure requirement for investments in subsidiaries, associates and joint ventures
- Explain the meaning of separate financial statements
- Describe the accounting treatment for subsidiaries, associates and joint ventures in separate financial statements

Professional level
Corporate Reporting

CHAPTER 26

Foreign currency

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

C	Group financial statements		
	2	**Preparation of group financial statement of a complex group**	
		e	Discuss and appraise how foreign currency transactions of a single entity or group entities are measured and accounted for in the financial statements.
		f	Discuss and appraise how the financial statements of overseas entities are translated and consolidated.
		h	Prepare group financial statements where necessary in (c) to (g) above.

IAS 21 is an examinable document.

Exam context

This chapter explains the rules on accounting for transactions denominated in a foreign currency.

At the end of this chapter, you should be able to:

- Define functional currency and identify the functional currency of a company in simple situations;
- Account for direct transactions in a foreign currency and account for the exchange differences; and
- Account for foreign operations.

1 IAS 21: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Section overview

- The scope of IAS 21
- The two main accounting issues
- Terms and definitions used in IAS 21: currency definitions
- Terms and definitions used in IAS 21: other definitions

1.1 The scope of IAS 21

Many businesses have transactions and investments that are denominated in a foreign currency.

- Individual companies often enter into transactions in a foreign currency. These transactions need to be translated into the company's own currency in order to record them in its ledger accounts. For example:
  - a US company may take out a loan from a French bank in euros and will record the loan in its ledger accounts in US dollars; or
  - a German company may sell goods to a Japanese company invoiced in yen and will record the sale and the trade receivable in euros in its ledger accounts.
- Groups often contain overseas entities. A parent company might own a foreign subsidiary or associate. This foreign entity will normally maintain its accounting records and prepare its financial statements in a currency that is different from the currency of the parent company and the group's consolidated accounts.
  - For example, if a Japanese company has a US subsidiary, the financial statements of the US subsidiary will be prepared in US dollars, but will need to be translated into yen for the purpose of preparing the group's consolidated financial statements.

The rules on accounting for foreign currency items are concerned with translating or converting items from one currency into another currency, at an appropriate rate of exchange between the currencies. The rules are mostly contained in IAS 21 *The effects of changes in foreign exchange rates*. The rules in IAS 21 can be divided into two areas:

- Transactions affecting individual entities. IAS 21 deals with the translation of these transactions when they occur and at subsequent reporting dates when re-translation at a different exchange rate may be necessary.
- Foreign operations (subsidiaries, associates etc) which affect the consolidated financial statements. The rules in IAS 21 explain how to translate the financial statements of the foreign subsidiaries, associates or joint ventures. Once translated, the normal consolidation rules or equity accounting rules will apply.

One area that IAS 21 does not deal with is the translation of any transactions and balances that fall within the scope of IFRS 9 on financial instruments. For example, if a company takes out a forward foreign exchange contract to hedge against foreign currency exposure, the accounting treatment is covered by the rules in IFRS 9, because a forward contract is a financial instrument.

1.2 The two main accounting issues

Transactions and assets and liabilities in foreign currencies are translated or converted from the foreign currency into the currency of the reporting entity. The process of translation would be quite simple if exchange rates between currencies remained fixed. However, exchange rates are continually changing. The translated valuation of foreign currency assets or liabilities in the statement of financial position might therefore change if they are translated at different times.

The two main accounting issues when accounting for foreign currency items are:

- What exchange rate(s) should be used for translation?
- How to account for the gains or losses that arise when exchange rates change?

Before looking at these accounting rules in detail, it is important to understand the precise meaning of some key terms used in IAS 21.

1.3 Terms and definitions used in IAS 21: currency definitions

IAS 21 identifies three types of currency: the presentation currency, the functional currency and foreign currency.

Definitions

Presentation currency: The currency in which the financial statements of an entity are presented

Functional currency: The currency of the primary economic environment in which an entity operates.

Foreign currency: A currency other than the functional currency of the entity

Presentation currency

An entity is permitted to present its financial statements in any currency. This reporting currency is often the same as the functional currency, but does not have to be.

Functional currency

When a reporting entity records transactions in its financial records, it must identify its functional currency and make entries in that currency. It will also, typically, prepare its financial statements in its functional currency. This rule applies to stand-alone entities, parent companies and foreign operations (such as a foreign subsidiary or a branch). When financial statements prepared in a functional currency are translated into a different presentation currency, the translation of assets and liabilities must comply with the rules in IAS 21.

IAS 21 describes the functional currency as:

- The currency that mainly influences:
  - sales prices for goods and services; and
  - labour, material and other costs of providing goods or services.
- The currency in which funds are generated by issuing debt and equity

- The currency in which receipts from operating activities are usually retained.

The functional currency is not necessarily the currency of the country in which the entity operates or is based, as the next example shows.

Example: Presentation and functional currencies

P is a UK-registered mining company whose shares are traded on the London Stock Exchange. Its operating activities take place in the gold and diamond mines of South Africa.

(a) What is the presentation currency of P?

(b) What is its functional currency?

(c) P bought specialised mining equipment from the US, invoiced in US dollars. What type of currency is the US dollar, using the IAS 21 definitions?

Answer

(a) The presentation currency (reporting currency) is sterling (UK pounds). This is a requirement of the UK financial markets regulator for UK listed companies.

(b) The functional currency is likely to be South African rand, even though the company is based in the UK. This is because its operating activities take place in South Africa and so the company will be economically dependent on the rand if the salaries of most of its employees, and most operating expenses and sales are in rand.

(c) The US dollars are 'foreign currency' for the purpose of preparing P's accounts.

IAS 21 requires P to prepare its financial statements in its functional currency (rand).

However, P is permitted to use sterling as its presentation currency. If it does use sterling as its presentation currency (which it will do, given the UK rules), the translation of assets and liabilities from rand to sterling must comply with the rules in IAS 21.

1.4 Terms and definitions used in IAS 21: other definitions

Exchange rate definitions

IAS 21 uses the following terms to describe which exchange rate should be used in the translation.

Definitions

Exchange rate: The rate of exchange between two currencies

Spot rate: The exchange rate at the date of the transaction

Closing rate: The spot exchange rate at the end of the reporting period

For example, suppose that on 16 November a German company buys goods from a US supplier, and the goods are priced in US dollars. The financial year of the company ends on 31 December, and at this date the goods have not yet been paid for.

- The spot rate is the euro/dollar exchange rate on 16 November, when the transaction occurred.
- The closing rate is the exchange rate at 31 December.

Other definitions

IAS 21 also includes some other terms and definitions.

Definitions

Foreign operation: This is a subsidiary, associate, joint venture or branch whose activities are conducted in a country or currency different from the functional currency of the reporting entity.

Net investment in a foreign operation: The amount of the reporting entity's interest in the net assets of a foreign operation.

Exchange difference: A difference resulting from translating the same assets, liabilities, income or expenses from one currency into another currency at different exchange rates.

Monetary items: Units of currency held, or assets and liabilities to be received or paid (in cash), in a fixed number of currency units. Examples of monetary items include cash itself, loans, trade payables, trade receivables and interest payable.

Non-monetary items are not defined by IAS 21, but they are items that are not monetary items. They include tangible non-current assets, investments in other companies, investment properties and deferred taxation (which is a notional amount of tax rather than an actual amount of tax payable.)

2 THE INDIVIDUAL ENTITY: ACCOUNTING RULES

Section overview

- Introduction
- Initial recognition: translation of transactions
- Reporting at the end of each reporting period
- Gain or loss arising on translation
- Reporting at the settlement of a transaction

2.1 Introduction

An individual company may have transactions that are denominated in a foreign currency. These must be translated into the company's functional currency for the purpose of recording the transactions in its ledger accounts and preparing its financial statements.

These transactions may have to be translated on several occasions. When a transaction or asset or liability is translated on more than one occasion, it is:

- translated at the time that it is originally recognised; and
- re-translated at each subsequent occasion.

Re-translation may be required, after the transaction has been recognised initially:

- at the end of a financial year (end of a reporting period);
- when the transaction is settled (which may be either before, or after the end of the financial year)?

On each subsequent re-translation, an exchange difference will occur. This gives rise to a gain or loss on translation from the exchange difference.

2.2 Initial recognition: translation of transactions

On initial recognition, a transaction in a foreign currency must be translated at the **spot rate** on the date of the transaction.

If the company purchases goods on most days in the foreign currency, it might be administratively difficult to record every transaction at the actual spot rate. For practical reasons, IAS 21 therefore allows entities to use an **average rate** for a time period, provided that the exchange rate does not fluctuate significantly over the period. For example, an entity might use an average exchange rate for a week or a month for translating all the foreign currency-denominated transactions in that time period.

These rules apply when an entity:

- buys goods or services that will be paid for in another currency;
- sells goods or services invoiced in another currency;
- borrows or lends when the interest payments and repayments of principal are in another currency;
- purchases or disposes of non-current assets in another currency; or
- receives dividends and other payments in another currency.

Example: Initial recognition

A UK company (with sterling as its functional currency) has a financial year ending on 31 December.

It buys goods from a supplier in France (with euros as its functional currency) on 17 November 20X6 invoiced in euros €140,000. The French supplier is eventually paid in March 20X7.

Exchange rates over the period were as follows:

17 November 20X6 €1 = £0.70

31 December 20X6 €1 = £0.75

Average for November €1 = £0.72

The purchase/inventory and the trade payable should be recorded initially by translating the transaction at the spot rate of €1 = £0.70. This gives a translated value of £98,000 for recording in the ledger accounts (€140,000 × 0.70).

For practical purposes, if the entity buys items in euros frequently, it may be able to use an average spot rate for a period, for all transactions during that period.

2.3 Reporting at the end of each reporting period

Transactions in a foreign currency

Transactions in a foreign currency may still 'exist' in the statement of financial position at the end of the financial period. They were recognised initially in the accounts at the spot rate on the date of the transaction. However exchange rates change over time and the exchange rate at the end of the reporting period will not be the same as the spot rate on the date of the transaction.

For example, there may be a trade receivable in the statement of financial position relating to a sale denominated in a foreign currency. The trade receivable would have been translated at the spot exchange rate on the transaction date. It is still a receivable in a foreign currency at the end of the reporting period.

An important accounting question is therefore: Should a different exchange rate now be used now to translate the asset into the functional currency of the entity, for the purpose of preparing the financial statements for the year?

Revaluations of non-current assets

A non-current asset in a foreign currency might be re-valued during a financial period. For example, a UK company might own an office property in the US. The cost of the office would have been translated at the spot rate when the property was originally purchased. However, it might subsequently be re-valued. The revaluation will almost certainly be in US dollars, and this re-valued amount will have to be translated into the functional currency of the entity (in this example, sterling).

- What exchange rate should be used to record the revaluation?
- What exchange rate should be used at the end of the reporting period, and at the end of any subsequent reporting period?

The rules

The rules in IAS 21 for reporting assets and liabilities at the end of a subsequent reporting period make a distinction between:

- monetary items, such as trade payables and trade receivables; and
- non-monetary items, such as non-current assets and inventory.

The rules are as follows, for entities preparing their individual financial statements:

Asset or liability	Accounting treatment for the statement of financial position:
Monetary items	Re-translate at the closing rate.
Non-monetary items carried at cost	No re-translation. The transaction is left at the original spot rate.
Non-monetary items carried at fair value	Re-translate at the exchange rate ruling at the date of the fair value adjustment.

2.4 Gain or loss arising on translation

Any subsequent re-translation after the initial recognition of a transaction will give rise to an exchange gain or loss if the exchange rate has changed since the initial transaction date.

The gain or loss is the difference between the original and re-translated value of the item.

- There is an exchange **gain** when an asset increases in value on re-translation, or when a liability falls in value.
- There is an exchange **loss** when an asset falls in value on re-translation, or when a liability increases in value.

A gain or loss arising on the re-translation of a monetary item should be recognised in profit or loss in the period that it arises.

When a gain or loss on a non-monetary item is recognised in other comprehensive income, any exchange rate gain or loss relating to it should also be included in other comprehensive income. For example when a gain or loss on revaluation of a non-current asset is reported in other comprehensive income, the related exchange difference is also recognised in other comprehensive income rather than in profit or loss for the period.

Example: Retranslation of monetary item

A UK company borrowed US$900,000 on 3 June when the spot rate was $1.80 = £1. At 31 December the exchange rate was $1.90 = £1. An interest payment of $18,500 was made on 3 December when the spot exchange rate was $1.85. The loan is a monetary item, denominated in US dollars.

The loan is recognised initially as £500,000 ($900,000/1.80).

On 31 December, the loan is re-translated as £473,684 ($900,000/1.90). There is an exchange difference on retranslation of £26,316 (£500,000 – £473,684). As the liability has fallen in value, this represents an exchange gain. The loan is a monetary item; therefore the gain will be reported in profit or loss for the year.

The interest payment of $18,500 is recognised at £10,000 ($18,500/1.85). This item is translated at the spot rate on the date of the transaction.

Example:

A UK company bought a machine from a German supplier for €260,000 on 1 March when the exchange rate was €1.30 = £1. By 31 December, the end of the company's accounting year, the exchange rate was €1.20 = £1.

At 31 December, the UK company had not yet paid the German supplier any of the money that it owed for the machine.

At the year end

The machine is recognised initially at £200,000 (€260,000/1.30). As it is a non-monetary item, it will not be re-translated and there is no gain or loss.

However, the company purchased the machine on credit and had not settled the account payable by the year-end. The amount payable should be re-translated at the closing rate, because this is a monetary item. The payable would therefore be re-translated to £216,667 (= €260,000/1.20).

The re-translation will give rise to an exchange difference. In this example the re-translated amount of the liability is higher, and a loss of $16,667 should be reported in profit or loss for the year.

2.5 Reporting at the settlement of a transaction

The settlement of a foreign currency transaction involves a receipt or payment in foreign currency. Settlement in the foreign currency is made at the spot exchange rate that applies on that date. (Note: This chapter ignores the possibility of using a forward exchange contract to fix the exchange rate in advance: the accounting effects of forward contracts are explained in another chapter.)

The exchange rate at the settlement date may be:

- different from the spot rate on the date of the original transaction, and
- different from the closing exchange rate at the end of the previous reporting period (if there is a year-end between the original transaction and settlement).

A gain or loss on translation may therefore occur:

- at the end of a reporting period and in addition
- at settlement of the transaction.

For example, suppose that a UK company buys goods, payable in US dollars, from a US supplier on 10 December Year 1. Its year end is 31 December, and the company pays the supplier on 9 February Year 2.

In this situation:

- The purchase transaction will be recorded in sterling at the spot rate on 10 December Year 1.
- The trade payable will also be recorded in sterling at the spot rate on 10 December Year 1.
- The trade payable will be re-translated on 31 December at the year-end, because it is a monetary item. A gain or loss will arise on the re-translation, and this will be recognised in profit or loss for the year ending 31 December Year 1.

- The US supplier is paid on 9 February, and the cost of obtaining the dollars to make the payment will be the exchange rate available on 9 February, the settlement date.

If the cost of the settlement is different from the amount at which the transaction is recorded in the ledger accounts (the amount at which the payable was re-translated on 31 December Year 1), a further gain or loss will arise. This is the difference between the translated value of the liability in the ledger accounts and the actual cost of making the settlement. This settlement gain or loss should be included in profit or loss for the year ended 31 December Year 2.

Example: Settlement of a transaction

A UK company sells goods to a customer in Saudi Arabia for $72,000 on 12 September, when the exchange rate was $1.80 = £1. It received payment on 19 November, when the exchange rate was $2 = £1. The financial year-end is 31 December.

The sale will be initially translated at the spot rate. This will give rise to revenue and receivables of £40,000 ($72,000/1.80).

The receipt of the payment is recorded at £36,000 ($72,000/2.00).

The receivable has fallen in value over the two months: it was initially recorded at £40,000 but at settlement it is only worth £36,000. The company has an exchange loss on settlement of £4,000. This is recognised in profit or loss for the year.

Example: Settlement of a transaction

A UK company buys goods from a US supplier for $30,000 on 30 November Year 1 when the spot exchange rate was $1.50. The company has a financial year that ends on 31 December. At 31 December Year 1, the exchange rate is $1.80 = £1. The payment for the goods is made on 16 March Year 2, when the exchange rate was $1.60 = £1.

The transaction is recorded initially at £20,000 ($30,000/1.50).

Debit Purchases £20,000

Credit: Trade payables £20,000.

If the purchased inventory is still held at the end of the reporting period on 31 December Year 1, it is not re-translated because inventory is a non-monetary item.

However, the amount payable at 31 December Year 1 is re-translated to the closing rate, giving a revised balance of £16,667 ($30,000/1.80).

The re-translated amount of the liability is lower; so there is a gain on the re-translation of £3,333. This gain is included in profit or loss for Year 1.

Debit: Trade payables £3,333

Credit: Profit or loss £3,333.

The payment on 16 March Year 2 is recorded at the exchange rate on settlement date. The payment is therefore £18,750 ($30,000/1.60).

Debit: Trade payables £16,667

Credit: Cash £18,750

There is a loss on settlement of £2,083 (£18,750 – £16,667), arising from the exchange difference between translating the foreign currency amount at the end of the previous reporting period and at the settlement date. This gain or loss from the exchange difference is included in profit or loss for Year 2.

3 THE FOREIGN OPERATION: ACCOUNTING RULES

Section overview

- Three stages in the consolidation process
- The translation stage
- The consolidation stage
- Consolidation example
- Exchange differences in other comprehensive income
- Disposal of a foreign subsidiary

3.1 Three stages in the consolidation process

If a company has a foreign operation (such as a foreign subsidiary) that prepares its accounts in a functional currency that is different from the group's presentation currency, there are three stages in the accounting process, for the purpose of preparing consolidated financial statements (or including the foreign associate or joint venture in the financial statements of the reporting entity).

Stage	Description
Adjust and update	▪ Ensure that the individual financial statements of the foreign entity are correct and up-to-date. ▪ If any adjustments are required to correct the financial statements of the foreign entity, these should be made in the statements of the foreign entity and in its own functional currency.
Translate	▪ The assets and liabilities of the foreign entity should be translated into the presentation currency of the parent company. (As explained earlier, the presentation currency of the parent company might be the same or might be different from its functional currency.) ▪ The rules for translation are explained below.
Consolidate	▪ After translation, all the financial statements are now in the same currency. ▪ Normal group accounting principles are now used to prepare the consolidated accounts of the group.

3.2 The translation stage

The rules set out below apply where the functional currency of the foreign entity is not a currency suffering from hyperinflation. (Hyperinflation is where the country's rate of inflation is very high. When there is hyperinflation, IAS 29 provides special accounting rules, which are described later.)

The normal rules for translation, contained in IAS 21, are as follows:

(1) The statement of financial position

- The assets and liabilities of the foreign operation, for inclusion in the consolidated statement of financial position, are translated at the **closing rate**. (Comparative figures for the previous year are translated at the same rate.)
- For foreign subsidiaries, this rule also applies to **purchased goodwill** arising on the acquisition of the subsidiary.

(2) The statement of profit or loss

- Income and expenses for inclusion in the consolidated statement of profit or loss are translated at the **spot rates** at the dates of each of the transactions.
- For practical reasons, **average rates** for a period may be used, if they provide a reasonable approximation of the spot rates when the transactions took place.

(3) Exchange differences

- All resulting exchange differences are recognised in other comprehensive income for the period and are credited (gain) or debited (loss) to a **separate reserve** within the equity section of the consolidated statement of financial position, and this reserve is maintained within equity until the foreign operation is eventually disposed of.
- Gains or losses are therefore reported as gains or losses in other comprehensive income and movements in the separate reserve, and not as a gain or loss in profit or loss and an increase or reduction in retained earnings.

The gain or loss on translation

The exchange differences on translation (see (3) above) result in a gain or loss. These gains or losses arise from a combination of two factors:

- Income and expense items are translated at the exchange rates ruling during the period (or an average rate as an approximation) but assets and liabilities are translated at closing rates. The profit is therefore calculated at the actual (average) exchange rates, but the accumulated profit in the consolidated statement of financial position is re-translated at the closing rate.
- The net assets of the subsidiary were translated at last year's closing rate at the end of the previous financial year. These net assets have now been retranslated and included in this year's statement of financial position at this year's closing rate.

IAS 21 states that these differences on translation are not recognised in profit or loss because changes in the exchange rates for these items have little or no effect on cash flows from operations. It would therefore be misleading to include them in profit or loss.

Example:

A UK parent company has a US subsidiary, which is 100% owned. The following information is available about the subsidiary for the year to 31 December Year 5:

Opening net assets, 1 January	$20,000
Profit for the year	$10,000
Closing net assets, 31 December	$30,000
Dividends paid	$0

Relevant $/£ exchange rates are as follows:

1 January Year 5	$1.70 = £1
Average for the year	$1.80 = £1
31 December Year 5	$1.90 = £1

Required

Calculate the total gain or loss on translation for the year, analysing it between:

a. the gain or loss on re-translating income and expenses

b. the gain or loss on re-translating the opening net assets.

Answer

The entire profit for the year is included in accumulated profit at the end of the year, because no dividends were paid during the year.

Exchange difference: gain or (loss)

	£	£
a On re-translating the opening net assets:		
$20,000 at opening rate 1.70	11,765	
$20,000 at closing rate 1.90	10,526	
		(1,239)
b On re-translating the profit for the year:		
$10,000 at average rate 1.80	5,556	
$10,000 at closing rate 1.90	5,263	
		(293)
Exchange loss arising		(1,532)

The exchange loss should be recognised in other comprehensive income for the year and taken to a separate reserve within equity in the consolidated statement of financial position.

3.3 The consolidation stage

After the translation stage, the financial statements of the overseas entity are in the presentation currency of the parent company.

The basic rule is that normal consolidation techniques can now be used. However, a foreign exchange reserve must be included in the consolidated statement of financial position for the cumulative exchange differences.

It is also necessary to comply with the requirements of IAS 21 for purchased goodwill and foreign subsidiaries.

Purchased goodwill and foreign subsidiaries

IAS 21 requires that goodwill and any fair value adjustments arising on the acquisition of a foreign subsidiary are to be treated as part of the assets and liabilities of the foreign subsidiary. The rules already described apply to these items.

This means that:

- Goodwill arising on the purchase of the foreign subsidiary (and also any fair value adjustments to the value of assets of the subsidiary) should be stated in the functional currency of the foreign subsidiary.
- The goodwill and fair value adjustments will therefore be translated each year at the **closing exchange rate**.

A gain or loss on translation will therefore arise (as described above for other assets and liabilities).

The effect of this rule is that goodwill and the acquisition of a foreign operation is re-stated over time because it is re-translated every year at the new closing exchange rate.

The rationale behind this accounting rule is that the amount paid for the investment in the subsidiary has been based on the expected future earnings stream. The goodwill relates to a business which operates in the economic environment of another country and should therefore be expressed in the functional currency of the foreign subsidiary.

Example: Retranslation of goodwill

A UK holding company acquired 100% of the capital of a US subsidiary on 30 September Year 6 at a cost of $8 million. The fair value of the net assets of the subsidiary at that date was $3 million.

The holding company prepares financial statements at 31 December each year. The company uses the partial goodwill method to account for non-controlling interests, and no goodwill is attributed to NCI.

Relevant $/£ exchange rates are as follows:

30 September Year 6 $2.00 = £1

31 December Year 6 $1.90 = £1

Required

(a) Calculate the goodwill arising at the date of the acquisition, in £.

(b) Calculate the goodwill (in £) which will appear in the consolidated statement of financial position as at 31 December Year 6.

Answer

(a) **Goodwill arising on acquisition**

All elements of the calculation are initially translated at the spot rate of 2.00

	$	Rate	£
Cost of investment	8m	2.00	4.0m
Minus: Net assets acquired	3m	2.00	1.5m
Goodwill	5m	2.00	2.5m

(b) Goodwill at 31 December Year 6

The goodwill must be re-translated to the closing rate of 1.90 The goodwill is therefore re-valued to £2.632 million ($5m / 1.90).

An exchange gain of £0.132m (2.632m – 2.5m) has arisen on re-translation.

This exchange gain is recognised in other comprehensive income and credited to the foreign exchange reserve within equity in the consolidated statement of financial position.

3.4 Consolidation example

The following example looks at the whole process of foreign currency consolidation, beginning with the translation of the foreign subsidiary's accounts and finishing with their consolidation into the parent group accounts.

Example:

AB owns 75% of JK which is located in a different country. The currency of this country is the Florin (Fl). AB acquired its shares in JK on 1 May Year 6 for 240 million Florins when the retained earnings of JK were 160 million Florins. Their statements of financial position are shown below:

Statements of financial position at 30 April Year 7:

	AB	JK
	$m	Fl m
Tangible non-current assets	594	292
Investment in JK	48	-
Current assets	768	204
	1,410	496
Share capital	120	64
Share premium	100	40
Retained earnings	720	190
	940	294
Non-current liabilities	60	82
Current liabilities	410	120
	1,410	496

Notes:

(i) The fair value of JK's net assets at acquisition is the same as their carrying value.

(ii) JK operates with autonomy in its business operations.

(iii) AB uses the **partial goodwill method** to account for non-controlling interests, and NCI does not include an amount for goodwill.

(iv) The following exchange rates are relevant:

1 May Year 6	Fl 5.0 = $1
Average for the year	Fl 4.0 = $1
30 April Year 7	Fl 4.2 = $1

Prepare a consolidated statement of financial position at 30 April Year 7.

Answer

There are a number of steps that need to be followed in consolidating a foreign currency operation.

Step 1

Deal with any adjustments to the accounts of the subsidiary and parent, e.g. inter-company trading transactions and inter-company loans. Apply the normal rules for dealing with these.

Step 2

When the financial statements of the subsidiary have been updated and adjusted as necessary, translate the subsidiary's accounts into the reporting currency (in this example translate from Florins into $).

Step 3

Calculate goodwill, consolidated reserves and non-controlling interest (the usual rules for preparing a consolidated statement of financial position apply).

Step 4

Consolidate the parent with the translated accounts of the subsidiary.

Answer

There are no adjustments to make in Step 1 so we can go straight to the translation in Step 2.

Step 2

The subsidiary's statement of financial position is translated at the closing rate.

JK Statement of financial position	Florins (m)	Exchange rate	$m
Non-current assets			
Tangible assets	292	4.2	69.5
Current assets	204	4.2	48.5
	496		118.0
Share capital	64	4.2	15.2
Share premium	40	4.2	9.5
Retained earnings at acquisition	160	4.2	38.1
Net assets at acquisition	264		62.8
Reserves – post acquisition	30	4.2	7.1
	294		69.9
Non-current liabilities	82	4.2	19.5
Current liabilities	120	4.2	28.6
	496		118.0

Answer (continued)

Step 3

Workings for consolidation

1 Goodwill:

Goodwill must be calculated and included in the consolidated statement of financial position at the closing rate.

	Florins (m)	Rate	$m
Cost of investment	240	4.2	57.1
Less parent's share of net assets acquired			
75% × 264 million Florins	(198)	4.2	(47.1)
Goodwill at closing rate	42	4.2	10.0

We also have to deal with the exchange gain or loss on the parent's cost of investment.

In the goodwill calculation above, the cost of investment is translated at the closing rate. When JK was purchased, AB recorded the cost of investment at the rate at that date. The gain or loss on re-translation to the closing rate will be recognised in other comprehensive income and recorded in the reserves attributable to the parent entity.

	$m
Cost of investment at historical rate: 240 /5.0	48.0
Cost of investment at closing rate: 240 /4.2	57.1
Exchange gain	9.1

2 Non-controlling interest

In $m, NCI = 25% × 69.9 = 17.5

3 Consolidated reserves attributable to owners of AB

	$m
AB	720.0
JK: share of post-acquisition profits: 75% × 7.1	5.3
Exchange gain (see above)	9.1
	734.4

Answer (continued)

AB: Consolidated statement of financial position as at 31 May Year 7

	$m
Non-current assets	
Tangible assets (594 + 69.5)	663.5
Intangible assets: goodwill	10.0
Current assets (768 + 48.5)	816.5
Total assets	1,490.0
Equity and liabilities	
Equity attributable to owners of AB	
Share capital	120.0
Share premium	100.0
Retained earnings	734.4
	954.4
Non-controlling interests	17.5
Total equity	971.9
Non-current liabilities (60 + 19.5)	79.5
Current liabilities (410 + 28.6)	438.6
	1,490.0

3.5 Exchange differences in other comprehensive income

Using the method of creating the consolidated statement of financial position shown in the previous example, you do not need to worry about exchange differences. By translating every balance in the subsidiary's statement of financial position at the closing rate, the exchange differences are automatically included in reserves.

However, you may be asked to calculate exchange differences arising for reporting in other comprehensive income and a separate equity reserve.

The easiest way to work out the exchange differences (excluding the gain or loss on re-translation of goodwill) is to create the accounting equation for the foreign subsidiary in its own currency. Once this is translated into the parent's currency it will not balance, and the exchange differences are the balancing figure. These are the exchange differences arising from:

- re-translating the opening net assets of the subsidiary at the closing rate, and
- re-translating the subsidiary's post-acquisition profit at the closing rate.

An example will be used to demonstrate the calculation.

Example: Exchange difference on consolidation

The same example that was used above will be used here, with the exception that the acquisition occurred one day earlier, at the end of the previous financial year.

AB owns 75% of JK which is located in a different country. The currency of this country is the Florin (Fl). AB acquired its shares in JK on 30 April Year 6 for 240 million Florins when the retained earnings of JK were 160 million Florins. The statement of financial position of JK as at 30 April Year 7 is shown below:

JK: Statement of financial position at 30 April Year 7:

	Fl m
Tangible non-current assets	292
Current assets	204
	496
Share capital	64
Share premium	40
Retained earnings	190
	294
Non-current liabilities	82
Current liabilities	120
	496

Notes:

(1) AB measures non-controlling interest on acquisition as a proportionate share of net assets.

(2) JK did not pay any dividends during the year.

(3) The following exchange rates are relevant:

30 April Year 6	Fl 5.0 = $1
Average for the year	Fl 4.0 = $1
30 April Year 7	Fl 4.2 = $1

Example (continued): Exchange difference on consolidation

At 30 April Year 6, the consolidated financial position of the AB Group would include the following items:

	Florins (m)	Exchange rate	$m
Cost of investment	240		
Parent's share of net assets of JK 75% × (64 + 40 + 160) m	198		
Goodwill	42.0	5.0	8.4
Net assets of JK: (64 + 40 + 160) m	264.0	5.0	52.8
Non-controlling interests: 25% × 264m	66.0	5.0	13.2

During the year to 30 April Year 7, the post-acquisition profit of JK is 30 million Florins (= $190 million - $160 million) retained reserves.

The consolidated profit for the year is reported as $7.5 million (= $30 million at average rate 4.0). 75% of this is attributable to the parent company and 25% to the NCI.

	Florins (m)	Exchange rate	$m
Opening net assets of JK	264.0	5.0	52.8
Profit for the year	30.0	4.0	7.5
			60.3
Closing net assets	294.0	4.2	70.0
Exchange gain			9.7

This total exchange gain is 75% attributable to the parent entity ($7.3 million) and 25% to NCI ($2.4 million).

There is also an exchange gain or loss on the re-translation of goodwill (100% attributable to the parent).

	Florins (m)	Exchange rate	$m
Opening goodwill	42.0	5.0	8.4
Closing goodwill (no impairment)	42.0	4.2	10.0
Exchange gain			1.6

Example (continued): Exchange difference on consolidation

The change in the consolidated statement of financial position between 30 April Year 6 and 30 April Year 7 arising from the consolidation of JK's financial statements can be summarised as follows:

	Florins (m)	Exchange rate	$m
Goodwill	42.0	4.2	10.0
Closing net assets of JK	294.0	4.2	70.0
			80.0
Equity attributable to owners of AB			
Share of JK profit (75%)	22.5	4.0	5.6
Exchange gain on revaluation of goodwill			1.6
Other exchange gains (75% × 9.7)			7.3
Increase in reserves attributable to parent			14.5
Non-controlling interest (25% × 70)			17.5
			32.0

The difference between the net assets side and the equity side is $48 million, the cost of the investment of AB in JK.

The total exchange gain attributable to the owners of the parent entity is $8.9 million (1.6 + 7.3). This should be recognised in other comprehensive income for the year and credited to a separate reserve in equity.

The closing balance of NCI is $17.5 million, which is the opening balance for NCI (= $13.2 million) plus the NCI share of the recognised profit of JK for the year ($1.9 million, = 25% × $7.5 million) plus a 25% share of the exchange gains recognised in other comprehensive income, excluding the gain on goodwill (= 25% × $9.7 million) = $2.4 million).

	$m
Opening balance, NCI	13.2
Share of recognised profit for the year	1.9
Share of other comprehensive income	2.4
Closing balance, NCI	17.5

3.6 Disposal of a foreign subsidiary

Most of the accounting rules for the disposal of a foreign subsidiary, or for the partial disposal of a foreign subsidiary, are set out in IFRS 10. Disposals are explained in another chapter.

However IFRS 10 does not deal with the accounting treatment of the balance on the separate equity reserve account when a foreign subsidiary is disposed of. This matter is dealt with by IAS 21.

- When the entire investment in a foreign subsidiary is disposed of, the cumulative balance in the separate equity reserve (which represents amounts previously recognised in other comprehensive income) should now be reclassified from equity to profit and loss.
- If there was a non-controlling interest in the subsidiary, the NCI is derecognised in the consolidated statement of financial position. Amounts previously recognised in other comprehensive income and attributed to NCI must not be reclassified and recognised in profit or loss of the reporting entity.
- When a proportion of an investment in a foreign subsidiary is disposed of, a proportionate share of the amounts previously recognised in other comprehensive income (the cumulative balance in the separate equity reserve) should now be reclassified from equity to profit or loss.

When income previously recognised as other comprehensive income is reclassified as a gain or loss to profit or loss as a re-classification adjustment, there must be an offsetting loss or gain in other comprehensive income, to avoid double-counting of the gain (or loss).

Example: Disposal

A company held 100% of the equity of a subsidiary S, but sold the entire investment on 1 June when the carrying value of the net assets S and the purchased goodwill were ₦30 million. The consideration received from selling the shares was ₦37 million.

The company had previously recognised exchange gains of ₦2 million in other comprehensive income on its investment in S.

Required

Show the amount to be recognised in the statement of profit or loss in respect of this disposal.

Answer

The company should recognise ₦9 million in profit or loss for the financial period when the disposal occurs as follows:

	₦m
Consideration received from sale of shares	37.0
Carrying value of net assets of S	30.0
Gain	7.0
Exchange gain previously recognised in other comprehensive income (reclassification adjustment)	2.0
Total gain recognised in profit or loss	9.0

A debit of ₦2 million should be recognised in other comprehensive income, to avoid double counting of the income previously recognised as other comprehensive income but now reclassified in profit or loss.

AB: Consolidated statement of financial position as at 31 May Year 7

	$m
Non-current assets	
Tangible assets (594 + 69.5)	663.5
Intangible assets: goodwill	10.0
Current assets (768 + 48.5)	816.5
Total assets	1,490.0
Equity and liabilities	
Equity attributable to owners of AB	
Share capital	120.0
Share premium	100.0
Retained earnings	734.4
	954.4
Non-controlling interests	17.5
Total equity	971.9
Non-current liabilities (60 + 19.5)	79.5
Current liabilities (410 + 28.6)	438.6
	1,490.0

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define functional currency and identify the functional currency of a company in simple situations
- Account for direct transactions in a foreign currency and account for the exchange differences
- Account for foreign operations

Professional level
Corporate Reporting

CHAPTER 27

IAS 7: Statement of cash flows

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	**Reporting of entity's performance to stakeholders**			
	1	**Performance reporting**		
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.	

IAS 7 is an examinable document.

Exam context

This chapter explains how to prepare a statement of cash flow.

This standard was examinable in a previous paper. It is covered here again in detail for your convenience.

At the end of this chapter, you should be able to:

- Prepare extracts from a statement of cash flow;
- Prepare a statement of cash flow;
- Prepare extracts from a consolidated statement of cash flow; and
- Prepare a consolidated statement of cash flow.

1 STATEMENT OF CASH FLOWS: INTRODUCTION

Section overview

- Purpose of statement of cash flows
- Format
- Direct method: Accruals based figures
- Working capital adjustments: Introduction

1.1 Purpose of statement of cash flows

IAS 1 states that a statement of cash flows is a part of a complete set of the financial statements of an entity. It provides information about:

- the cash flows of the entity during the reporting period, and
- the changes in cash and cash equivalents during the period.

A statement of cash flows groups inflows and outflows of cash under three broad headings:

- cash from operating activities;
- cash used in (or obtained from) investing activities;
- cash paid or received in financing activities.

It also shows whether there was an increase or a decrease in the amount of cash held by the entity between the beginning and the end of the period.

Illustration: Statement of cash flows

Cash from operating activities	X/(X)
Cash used in (or obtained from) investing activities	X/(X)
Cash paid or received in financing activities.	X/(X)
Net cash inflow (or outflow) during the period	X/(X)
Cash and cash equivalents at the beginning of the period	X/(X)
Cash and cash equivalents at the end of the period	X/(X)

A statement of cash flows reports the change in the amount of cash and cash equivalents held by the entity during the financial period.

Cash and cash equivalents

Definition: Cash, cash equivalents and cash flows

Cash comprises cash on hand and demand deposits.

Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

1.2 Format

IAS 7 does not include a format that must be followed. However it gives illustrative examples of formats that meet the requirements in the standard.

This section provides examples of these.

Illustration: Statement of cash flows

	₦	₦
Net cash flow from operating activities		**75,300**
Cash flows from investing activities:		
Acquisition of shares (debentures, etc.)	(5,000)	
Purchase of property, plant and machinery	(35,000)	
Proceeds from sale of non-current assets	6,000	
Interest received/dividends received	1,500	
Net cash used in investing activities		(32,500)
Cash flows from financing activities:		
Proceeds from issue of shares	30,000	
Proceeds from new loan	10,000	
Repayment of loan	(17,000)	
Dividends paid to shareholders	(25,000)	
Net cash used in financing activities		(2,000)
Net increase/decrease in cash/cash equivalents		40,800
Cash/cash equivalents at the beginning of the year		5,000
Cash/cash equivalents at the end of the year		45,800

Operating cash flows

IAS 7 permits two methods of presenting the cash flows from operating activities:

- the direct method, and
- the indirect method.

For clarity, what this means is that there are two approaches to arriving at the figure of ***₦75,300*** in the above example.

IAS 7 allows entities to use either method of presentation. It encourages entities to use the direct method. However, the indirect method is used more in practice.

The two methods differ only in the way that they present the cash flows for cash generated from operations. In all other respects, the figures in the statement of cash flows using the direct method are identical to the figures in a statement using the indirect method – cash flows from investing activities and financing activities are presented in exactly the same way.

The indirect method

The indirect method identifies the cash flows from operating activities by adjusting the profit before tax figure. It arrives at the cash from operating activities figure indirectly by reconciling a profit figure to a cash figure.

The starting point for the statement of cash flows for a company is the operating profit after deducting interest but before taxation.

This profit figure is adjusted to calculate the amount of cash received by the business or the amount of cash paid out as a consequence of its trading operations.

The adjustments are to remove the effect of:

- Non-cash items, for example:
  - Depreciation and amortisation (depreciation of intangible non-current assets);
  - Profit or loss on disposal of non-current assets; and
- Accruals based figures, for example:
  - Interest expense or income;
  - Movement on working capital items (receivables, payables and inventory).

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the indirect method.

Illustration: The indirect method

Statement of cash flows: indirect method	₦	₦
Cash flows from operating activities		
Profit before taxation	80,000	
Adjustments for:		
Depreciation and amortisation charges	20,000	
Interest charges in the statement of comprehensive income	2,300	
Gains on disposal of non-current assets	(6,000)	
Losses on disposal of non-current assets	4,500	
	100,800	
Increase in trade and other receivables	(7,000)	
Decrease in inventories	2,000	
Increase in trade payables	3,000	
Cash generated from operations	98,800	
Taxation paid (tax on profits)	(21,000)	
Interest charges paid	(2,500)	
Net cash flow from operating activities		**75,300**

The direct method

The direct method calculates the cash flow from operating activities by calculating cash received from customers, cash paid to suppliers and so on.

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the direct method.

Illustration: The direct method

Statement of cash flows: direct method	₦
Cash flows from operating activities	
Cash receipts from customers	348,800
Cash payments to suppliers	(70,000)
Cash payments to employees	(150,000)
Cash paid for other operating expenses	(30,000)
Cash generated from operations	98,800
Taxation paid (tax on profits)	(21,000)
Interest charges paid	(2,500)
Net cash flow from operating activities	75,300

The figures in the two statements are identical from 'Cash generated from operations' down to the end. The only differences are in the presentation of the cash flows that produced the 'Cash generated from operations'.

IAS 7 allows some variations in the way that cash flows for interest and dividends are presented in a statement of cash flows, although the following should be shown separately:

- interest received;
- dividends received;
- interest paid; and
- dividends paid.

1.3 Direct method: Accruals based figures

Interest

The interest liability at the start of the year and the interest charge during the year is the most the business would pay. If the business had paid nothing it would owe this figure. The difference between this amount and the liability at the end of the year must be the amount that the business has paid.

Example: Interest paid

A company had liabilities in its statement of financial position at the beginning and at the end of 20X9, as follows:

	Interest (₦)
Beginning of 20X9	4,000
End of 20X9	22,000

During the year, interest charges in the income statement were ₦22,000.

The interest payment for inclusion in the statement of cash flows can be calculated as follows:

	₦
Liability at the start of the year	4,000
Charge for the year	22,000
Total amount payable in the year	26,000
Liability at the end of the year	(3,000)
Cash paid	23,000

Taxation

The tax paid is the last figure in the operating cash flow calculation.

Example: Taxation paid

A company had liabilities in its statement of financial position at the beginning and at the end of 20X9, as follows:

	Taxation (₦)
Beginning of 20X9	53,000
End of 20X9	61,000

During the year, taxation on profits was ₦77,000.

The tax payment (cash flows) for inclusion in the statement of cash flows can be calculated as follows:

	₦
Taxation liability at the start of the year	53,000
Charge for the year	77,000
Total amount payable	130,000
Taxation liability at the end of the year	(61,000)
Cash paid	69,000

Deferred taxation

A question might include deferred taxation.

A deferred tax balance might be an asset or a liability. Deferred tax liability is more common (in practice and in questions) so this discussion will be about liabilities.

A deferred tax liability is an amount that a company expects to pay in the future. Therefore it has had no cash effect to date.

Any movement on the deferred tax liability will be due to a double entry to tax expense in the profit or loss section of the statement of comprehensive income. (There are double entries to other comprehensive income and directly to equity but these are outside the scope of your syllabus).

There are two possible courses of action in dealing with deferred tax. Either:

- ignore it entirely and work with numbers that exclude the deferred tax (in effect this was what happened in the example above where there was no information about deferred tax); or
- include it in every tax balance in the working.

The second approach is usually used.

Example: Deferred tax

A company had liabilities in its statement of financial position at the beginning and at the end of 20X9, as follows:

	Taxation (₦)	Deferred taxation (₦)
Beginning of 20X9	53,000	20,000
End of 20X9	61,000	30,000

The tax expense for the year in the statement of profit or loss was ₦87,000. This was made up of the current tax expense of ₦77,000 and the deferred tax of ₦10,000.

The tax payment (cash flows) for inclusion in the statement of cash flows can be calculated as follows:

		₦
Liability at the start of the year	(53,000 + 20,000)	73,000
Charge for the year	(77,000 + 10,000)	87,000
Total amount payable in the year		160,000
Liability at the end of the year	(61,000 + 30,000)	(91,000)
Cash paid		69,000

1.4 Working capital adjustments: Introduction

Definition

Working capital is current assets less current liabilities.

The previous section showed that taxation and interest cash flows can be calculated by using a figure from the statement of comprehensive income and adjusting it by the movement on the equivalent balances in the statement of financial position.

This section shows how this approach is extended to identify the cash generated from operations by making adjustments for the movements between the start and end of the year for elements of working capital, namely:

- trade receivables and prepayments;
- inventories; and
- trade payables and accruals.

Assuming that the calculation of the cash flow from operating activities starts with a profit (rather than a loss) the adjustments are as follows:

Balance	Increase in balance from start to the end of the year	Decrease in balance from start to the end of the year
Receivables	Subtract from profit before tax	Add back to profit before tax
Inventory	Subtract from profit before tax	Add back to profit before tax
Payables	Add back to profit before tax	Subtract from profit before tax

These are known as the working capital adjustments and are explained in more detail in the rest of this section

Practice question **1**

A company made an operating profit before tax of ₦16,000 in the year just ended.

Depreciation charges were ₦15,000.

There was a gain of ₦5,000 on disposals of non-current assets and there were no interest charges. Values of working capital items at the beginning and end of the year were:

	Receivables	Inventory	Trade payables
Beginning of the year	₦9,000	₦3,000	₦4,000
End of the year	₦6,000	₦5,000	₦6,500

Taxation paid was ₦4,800.

Required

Calculate the amount of cash generated from operations, as it would be shown in a statement of cash flows using the indirect method.

2 CASH FLOWS FROM INVESTING ACTIVITIES

Section overview

- Cash paid for the purchase of property, plant and equipment
- Cash from disposals of property, plant and equipment
- Cash paid for the purchase of investments and cash received from the sale of investments

2.1 Cash paid for the purchase of property, plant and equipment

This is the second part of a statement of cash flows, after cash flows from operating activities.

The most important items in this part of the statement are cash paid to purchase non-current assets and cash received from the sale or disposal of non-current assets but it also includes interest received and dividends received on investments.

Movement on non-current assets might be summarised as follows:

Illustration: Movement on non-current assets

	₦
At cost or valuation, at the beginning of the year	X
Disposals during the year (cost)	(X)
Upward/(downward) revaluation during the year	X/(X)
	X
Additions to non-current assets (balancing figure)	X
At cost or valuation, at the end of the year	X

Alternatively carrying amount (NBV) can be used	₦
Non-current assets at the beginning of the year at NBV	X
Depreciation	(X)
Disposals during the year (NBV)	(X)
Upward/(downward) revaluation during the year	X/(X)
	X
Additions to non-current assets (balancing figure)	X
Non-current assets at the end of the year at NBV	(X)

Example: Cash paid for property, plant and equipment

The statements of financial position of Grand Company at the beginning and end of 20X9 include the following information:

Property, plant and equipment	20X8	20X9
	₦	₦
At cost/re-valued amount	1,400,000	1,900,000
Accumulated depreciation	350,000	375,000
Carrying amount	1,050,000	1,525,000

During the year, some property was revalued upwards by ₦200,000. An item of equipment was disposed of during the year at a profit of ₦25,000. This equipment had an original cost of ₦260,000 and accumulated depreciation of ₦240,000 at the date of disposal.

Depreciation charged in the year was ₦265,000.

Example (continued): Cash paid for property, plant and equipment

Additions may be calculated as follows:

	Cost	NBV
Balance at the start of the year	1,400,000	1,050,000
Disposals during the year:		
At cost	(260,000)	
At carrying amount: (260,000 – 240,000)		(20,000)
Depreciation		(265,000)
Revaluation	200,000	200,000
	1,340,000	965,000
Additions (balancing figure)	560,000	560,000
Balance at the end of the year	1,900,000	1,525,000

The revaluation recognised in the year can be found by comparing the opening and closing balances on the revaluation surplus account. There might also be revaluation double entry recognised as a gain or loss in other comprehensive income. You need to total revaluation recognised in the year so you may have to add or net both amounts.

2.2 Cash from disposals of property, plant and equipment

A statement of cash flows should include the net cash received from any disposals of non-current assets during the period.

This might have to be calculated from the gain or loss on disposal and the carrying amount of the asset at the time of its disposal.

Illustration: Disposal of property, plant and equipment

	₦
At cost (or re-valued amount at the time of disposal)	X
Accumulated depreciation, at the time of disposal	(X)
Net book value/carrying amount at the time of disposal	X
Gain or (loss) on disposal	X
Net disposal value (= **assumed cash flow**)	X

2.3 Cash paid for the purchase of investments and cash received from the sale of investments

A statement of cash flows should include the net cash paid to buy investments in the period and the cash received from the sale of investment in the period.

It is useful to remember the following relationship:

Illustration: Movement on investments

	₦
Carrying amount at the start of the year	X
Disposals	(X)
Additions	X
Revaluation	X/(X)
Carrying amount at the end of the year	X

3 CASH FLOWS FROM FINANCING ACTIVITIES

Section overview

- Examples of cash flows from financing activities
- Cash from new share issues
- Cash from new loans/cash used to repay loans
- Dividend payments to equity shareholders
- Repayments on leases
- Changes in liabilities arising from financing activities

3.1 Examples of cash flows from financing activities

Examples of cash flows from financing activities are listed below:

Cash payments	Cash receipts
Cash payments to redeem/buy back shares	Cash proceeds from issuing shares
Cash payments to repay a loan or redeem bonds	Cash proceeds from a loan or issue of bonds
Cash payments to a lessor under a lease agreement that represent a reduction in the remaining lease obligation (= a reduction in the leases creditor)	

Dividends are also usually included within cash flows from financing activities, in this part of the statement of cash flows. (Some entities may also include interest payments in this section, instead of including them in the section for cash flows from operating activities.)

3.2 Cash from new share issues

The cash raised from new share issues can be established by comparing the equity share capital and the share premium in the statements of financial position at the beginning and the end of the year.

Illustration: Cash from new share issues

	₦
Share capital + Share premium at the end of the year	X
Share capital + Share premium at the beginning of the year	X
Cash obtained from issuing new shares in the year	X

Example: Cash from new share issues

The statements of financial position of Company P at 1 January and 31 December included the following items:

	1 January 20X9	31 December 20X9
	₦	₦
Equity shares	600,000	750,000
Share premium	800,000	1,100,000

There was a 1 for 6 bonus issue during the year funded out of retained earnings. The bonus issue was followed later in the year by a rights issue to raise cash for the purchase of new plan.

(The information about the bonus issue means that for every 6 shares held at the start of the year one new share was issued. Therefore, the share capital changed from ₦600,000 to ₦700,000. The double entry to achieve this was Dr Retained earnings and Cr Share capital).

The cash obtained from issuing shares during the year is calculated as follows.

	₦
Share capital + Share premium at the end of 20X9	1,850,000
Share capital + Share premium at the beginning of 20X9	(1,400,000)
Bonus issue (600,000 $\times$ $^{7}/_{6}$)	(100,000)
Cash obtained from issuing new shares in 20X9	350,000

If a bonus issue is funded out of share premium, it can be ignored because the balances on the two accounts are added together so the total would not be affected.

3.3 Cash from new loans/cash used to repay loans

Cash from new loans or cash paid to redeem loans in the year can be calculated simply by looking at the difference between the liabilities for loans and bonds at the beginning and the end of the year.

- An increase in loans or bonds means there has been an inflow of cash.
- A reduction in loans or bonds means there has been a payment (outflow) of cash.

Remember to add any loans, loan notes or bonds repayable within one year (current liability) to the loans, loan notes or bonds repayable after more than one year (non-current liability) to get the total figure for loans, loan notes or bonds.

Illustration: Cash from loans

	₦
Loans at end of year (current and non-current liabilities)	X
Loans at beginning of year (current and non-current liabilities)	X
Cash inflow or outflow	X

Note: The same calculation can be applied to bonds or loan notes that the company might have issued. Bonds and loan notes are long-term debt.

3.4 Dividend payments to equity shareholders

These should be the final dividend payment from the previous year and the interim dividend payment for the current year. The dividend payments during the year are shown in the statement of changes in equity (SOCIE).

You might be expected to calculate dividend payments from figures for retained earnings and the profit after tax for the year.

If there have been no transfers to the retained earnings reserve from the revaluation reserve in the year, the equity dividend payments can be calculated as follows:

Illustration:

	₦
Retained earnings reserve at the beginning of the year	X
Profit for the year after tax	X
Increase in the retained earnings reserve	X
Retained earnings reserve at the end of the year	(X)
Equity dividend payments	X

Practice questions **2**

From the following information, calculate the cash flows from investing activities for Company X in 20X9.

	Beginning of 20X9	End of 20X9
	₦	₦
Share capital (ordinary shares)	400,000	500,000
Share premium	275,000	615,000
Retained earnings	390,000	570,000
	1,065,000	1,685,000
Loans repayable after more than 12 months	600,000	520,000
Loans repayable within 12 months or less	80,000	55,000

The company made a profit of ₦420,000 for the year after taxation.

Required

Calculate for 20X9, for inclusion in the statement of cash flows:

(a) the cash from issuing new shares

(b) the cash flows received or paid for loans

(c) the payment of dividend to ordinary shareholders.

3.5 Repayments on leases

When non-current assets are acquired under a lease, the lessee makes payments under the lease agreement which are treated:

- partly as interest payments; and
- partly as repayment of the lease finance.

For the purposes of the statement of cash flows:

- The interest element in the lease payments is treated as an interest payment. It is included either as a cash flow from operating activities or a cash flow from financing activities
- The repayment of the lease liability is treated as a repayment of a debt, and is included as a cash flow from financing activities.

3.6 Changes in liabilities arising from financing activities

An entity must provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.

One way of doing this would be to provide a reconciliation showing:

- ❑ opening balances of liabilities arising from financing activities;
- ❑ movements in the period, including:
  - changes from financing cash flows;
  - changes arising from obtaining or losing control of subsidiaries or other businesses; and
  - other non-cash changes (for example, the effect of changes in foreign exchange rates).
- ❑ closing balances of liabilities arising from financing activities.

4 CONSOLIDATED STATEMENT OF CASH FLOWS

Section overview

- The special features of a consolidated statement of cash flows
- Illustrative format

4.1 The special features of a consolidated statement of cash flows

A consolidated statement of cash flows is prepared largely from the consolidated statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. The rules for preparing a group statement of cash flows are similar to the rules for a statement of cash flows for an individual entity.

However, there are additional items in a consolidated statement of cash flows that are not found in the statement of cash flows of an individual company. The most significant of these are cash flows (or adjustments to profit before tax) relating to:

- non-controlling interests;
- associates (or JVs);
- and acquiring or disposing of subsidiaries during the year.

Exchange rate differences

A gain or loss arising from exchange rate differences is not a cash flow item. When the indirect method is used to present cash flows from operating activities, it is therefore necessary to make an adjustment to get from 'profit' to 'cash flow'.

- A loss arising from exchange rate differences (shown in the example above as a 'foreign exchange loss') must be added back.
- A gain arising from exchange rate differences must be subtracted.

4.2 Illustrative format

It might be useful to look at the format of a consolidated statement of cash flows, to see where these items appear. The indirect method is used here to present the cash flows from operating activities.

Illustration: X Plc: Consolidated statement of cash flows for the year ended 31 December 20X7

	₦000	₦000
Cash flows from operating activities		
Profit before tax	440	
Adjustments for:		
Depreciation and amortisation charges	450	
Loss on disposal of plant and machinery	50	
Share of profit of associates and joint ventures	(100)	
Foreign exchange loss	40	
Investment income	(25)	
Interest expense	25	
	880	
Increase in trade and other receivables	(80)	
Increase in inventories	(60)	
Increase in trade payables	40	
Cash generated from operations	780	
Interest paid	(30)	
Income taxes paid	(200)	
Net cash from operating activities		550
Cash flows from investing activities		
Acquisition of subsidiary, net of cash acquired (note 1)	(450)	
Purchase of property, plant and equipment (note 2)	(220)	
Proceeds from the sale of equipment	30	
Interest received	25	
Dividends received from associates	45	
Net cash used in investing activities		(570)
Cash flows from financing activities		
Proceeds from the issue of share capital	500	
Proceeds from long-term loan	100	
Redemption of debt securities	(150)	
Payment of lease liabilities	(80)	
Dividends paid to non-controlling interests	(70)	
Dividends paid to parent company shareholders	(200)	
Net cash inflow from financing activities		100
Net increase in cash and cash equivalents		80
Cash and cash equivalents at the start of the year (note 3)		150
Cash and cash equivalents at the end of the year (note 3)		230

Notes to the statement of cash flows

Illustration: Notes to the statement of cash flows

Note 1: Acquisition of subsidiary

During the year, the group acquired a subsidiary A Limited. The fair value of assets acquired and liabilities assumed were as follows:

	₦000
Cash	50
Inventories	90
Trade receivables	60
Property, plant and equipment	870
Trade payables	(70)
Long-term loan	(200)
Total purchase price	800
Minus cash of A Limited	(50)
	750
Shares issued as part of the purchase price	300
Cash flow on acquisition net of cash acquired	450

Note 2: Property, plant and equipment

During the year, the group acquired property, plant and equipment with a total cost of ₦400,000, of which ₦180,000 was acquired by means of leases. Cash payments of ₦220,000 were made to acquire property, plant and equipment.

Note 3: Cash and cash equivalents

Cash and cash equivalents consist of cash in hand, bank balances, and money market investments. Cash and cash equivalents in the statement of cash flows comprise the following amounts in the statement of financial position:

	20X7	20X6
	₦000	₦000
Cash in hand and balances with banks	120	110
Short-term investments	210	80
Cash and cash equivalents as previously reported	330	190
Effect of exchange rate changes	-	(40)
Cash and cash equivalents as re-stated	330	150

5 NON-CONTROLLING INTERESTS AND ASSOCIATES (OR JVS) IN THE STATEMENT OF CASH FLOWS

Section overview

- Obtaining the required figures for cash flows
- Non-controlling interests and the group statement of cash flows
- Dividends paid to non-controlling interests and foreign exchange adjustments
- Associates (or JVs) and the group cash flow statement
- Calculating dividends received from an associate

5.1 Obtaining the required figures for cash flows

The cash flows and adjustments in a group statement of cash flows are obtained from the other group financial statements. You should expect an examination question to provide you with an opening and closing consolidated statement of financial position, together with the related consolidated statement of profit or loss and other comprehensive income, and possibly a statement of changes in equity. Other relevant information may also be provided.

A group statement of cash flows reports the cash flows that affect the group's consolidated cash (and cash equivalents). Any transactions not affecting the group cash position should not be shown in the statement of cash flows , except (with the indirect method) where a non-cash item is presented as an adjustment to the profit before tax to calculate the 'Cash generated from operations'.

5.2 Non-controlling interests and the group statement of cash flows

Unless there is an acquisition or a disposal of a subsidiary during the year, the only cash flow relating to non-controlling interests is the amount of dividends paid to the non-controlling interests by subsidiaries.

This might have to be calculated as a balancing figure, using the following calculation:

Illustration: Dividends paid to NCI

	₦
Non-controlling interest in group net assets at the beginning of the year	X
Non-controlling interest in profits after tax for the year	(X)
	X
Dividends paid to non-controlling interests (balancing figure)	(X)
Non-controlling interest in group net assets at the end of the year	X

The dividends paid to non-controlling interests by subsidiaries are usually included in the 'Cash flows from **financing activities**' part of the statement of cash flows. (This is the same part of the statement of cash flows where dividends paid to the parent company shareholders are usually shown.)

Example: Dividends paid to NCI

The following information has been extracted from consolidated financial statements of P, a holding company which prepares accounts to 31 December. P has a subsidiary Q, for which a final dividend is declared before the end of the financial year.

	20X7	20X6
	₦000	₦000
Non-controlling interest in group net assets	1,510	1,380
Non-controlling interest in consolidated profit after taxation	250	470

What figure should appear in the consolidated statement of cash flows for the year to 31 December 20X7 for the dividends paid to non-controlling interests?

Under what heading will this figure appear in the group statement of cash flows?

Answer

	₦000
Non-controlling interest in group net assets at the beginning of the year	1,380
Non-controlling interest in profits after tax for the year	250
	1,630
Dividends paid to non-controllinginterests (balancing figure)	(120)
Non-controlling interest in group net assets at the end of the year	1,510

The dividend paid of ₦120,000 will be disclosed as a cash flow from financing activities.

Practice question **3**

The following information has been extracted from the consolidated financial statements of P, a holding company which prepares accounts to 31 December each year:

	Year 4	Year 3
	₦000	₦000
Dividends payable to non-controlling interests	200	320
Non-controlling interests in group equity	1,560	1,380
Non-controlling interest in profit for the year	240	220

What figure will appear in the consolidated statement of cash flows for the year to 31 December Year 4 for dividend paid to non-controlling interests?

Practice question **4**

The following information has been extracted from the consolidated financial statements of X Plc:

	Year 4	Year 5
	₦000	₦000
NCI dividends payable at 31 December	20	25
NCI share of group profits after tax for the year	270	300
NCI share in group net assets as at 31 December	600	630

What figure will appear in the consolidated statement of cash flows for the year to 31 December Year 5 in respect of non-controlling interests?

Practice question **5**

The consolidated financial statements of Entity P for the year ended 31 March Year 6 showed the following balances:

Non-controlling interests in the consolidated statement of financial position at 31 March Year 6 are ₦6 million (₦3.6 million at 31 March Year 5).

Non-controlling interests in the consolidated profit for the year ended 31 March Year 6 is ₦2 million.

During the year ended 31 March Year 6, the group acquired a new 75% subsidiary whose net assets at the date of acquisition were ₦6.4 million.

On 31 March Year 6, the group revalued all its properties and the non-controlling interest in the revaluation surplus was ₦1.5 million.

There were no dividends payable to non-controlling interests at the beginning or end of the year.

What is the dividend paid to non-controlling interests that will be shown in the consolidated statement of cash flows of Entity P for the year ended 31 March Year 6?

5.3 Dividends paid to non-controlling interests and foreign exchange adjustments

If there is a gain or loss on translation for a foreign subsidiary, the non-controlling interest has a share of this exchange gain or loss. This means that the amount shown as the non-controlling interest in the consolidated statement of financial position includes the non-controlling interest share of any foreign exchange gains or is after deducting any foreign exchange losses.

A gain or loss arising from exchange rate differences is not a cash flow, but it changes the amount for non-controlling interest in the consolidated statement of financial position. When the figures for non-controlling interest in the opening and closing statements of financial position are used to calculate dividend payments to non-controlling interests, we must therefore remove the effect of exchange rate differences during the year.

The calculation of the dividends paid to the non-controlling interests should then be calculated as follows:

Illustration: Dividends paid to NCI

	₦
Non-controlling interest in group net assets at the beginning of the year	X
Non-controlling interest in profits after tax for the year	X
Add non-controlling interest share of foreign exchange gain (or subtract NCI share of a loss)	X/(X)
	X
Dividends paid to non-controlling interests (as a balancing figure)	X
Non-controlling interest in group net assets at the end of the year	X

5.4 Associates (or JVs) and the group statement of cash flows

When a group has an interest in an associate entity, the consolidated statement of cash flows must show the cash flows that occur between the associate (or JV) and the group. The consolidated statement of cash flows shows the effect on the group's cash position of transactions between the group and its associate (or JV).

The cash held by an associate (or JV) is not included in the group's cash figure in the consolidated statement of financial position. This is because the equity method of accounting does not add the associate's (or JV's) cash to the cash of the holding company and subsidiaries. As far as cash flows are concerned, the associate (or JV) is outside the group. (The same principles apply to other investments accounted for under the equity method, such as joint ventures accounted for by the equity method).

Share of profit (or loss) of an associate (or JV)

In the consolidated statement of profit or loss, the group profit includes the group's share of the profits of associates (or JVs). These profits are not a cash flow item. When the indirect method is used to present the cash flows from operating activities, an adjustment is therefore needed to get from 'profit' to 'cash flow'.

- The group's share of the profit of an associate (or JV) must be deducted from profit.
- The group's share of the loss of an associate (or JV) must be added to profit.

Cash flows involving associates (or JVs)

The cash flows that might occur between a group and an associate (or JV), for inclusion in the consolidated statement of cash flows are as follows:

- **Investing activities**
  - cash paid to acquire shares in an associate (or JV) during the year
  - cash received from the disposal of shares in an associate (or JV) during the year
  - dividends received from an associate during the year.
- **Financing activities**
  - cash paid as a new loan to or from an associate (or JV) during the year
  - cash received as a repayment of a loan to or from an associate (or JV) during the year.

Note that dividends received from an associate (or JV) are shown as cash flows from investing activities; whereas dividends paid to non-controlling interests in subsidiaries are (usually) shown as cash flows from financing activities.

5.5 Calculating dividends received from an associate (or JV)

In an examination, you may be required to calculate the dividends received from an associate (or JV), using information in the opening and closing consolidated statements of financial position and the consolidated statement of profit or loss. The technique is similar to the calculation of dividends paid to non-controlling interests.

Illustration: Dividends received from an associate (or JV)

	₦
Group investment in net assets of associate (or JV) at the beginning of the year	X
Group share of associate's (or JV's) profits before tax	(X)
	X
Dividends received from associate (or JV) in the year	(X)
Group investment in net assets of associate (or JV) at the end of the year	X

Example: Dividends received from an associate (or JV)

The following information has been extracted from the consolidated financial statements of P for the year ended 31 December 20X7. The group has neither purchased nor disposed of any investment during this period.

Group statement of profit or loss

	₦000
Group operating profit	1,468
Share of associate's profit after tax	136
	1,604
Tax on profit on ordinary activities:	
Income taxes: group	(648)
Profit on ordinary activities after tax	956

Group statement of financial position at 31 December

	20X7	20X6
	₦000	₦000
Investments in associates		
Share of net assets	932	912

Required

(a) What figure should appear in the group statement of cash flows for the year to 31 December 20X7 for the associate?

(b) Under which heading would you expect this figure to appear in the group statement of cash flows?

Answer

(a)

	₦000
Group investment in net assets of associate at the beginning of the year	912
Group share of associate's profits after tax	136
	1,048
Dividends received from associate in the year (as a balancing figure)	(116)
Group investment in net assets of associate at the end of the year	932

(b) The cash flow of ₦116,000 will be shown as a cash flow from investing activities in the group statement of cash flows.

Practice question **6**

The following information has been extracted from the consolidated financial statements of P, a holding company which prepares accounts to 31 December each year:

Consolidated statement of financial position (extract):

	Year 4	Year 3
	₦000	₦000
Investments in associated undertakings	932	912
Current assets		
Dividend receivable from associate	96	58

Consolidated statement of profit or loss (extract):

Investments in associated undertakings	Year 4
	₦000
Group operating profit	1,468
Share of operating profit of associate	136
	1,604
Income taxes:	(648)
Profit after tax	956

What figure will appear in the consolidated statement of cash flows for the year to 31 December Year 4 in respect of dividend received from associates?

6 ACQUISITIONS AND DISPOSALS OF SUBSIDIARIES IN THE STATEMENT OF CASH FLOWS

Section overview

- Acquisition of a subsidiary in the statement of cash flows
- Note to the statement of cash flows on acquisitions
- Avoiding double counting when a subsidiary has been acquired
- Disposal of a subsidiary in the statement of cash flows

6.1 Acquisition of a subsidiary in the statement of cash flows

When a subsidiary is acquired:

- the group gains control of the assets and liabilities of the subsidiary, which might include some cash and cash equivalents, and
- the group pays for its share of the subsidiary, and the purchase consideration might consist partly or entirely of cash.

In the group statement of cash flows, a single figure is shown (under the heading 'Cash flows from investing activities') for the net effect of the cash flows from acquiring the subsidiary. This net effect is:

Illustration: Cash paid for a subsidiary

	₦
Cash element in the purchase consideration	X
Minus: Cash assets of the subsidiary at the acquisition date	(X)
Cash payment on acquisition of subsidiary, net of cash received	X

This net cash payment is the amount shown in the group statement of cash flows.

Example: Cash paid for a subsidiary

Blue Group acquired 80% of the shares in Green Entity on 5 September 20X6, when the net assets of Green Entity were ₦800,000, including ₦25,000 in cash and cash equivalents. The purchase consideration was ₦700,000, consisting of ₦500,000 in new shares of Blue (the holding company) and ₦200,000 in cash.

The cash flow shown in the group statement of cash flows for the year to 31 December 20X6 is:

	₦
Cash element in the purchase consideration	200,000
Minus: Cash assets of the subsidiary at the acquisition date	(25,000)
Cash payment on acquisition of subsidiary, net of cash received	175,000

Note that in the above example, even though only 80% of the shares in Green Entity have been acquired, the full ₦25,000 of cash held by the subsidiary is brought into the group statement of financial position at the acquisition date. The

figure deducted from the cash in the purchase consideration is therefore 100% of the subsidiary's cash and cash equivalents acquired.

6.2 Note to the statement of cash flows on acquisitions

In an examination, it is useful to prepare a statement summarising the cash flow effects of an acquisition. This statement is actually required by IAS 7, and should be presented as a note to the statement of cash flows.

The statement should be presented as follows:

Illustration: Note to the cash flow statements re-acquisition

	₦
Assets of the subsidiary at the acquisition date, at fair value	X
Liabilities of the subsidiary at the acquisition date	(X)
Net assets of the subsidiary at the acquisition date	X
Minus non-controlling interest in the subsidiary at this date (% Non-controlling interest × Net assets)	(X)
Purchased goodwill	X
Fair value of net assets acquired	X
Satisfied by:	
New shares in holding company	X
Cash	X
Purchase consideration	X

The total purchase consideration equals the fair value of the net assets acquired.

The cash of the subsidiary at the acquisition date (C_2) is then deducted from the cash paid (C_1) to arrive at the figure that appears in the statement of cash flows for the 'Acquisition net of cash received'.

Example: Note to the cash flow statements re acquisition

A typical note to the statement of cash flows, using illustrative figures, might appear as follows for a subsidiary in which 80% of the shares are acquired:

	₦000
Net assets acquired:	
Cash	3
Trade receivables	85
Inventories	139
Property, plant and equipment	421
Trade payables	(68)
Bank loan	(100)
	480
Non-controlling interest (20% × 480)	(96)
	384
Purchased goodwill	76
Fair value of net assets acquired	460
Satisfied by:	
Issue of shares	152
Cash paid	308
	460

Extract from statement of cash flows

Investing activities

Acquisition of subsidiary net of cash received (₦308,000 – ₦3,000) ₦305,000

In the statement of cash flows itself, the cash payment on the acquisition of the subsidiary is not ₦308,000, because the cash flow is shown as the payment minus the cash held by the subsidiary at the acquisition date (which is cash brought into the group by acquiring the subsidiary).

In this example, the cash brought into the group on acquisition, as a part of the net assets of the subsidiary, is ₦3,000.

6.3 Avoiding double counting when a subsidiary has been acquired

Cash flow information is often calculated from information in the opening and closing statements of financial position.

If there is an acquisition during the year, it is important to make an adjustment to the calculation for the assets or liabilities in the subsidiary that were acquired.

Unless this adjustment is made, the assets and liabilities in the subsidiary at the acquisition date will be counted twice and the calculations will be incorrect.

An adjustment will be needed for every item of asset or liability acquired, **except for** cash and cash equivalents.

Inventory, trade receivables, trade payables

When the indirect method is used to present cash flows from operating activities, the changes in receivables, inventory and trade payables are shown as adjustments to the profit figure, to get to a figure for cash flow.

When preparing a statement of cash flows for an individual company, the changes in these items are calculated by calculating the difference in the figure in the closing statement of financial position and the corresponding value in the opening statement of financial position.

However, when a subsidiary has been acquired, the working capital brought into the group (receivables plus inventory minus trade payables of the acquired subsidiary) is paid for in the purchase price to acquire the subsidiary. As we have seen, this is treated as a separate item in the investing activities section of the statement of cash flows.

To avoid double counting of the effects of the working capital in the subsidiary at the acquisition date, we need to deduct from the value in the closing statement of financial position, **or** add to the value in the opening statement of financial position:

- the receivables in the net assets of the subsidiary acquired, as at the acquisition date
- the inventory in the net assets of the subsidiary acquired, as at the acquisition date, and
- the trade payables in the net assets of the subsidiary acquired, as at the acquisition date.

Example: Adjustment to calculation

D Group is preparing a group statement of cash flows for the year using the indirect method. In the group opening and closing statements of financial position, inventories were:

At the beginning of the year	₦120,000
At the end of the year	₦190,000

During the year, the group acquired a 75% interest in a new subsidiary, Entity S, which had inventories of ₦40,000 at the acquisition date.

Required

What figure should be shown in the group statement of cash flows as the adjustment for the increase or decrease in inventories?

Answer

	₦
Group inventories at the beginning of the year	120,000
Add: Inventories acquired in the subsidiary	40,000
	160,000
Adjustment for increase in inventories on acquisition of new subsidiary	30,000
Group inventories at the end of the year	190,000

Inventories have increased by ₦30,000 after allowing for the ₦40,000 of inventories brought into the group when the subsidiary was purchased.

This would usually be shown as a working on the face of the answer as (₦190,000 – (120,000 + 40,000)).

Purchases of non-current assets

When non-current assets are shown at their carrying amount (net book value) and a subsidiary has been acquired during the year, purchases of non-current assets (assumed to be cash payments) are calculated as follows.

Example: Cash paid to buy non-current assets

	₦
Non-current assets at carrying amount, at the beginning of the year	240,000
Net book value of disposals of non-current assets during the year	(30,000)
Depreciation charge for the year	(40,000)
Cash paid to acquire non-current assets during the year (second balancing figure)	55,000
Non-current assets acquired on acquisition of the subsidiary	65,000
Total additions (first balancing figure)	120,000
Non-current assets at carrying amount, at the end of the year	290,000

Other items

Similar principles can be applied to all other assets and liabilities to find the cash effect, for example to calculate loan repayments and repayments of leasing obligations.

Example: Tax paid

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1 January 20X6	At 31 December 20X6
	₦000	₦000
Current tax payable	250	325
Deferred tax (liability)	136	165

The Spot Group acquired a 60% holding in a subsidiary, Entity B, on 7 May 20X6. The total tax liability of Entity B at this date was ₦120,000. The total charge for taxation in the consolidated statement of profit or loss of the Spot Group for the year to 31 December 20X6 was ₦950,000.

Required

What was the cash payment for taxation during the year, for inclusion on the group statement of cash flows?

Answer

The tax liability in the subsidiary when it was acquired should be deducted from the closing tax liability for the group (or added to the opening tax liability for the group) to avoid double counting.

	₦000
Group tax liability at the beginning of the year	386
Tax liability acquired in the subsidiary	120
Group tax charge in the year	950
	1,456
Tax paid in the year	(966)
Group tax at the end of the year (325 + 165)	490

Note

To calculate the tax payment for the year, you should take the entire tax charge at the beginning and at the end of the year – both current tax and deferred tax.

Example: dividends paid to non-controlling interest when a subsidiary has been acquired

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1 January 20X6	At 31 December 20X6
	₦000	₦000
Non-controlling interest	350	415

The Spot Group acquired a 60% holding in a subsidiary, Entity B, on 7 May 20X6. The net assets of Entity B at this date were ₦800,000 at fair value. The profit attributable to non-controlling interests in the group's statement of profit or loss for the year to 31 December 20X6 was ₦270,000.

Required

What dividends were paid to the non-controlling interests during the year to 31 December 20X6?

Answer

Again, to avoid double counting we need to:

a. deduct the non-controlling interest acquired from the value for non-controlling interest in the closing consolidated statement of financial position; or

b. (as shown below) add the non-controlling interest acquired to the non-controlling interest in the opening consolidated statement of financial position.

	₦000
Non-controlling interest at the beginning of the year	350
Non-controlling interest acquired in the subsidiary (40% × 800)	320
Non-controlling interest share of profits for the year	270
	940
Dividends paid to non-controlling interest during the year	(525)
Non-controlling interest at the end of the year	415

The cash outflow will be shown as a cash flow from financing activities.

Example: adjustment for the impairment of goodwill

The Spot Group had the following items in its opening and closing group statements of financial position at the beginning and at the end of 20X6:

	At 1 January 20X6	At 31 December 20X6
	₦000	₦000
Goodwill	600	540

The Spot Group acquired a 60% holding in a subsidiary, Entity B, on 7 May 20X6. Purchased goodwill arising on the acquisition of Entity B was ₦110,000. The Spot Group uses the indirect method to present its group statement of cash flows.

Required

What is the impairment to goodwill for the year, and where would it appear in the group statement of cash flows?

Answer

The impairment of goodwill is a non-cash item that reduces profit. When the indirect method is used to present cash flows from operating activities, any impairment of assets during the year and charged against profit must be added back to the profit figure (in the same way that depreciation and amortisation charges are added back).

When a subsidiary is acquired during the year, the calculation of the impairment must allow for the purchased goodwill in the newly-acquired subsidiary. An adjustment is needed to avoid double-counting.

	₦000
Goodwill at the beginning of the year	600
Goodwill acquired in the subsidiary	110
	710
Impairment	(170)
Goodwill at the end of the year	540

6.4 Disposal of a subsidiary in the statement of cash flows

The procedures for reporting the cash effect of disposals of subsidiaries in a group statement of cash flows are similar to those used for acquisitions, except that the process applies in reverse.

In the group statement of cash flows, the cash received from the disposal is the cash actually received from the disposal, minus any cash in the subsidiary at the disposal date.

A note to the statement of cash flows should show the details of the disposal, including the cash received from the sale minus the cash in the subsidiary at the disposal date.

The assets and liabilities disposed of, and the non-controlling interest leaves the group on the disposal. To avoid double counting the other cash flow items in the statement of cash flows.

Example: Disposal

Entity D disposed of its 80% interest in the equity capital of Entity S for a cash sum of ₦550 million. The statement of financial position of Entity S at the date of disposal showed the following balances:

	₦000
Tangible non current assets	500
Inventories	200
Trade receivables	300
Trade payables	(200)
Taxation (including deferred taxation)	(80)
Bank overdraft	(320)
	400

D acquired its interest in S at the date of incorporation of that company, so no goodwill arose.

Required

Prepare a statement summarising the effect of the disposal as a note to the consolidated statement of cash flows.

Answer

Cash received from the sale of the shares in the subsidiary is ₦550,000. However, a note to the statement of cash flows should present the details of the net assets disposed of, the proceeds from the sale, and the profit or loss on disposal.

The profit or loss is the difference between the value of the net assets disposed of and the proceeds from the sale. It is a balancing figure, in the same way that the purchased goodwill is the balancing figure in a similar note to the statement of cash flows when a subsidiary has been acquired.

In this example, the subsidiary had a bank overdraft when it was disposed of. The cash in the subsidiary at the date of disposal was therefore a negative amount. The group no longer has the bank overdraft, which means that its cash flow position improved by selling off the subsidiary.

In the statement of cash flows itself, the cash proceeds from the disposal of the subsidiary (net of cash 'lost') is the cash from the disposal proceeds plus the bank overdraft that is no longer in the group (₦550,000 + ₦320,000 = ₦870,000).

	₦000
Net assets disposed of:	
Tangible non current assets	500
Inventories	200
Trade receivables	300
Trade payables	(200)
Taxation	(80)
Bank overdraft	(320)
	400
Non-controlling interest (20% × 400)	(80)
	320
Profit on disposal	230
Proceeds	550
Satisfied by:	
Cash	550

Extract from the statement of cash flows

Investing activities

Sale of subsidiary (550 + 320)	870

Example: Disposal

Suppose that the group in the previous example uses the indirect method of computing the cash flow from operating activities. Inventories were ₦1,600,000 in the opening group statement of financial position at the beginning of the year and ₦1,500,000 in the closing group statement of financial position.

Required

What figure in respect of inventories would be used as an adjustment in calculating the cash flows from operating activities?

Answer

	₦000
Group inventories at the beginning of the year	1,600
Inventories disposed of in the subsidiary	(200)
	1,400
Adjustment for increase in inventories	100
Group inventories at the end of the year	1,500

7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Prepare extracts from a statement of cash flow;
- Prepare a statement of cash flow;
- Prepare extracts from a consolidated statement of cash flow; and
- Prepare a consolidated statement of cash flow.

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

	₦	₦
Cash flows from operating activities		
Profit before taxation	16,000	
Adjustments for:		
Depreciation and amortisation charges	15,000	
Gains on disposal of non-current assets	(5,000)	
	26,000	
Decrease in trade and other receivables	3,000	
Increase in inventories	(2,000)	
Increase in trade payables	2,500	
Cash generated from operations	29,500	
Taxation paid (tax on profits)	(4,800)	
Net cash flow from operating activities		24,700

Solution **2**

Workings

Proceeds from new issue of shares	₦
Share capital and share premium:	
At the end of the year (500,000 + 615,000)	1,115,000
At the beginning of the year (400,000 + 275,000)	675,000
Proceeds from new issue of shares during the year	440,000

Repayment of loans	₦
Loans repayable:	
At the end of the year (520,000 + 55,000)	575,000
At the beginning of the year (600,000 + 80,000)	680,000
Repayment of loans during the year	105,000

Payment of dividends	₦
Retained earnings at the beginning of the year	390,000
Profit after taxation for the year	420,000
	810,000
Retained earnings at the end of the year	570,000
Dividends paid during the year	240,000

Cash flows from financing activities can now be presented as follows.

Cash flows from financing activities	₦	₦
Proceeds from issue of shares	440,000	
Repayment of loans	(105,000)	
Dividends paid to shareholders	(240,000)	
Net cash from financing activities		95,000

Solution **3**

Dividend paid to non-controlling interest is as follows:

	₦000
Opening balances (320 + 1,380)	1,700
Share of profit for the year	240
	1,940
Closing balances (200 + 1,560)	(1,760)
Dividend paid	180

Solution **4**

Dividend paid to non-controlling interest is as follows:

	₦000
Balances at start of Year 5 (20+ 600)	620
Attributable to NCI in profit or loss for the year	300
	920
Balances at end of Year 5 (25 + 630)	655
Cash paid to NCI	(265)

Solution **5**

Dividend paid to non-controlling interest is as follows:

	₦m
Opening balance, NCI	3.6
NCI in profit for the year	2.0
Effect of acquisition: addition to NCI (25% × ₦6.4)	1.6
Revaluation surplus: addition to NCI	1.5
	8.7
Closing balance, NCI	6.0
Dividend paid to NCI (balancing figure)	(2.7)

Solution **6**

Dividend from associate is as follows:

	₦000
Opening balances (912 + 58)	970
Share of profit after tax for the year	136
	1,106
Closing balances (200 + 1,560)	(1,028)
Dividend received	78

Professional level
Corporate Reporting

CHAPTER 28

IAS 33: Earnings per share

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

B	Reporting of entity's performance to stakeholders		
	1	Performance reporting	
		b	Apply accounting standards relating to performance reporting such as IFRS 15, IFRS 8, IFRS 5, IAS 33 and IAS 34 to the preparation of financial statements.
		e	Prepare entity's financial statements in accordance with legal requirements and applicable Financial Reporting standards.

IAS 33 is an examinable document.

Exam context

This chapter explains how to calculate earnings per share

This standard was examinable in a previous paper. It is covered here again in detail for your convenience.

At the end of this chapter, you should be able to:

- Explain why a standard calculation of earnings per share is important;
- Calculate basic earnings per share; and
- Calculate diluted earnings per share.

1 P/E RATIO AND EARNINGS PER SHARE (EPS)

Section overview

- The need for a standard on earnings per share
- IAS 33: Earnings per share

1.1 The need for a standard on earnings per share

Earnings per share

Earnings are profits available for equity (ordinary shareholders). Earnings per share (EPS) is a measure of the amount of earnings in a financial period for each equity share.

As its name implies, EPS is calculated as reported earnings divided by the number of ordinary shares in issue.

The price/earnings ratio

The price/earnings ratio (P/E ratio) is a key stock market ratio. It is a measure of the company's current share price (market price) in relation to the EPS. The P/E ratio is calculated as follows:

Formula: Price earnings ratio

$$\text{P/E ratio} = \frac{\text{Market value of share}}{\text{Earnings per share}}$$

The P/E ratio can be used by investors to assess whether the shares of a company appear expensive or cheap. A high P/E ratio usually indicates that the stock market expects strong performance from the company in the future and investors are therefore prepared to pay a high multiple of historical earnings to buy the shares.

EPS is used by investors as a measure of the performance of companies in which they invest – or might possibly invest. Investors are usually interested in changes in a company's EPS over time – trends – and also in the size of EPS relative to the current market price of the company's shares.

EPS should therefore be calculated by all companies in a standard way, so that investors can obtain a reliable comparison between the EPS and P/E ratios of different companies.

1.2 IAS 33: Earnings per share

The rules for calculating EPS are set out in IAS 33 **Earnings per share**

The concept of EPS is quite straightforward. It is simply the profit in the year divided by the number of ordinary shares in that year.

IAS 33 specifies the profit figure that should be used and explains how to calculate the appropriate number of shares when there have been changes in share capital during the period under review.

IAS 33 also describes the concept of dilution which is caused by the existence of potential ordinary shares.

Each of these issues is dealt with in later sections.

Objective of IAS 33

The objective of IAS 33 is to set out principles for:

- the calculation of EPS; and
- the presentation of EPS in the financial statements.

The purpose of standardising the calculation and presentation of EPS is to make it easier for the users of financial statements to compare the performance of:

- different entities in the same reporting period; and
- the same entity for different reporting periods over time.

Scope of IAS 33

IAS 33 applies only to **publicly-traded entities** or those which are about to be publicly traded. A publicly-traded entity is an entity whose shares are traded by the investing public, for example on a stock exchange.

Most publicly-traded entities prepare consolidated financial statements as well as individual financial statements. When this is the case, IAS 33 requires disclosure only of EPS based on the figures in the consolidated financial statements.

Definition

Definition

An ordinary share is an equity instrument that is subordinate to all other classes of equity instruments.

The ordinary shares used in the EPS calculation are those entitled to the residual profits of the entity, after dividends relating to all other shares have been paid. As stated earlier, if you are given an examination question on this topic, preference shares are not ordinary shares because they give more rights to their holders than ordinary shares.

Preference shares and EPS

Preference shares are not ordinary shares. Since EPS is a measure of earnings per ordinary share in a financial year, preference shares are excluded from the number of shares.

The dividends paid to preference shareholders must therefore be excluded from the total earnings for the period. A broad definition of 'earnings' is therefore profit after tax less non-controling interest less preference dividends paid.

Basic and diluted earnings per share

IAS 33 requires entities to calculate and present basic earnings per share and diluted earnings per share.

Diluted EPS and basic EPS will usually differ when there are potential ordinary shares in existence.

Definition

A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares at some time in the future.

IAS 33 gives the following examples of potential ordinary shares:

- financial liabilities or equity instruments that are convertible into new ordinary shares at some time in the future (convertible debentures, convertible preference shares);
- share options and warrants. Options and warrants are financial instruments that give the holder the right (but not the obligation) to purchase new ordinary shares at some time in the future, at a fixed price;
- shares that will be issued if certain contractual conditions are met, such as contractual conditions relating to the purchase of a business.

The chapter explains the calculation of basic EPS and then the calculation of diluted EPS.

2 CALCULATING BASIC EPS

Section overview

- Basic EPS
- Total earnings
- Earnings and non-controlling interest
- Changes in the number of shares during a period
- Issue of shares at full market price
- Bonus issues of shares
- Rights issues of shares

2.1 Basic EPS

The calculation of the basic earnings per share (EPS) is as follows:

Formula: Basic EPS

$$\frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

Basic EPS is calculated by dividing the profit (or loss) attributable to ordinary shareholders of the parent (commonly referred to as ***total earnings***) by the weighted average number of ordinary shares in issue during the period. In addition, basic EPS must also be calculated for the profit or loss from continuing operations when that figure is presented. Both of these figures must be presented in the statement of comprehensive income. When there is a loss, EPS is negative.

The number of shares used in the calculation is the weighted average number of shares in issue during the period. Changes in share capital during a period must be taken into account in arriving at this number. IAS 33 provides guidance on how to do this.

Earnings from discontinued operations are dealt with separately. An EPS from any **discontinued operations** must also be disclosed, but this does not have to be disclosed on the face of the statement of comprehensive income. Instead, it may be shown in a note to the financial statements.

2.2 Total earnings

The aim of the EPS calculation is to show the profit attributable to ordinary shareholders. Therefore, all other claims on the profit for the year must be taken into account.

The total earnings figure is the profit or loss attributable to ordinary shareholders. This is the profit after tax for the year after excluding the earnings attributable to non-controlling interests (if any). Therefore, total earnings include any income from associates (i.e. any share of profits or losses of associates).

It may be necessary to adjust this figure for preference dividends.

Preference shares

Preference shares must be classified as equity or liability in accordance with the rules in IAS 32: *Financial Instruments: Presentation.*

If a class of preference shares is classified as equity, any dividend relating to that share is recognised in equity. Any such dividend must be deducted from profit attributable to ordinary shareholders (and the profit or loss from continuing operations).

If a class of preference shares is classified as liability, any dividend relating to that share is recognised as borrowing cost in the statement of profit or loss. It has already been deducted in arriving at profit and no further adjustment need be made.

Example: Basic EPS

In the year ended 31 December Year 1, X Ltd had the following results:

	₦
Profit from continuing operations	3,000,000
Profit from discontinued operations	500,000
Profit attributable to ordinary shareholders	3,500,000

A Ltd paid ordinary dividends of ₦150,000 and preference dividends of ₦65,000.
X Ltd had 1 million ordinary shares in issue throughout the year.

X Ltd's basic EPS calculations for the year ended December 31, Year 1 are as follows if the **preference shares are classified as liabilities:**

	Earnings (₦)	Number of shares	EPS (₦)
Profit from continuing operations	3,000,000	1,000,000	3.0
Profit from discontinued operations	500,000		0.5
Profit attributable to ordinary shareholders	3,500,000		3.5

X Ltd's basic EPS calculations for the year ended December 31, Year 1 are as follows if the **preference shares are classified as equity:**

	Earnings (₦)	Number of shares	EPS (₦)
Profit from continuing operations (3,000,000 – 65,000)	2,935,000	1,000,000	2.94
Profit from discontinued operations	500,000		0.5
Profit attributable to ordinary shareholders (3,500,000 – 65,000)	3,435,000		3.44

Cumulative preference shares

There is a further complication concerning preference shares. Some preference shares are cumulative preference shares. This means that if a company fails to declare a preference dividend in a period the holders are entitled to receive the missed dividend sometime in the future. In other words, their right to receive a dividend accumulates when a dividend is not declared. If there are cumulative preference shares in issue the dividend must be deducted from profit or loss from continuing operations regardless of whether the dividend has been declared or not.

Example: Cumulative preference shares

In the year ended 31 December Year 1, Entity G made profit after tax from continuing operations of ₦3,500,000.

Entity G has ₦1,000,000 10% preference share capital in issue. (This would entitle investors to receive a dividend of ₦100,000 = 10% of ₦1,000,000) if declared).

Entity G had 1 million ordinary shares in issue throughout the year.

Entity G's basic EPS for the year ended 31 December Year 1 is calculated as follows:

$$\text{EPS} = \frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

$$= \frac{₦3{,}500{,}000 - ₦100{,}000}{1{,}000{,}000} = ₦3.4 \text{ per share}$$

2.3 Earnings and non-controlling interest

For consolidated accounts, EPS is calculated for the profit figures attributable to the shareholders of the parent company. Therefore, profit figures for the year need to be adjusted for non-controlling interest.

IAS 1: Presentation of financial statements requires that the results for a discontinued operation be shown as a single amount on the face of the statement of profit or loss. IAS 1 also requires the disclosure of profit or loss for the period attributable to

- non-controlling interests; and
- owners of the parent.

These disclosures can be used to illustrate the adjustments needed to produce the profit figures for the EPS calculations.

Example: Basic EPS with NCI

In the year ended 31 December Year 1, X Ltd had the following results:

	₦
Profit from continuing operations	3,000,000
Profit from discontinued operations	500,000
Profit attributable to ordinary shareholders	3,500,000

The non-controlling interest in the above is 20%. Therefore, the following disclosure is made in accordance with IAS 1:

Profit attributable to:	
Owners of the parent	2,800,000
Non-controlling interests	700,000
Profit attributable to ordinary shareholders	3,500,000

The total profit attributable to the owners of the parent (2,800,000) must be analysed into the part attributable to continuing operations and discontinued operations to satisfy the IAS 33 requirements.

The figures that would be used in the basic EPS calculations are as follows:

	Profit for the year (₦)	NCI (20%)	Attributable to owners of the parent (₦)
Profit from continuing operations	3,000,000	600,000	2,400,000
Profit from discontinued operations	500,000	100,000	400,000
Profit attributable to ordinary shareholders of the parent	3,500,000	700,000	2,800,000
			↑ Used in EPS calculations

In the above example, the non-controlling interest was the same for each component of the results of the company. This might not always be the case.

Example: Basic EPS with NCI

In the year ended 31 December Year 1, X Ltd had the following results:

	₦
Profit from continuing operations	3,000,000
Profit from discontinued operations	500,000
Profit attributable to ordinary shareholders	3,500,000

The non-controlling interest in the continuing operation is 20%.
The non-controlling interest in the discontinued operation is 30%.
Therefore, the following disclosure is made in accordance with IAS 1:

Profit attributable to:	
Owners of the parent	2,750,000
Non-controlling interests	750,000
Profit attributable to ordinary shareholders	3,500,000

The figures that would be used in the basic EPS calculations are as follows:

	Profit for the year (₦)	NCI (20%/30%)	Attributable to owners of the parent (₦)
Profit from continuing operations	3,000,000	600,000	2,400,000
Profit from discontinued operations	500,000	150,000	350,000
Profit attributable to ordinary shareholders of the parent	3,500,000	750,000	2,750,000
			↑ Used in EPS calculations

2.4 Changes in the number of shares during a period

IAS 33 gives guidance on how to incorporate changes in share capital during a period into the calculation of the weighted average of shares that must be used in the EPS calculation.

There are different ways in which the number of shares may change:

- Issues for full consideration (issue (or redemption) of shares at a full market price).
- Issues for no consideration (issue (or redemption) of shares with no change in net assets), for example:
  - bonus issues;
  - share splits (where one share is split into several others);
  - reverse share splits;
  - bonus elements in other issues (see later discussion on rights issues).
- Rights issues (issue of shares for consideration but at less than the full market price of the share).

IAS 33 gives guidance on each of these.

Overall approach

At this point we will provide an overall approach designed to enable you to deal with complicated situations where there has been more than one capital change in the period.

Step 1: Write down the number of shares at the start of the year.

Step 2: Write down the date of the first capital change and the number of shares in existence after that capital change. Repeat this step until all capital changes have been dealt.

Step 3: Multiply each number of shares by the fraction of the year that it was in existence.

Step 4: Add up the results from step 4 to give the weighted average number of shares.

Note: If any capital change is due to or contains a bonus issue multiply each preceding number of shares by the bonus fraction.

This will not make much sense to you at first but it will become clear as you study later examples.

Example: Time apportionment to find weighted average

On 1 January a company had 5,000,000 ordinary shares in issue.

On 1 April, 1,000,000 new shares were issued.

On 1 July an extra 1,000,000 shares came into existence

On 1 November 500,000 more shares were issued.

(All issues were at full market price – the implication of this will be explained in more detail in the next section).

The weighted average number of shares is calculated as follows.

Date	Number of shares	Time factor	Weighted Average number
1 January to 31 March	5,000,000	× 3/12	1,250,000
New issue on the 1 April	1,000,000		
1 April to 30 June	6,000,000	× 3/12	1,500,000
New issue on the 1 July	1,000,000		
1 July to 31 October	7,000,000	× 4/12	2,333,333
New issue on the 1 November	500,000		
1 November until 31 December	7,500,000	× 2/12	1,250,000
			6,333,333

2.5 Issue of shares at full market price

The consideration received is available to boost earnings. Therefore, the shares are included from the date of issue to ensure consistency between the numerator (top) and denominator (bottom) of the EPS calculation.

As explained above, the starting point for the weighted average number of shares is the number of shares in issue at the beginning of the period. This is then adjusted for any shares issued during the period and a time weighting factor must then be applied to each figure.

There is no adjustment to comparatives resulting from an issue at full price.

Example: Issue of shares at full market price Company A has a financial year ending 31 December.

On 1 January Year 1, there were 6,000,000 ordinary shares in issue. On 1 April, it issued 1,000,000 new shares at full market price.

Total earnings in Year 1 were ₦27,000,000.

EPS in Year 1 is calculated as follows:

Date	Number of shares	Time factor	Weighted average number
1 January to 31 March	6,000,000	× 3/12	1,500,000
New issue on the 1 April	1,000,000		
1 April to 31 December	7,000,000	× 9/12	5,250,000
			6,750,000

EPS = ₦27,000,000/6,750,000 shares = ₦4

Practice question **1**

Company B has a financial year ending 31 December.

On 1 January Year 3, there were 9,000,000 ordinary shares in issue.

On 1 May, Company B issued 1,200,000 new shares at full market price.

On 1 October, it issued a further 1,800,000 shares, also at full market price.

Total earnings in Year 3 were ₦36,900,000.

Calculate the EPS for the year to 31 December Year 3.

Partly paid shares

The number of ordinary shares is calculated based on the number of fully paid shares. In order to do this partly paid shares are included as an equivalent number of fully paid shares.

Example: Issue of shares at full market price Company A has a financial year ending 31 December.

On 1 January Year 1 there were 6,000,000 ordinary shares in issue.

1,000,000 of these shares were partly paid to 75% of their value.

On 1 April, the remaining 25% of the value of the partly paid shares was received.

Total earnings in Year 1 were ₦24,750,000.

EPS in Year 1 is calculated as follows.

Date	Number of shares	Time factor	Weighted average number
1 January to 31 March	6,000,000	× 3/12	1,500,000
Receipt of partly of balance on partly paid shares (25% of 1,000,000)	250,000		
1 April to 31 December	6,250,000	× 9/12	4,687,500
			6,187,500

EPS = ₦24,750,000/6,187,500 shares = ₦4

2.6 Bonus issues of shares

A bonus issue of shares (also called a scrip issue or a capitalisation issue) is an issue of new shares to existing shareholders, in proportion to their existing shareholding, for no consideration. In other words, the new shares are issued 'free of charge' to existing shareholders.

The new shares are created by converting equity reserves in the statement of financial position, often some or all of the share premium account, into ordinary share capital.

No cash is raised from a bonus issue, therefore is no earnings boost from the issue. Bonus issued shares are treated as if they have always been in issue.

The new number of shares (i.e. the number of shares after the bonus issue) can be found by multiplying the number of shares before the bonus issue by the bonus issue fraction.

The bonus issue fraction is

Formula: Bonus issue fraction

$$\frac{\text{Number of shares in holding after the bonus issue}}{\text{Number of shares in holding before the bonus issue}}$$

Example: Bonus fraction

A company has 4,000,000 shares in issue.

It made a 1 for 4 bonus issue

The bonus fraction is

$$\frac{\text{Number of shares in holding after the bonus issue}}{\text{Number of shares in holding before the bonus issue}}$$

$$\frac{4+1}{4} = \frac{5}{4}$$

Number of shares in issue after the bonus issue:

$$4{,}000{,}000 \times 5/4 = 5{,}000{,}000$$

The above example is very straightforward but it illustrates an approach of wider applicability.

Example: Bonus issue

Company C has a 31 December financial year end.

On 1 January Year 5 it has 4,000,000 shares in issue.

On 1 July Year 5 it made a 1 for 4 bonus issue.

The financial results for Company C in Year 4 and Year 5 were as follows.

	Year 5	Year 4
Total earnings	₦20,000,000	₦20,000,000

There were no share issues in Year 4.

Basic EPS in Year 4 was: ₦20,000,000/4,000,000 shares = ₦5 per share.

Basic EPS could be calculated for the Year 5 financial statements as follows, by taking as the number of shares for the current period and the previous period the total number of shares after the bonus issue.

The weighted average number of shares in the current year (using the method explained earlier) is calculated as:

Date	Number of shares	Time factor	Bonus fraction	Weighted average number
1 January to 30 June	4,000,000	× 6/12	× 5/4	2,500,000
Bonus issue on 1 July	1,000,000			
1 July to 31 December	5,000,000	× 6/12		2,500,000
				5,000,000

Remember that if a capital change is due to a bonus issue each preceding year must be multiplied by the bonus fraction.

This must be done so that the new shares issued are not time apportioned. The new shares are included from 1 July to 31 December so they must also be included in the period(s) before this.

There is a much easier way to arrive at the number of shares in this example. It is simply the number in issue at the end of the year. However, this only works if the bonus issue is the only capital change in a year. In such cases do it this way but if there is more than one capital change in a period you must use the longer method shown above.

Basic EPS in Year 5 is: ₦20,000,000/5,000,000 shares = ₦4 per share.

In the above example, nothing changed between Year 4 and Year 5 except for the number of shares, yet the EPS figures calculated indicate deterioration from ₦5 per share to ₦4 per share.

Comparatives

There is no time apportionment for a bonus issue. This means that all comparative figures must be restated into the same terms to take account of the bonus. Unless a suitable adjustment is made to the EPS calculation, the comparison of EPS in the current year (after the bonus issue) with EPS in the previous year (before the bonus issue) would be misleading.

In order to ensure that the EPS in the year of the bonus issue is comparable with the previous year's EPS, IAS 33 requires that the weighted average number of shares should be calculated as if the bonus shares had always been in issue.

This means that:

- the current period's shares are adjusted as if the bonus shares were issued on the first day of the year; and
- the comparative EPS for the previous year is restated on the same basis.

The restatement of the comparatives is easily achieved by multiplying it by the inverse of the bonus fraction.

Example (continued): Bonus issue – restatement of comparatives

Company C made a 1 for 4 bonus issue in Year 5.

Basic EPS in Year 4 was: ₦20,000,000/4,000,000 shares = ₦5 per share.

This is restated by multiplying it by the inverse of the bonus fraction as follows:

₦5 per share ×4/5 = ₦4 per share

The figures presented in Company C's Year 5 accounts would be:

	Year 5	Year 4
Earnings per share	₦4	₦4

Practice question **2**

Company D has a 31 December year end and had 2,000,000 ordinary shares in issue on 1 January Year 2.

On 31 March Year 2, it issued 500,000 ordinary shares, at full market price.

On 1 July Year 2, Company D made a 1 for 2 bonus issue.

In Year 1, the EPS had been calculated as ₦30 per share.

In Year 2, total earnings were ₦85,500,000.

Calculate the EPS for the year to 31 December Year 2, and the comparative EPS figure for Year 1.

2.7 Rights issues of shares

A rights issue of shares is an issue of new shares for cash, where the new shares are offered initially to current shareholders in proportion to their existing shareholdings.

The issue price of the new shares in a rights issue is always below the current market price for the shares already in issue. This means that they include a bonus element which must be taken into account in the calculation of the weighted average number of shares. Also note that any comparatives must be restated by multiplying them be the inverse of the rights issue bonus fraction.

The rights issue bonus fraction is calculated as follows:

Formula: Rights issue bonus issue fraction

$$\frac{\text{Actual cum rights price}}{\text{Theoretical ex rights price}}$$

The **actual cum-rights price** is the market price of the shares before the rights issue.

The **theoretical ex-rights price** is the price that the shares ought to be, in theory, after the rights issue. It is a weighted average price of the shares before the rights issue and the new shares in the rights issue.

The calculation of the theoretical ex rights price looks a little complicated at first but it is always done this way. This is demonstrated in the following example.

Example:

Company E had 3,600,000 shares in issue on 1 January Year 2.

It made a 1 for 4 rights issue on 1 June Year 2, at a price of ₦40 per share. (After the rights issue, there will be 1 new share for every 4 shares previously in issue).

The share price just before the rights issue was ₦50.

Total earnings in the financial year to 31 December Year 2 were ₦25,125,000. The reported EPS in Year 1 was ₦6.4.

EPS for the year to 31 December Year 2 and the adjusted EPS for Year 1 for comparative purposes are calculated as follows:

Theoretical ex-rights price		₦
4 existing shares have a 'cum rights' value of	(4 × ₦50)	200
1 new share is issued for		40
5 shares after the issue have a theoretical value of		240

Therefore, the theoretical ex-rights price = ₦240/5 = ₦48

Rights issue bonus fraction:

Actual cum rights price/Theoretical ex rights price = 50/48.

Weighted average number of shares

Date	Number of shares	Time factor	Rights fraction	Weighted average number of shares
1 January to 31 May	3,600,000	× 5/12	× $^{50}/_{48}$	1,562,500
Rights issue on 1 June	900,000			
1 June to 31 December	4,500,000	× 7/12		2,625,000
				4,187,500

Calculation of EPS

EPS Year 2 = ₦25,125,000/4,187,500 = ₦6 per share Comparative

EPS in Year 1 = ₦6.4 × (₦48/₦50) = ₦6.14 per share

Practice question **3**

Company F had 3 million ordinary shares in issue on 1 January Year 7.

On 1 April Year 7, it made a 1 for 2 rights issue of 1,500,000 ordinary shares at ₦20 per share.

The market price of the shares prior to the rights issue was ₦50.

An issue of 400,000 shares at full market price was then made on 1 August Year 7.

In the year to 31 December Year 7, total earnings were ₦17,468,750. In Year 6 EPS had been reported as ₦3.5.

Required

Calculate the EPS for the year to 31 December Year 7, and the adjusted EPS for Year 6 for comparative purposes.

3 DILUTED EPS

Section overview

- The meaning of dilution
- IAS 33 and diluted EPS
- Diluted EPS: convertible preference shares and convertible bonds
- Diluted EPS: options and warrants
- Diluted EPS: Employee share options
- Potential ordinary shares that are not dilutive
- Contingently issuable shares
- Actual conversion during the year

3.1 The meaning of dilution

'Dilution' means 'watering down' or 'reduction in strength'.

An entity might have potential ordinary shares in issue. There is a possibility that these will become actual ordinary shares at some time in the future.

For example, if an entity has issued some convertible bonds or convertible preference shares, these might be converted into ordinary shares at some time in the future.

Similarly, holders of share options or warrants might exercise their right at a future date to subscribe for new shares at a fixed price.

If potential shares become actual ordinary shares, the earnings figure will be shared with a larger number of ordinary shares. This would dilute the EPS.

3.2 IAS 33 and diluted EPS

IAS 33 requires publicly-traded companies to calculate a diluted EPS in addition to their basic EPS for the current year (with a comparative diluted EPS for the previous year), allowing for the effects of all dilutive potential ordinary shares.

Potential ordinary shares might not dilute the EPS. The diluted EPS calculation only includes potential ordinary shares that would be dilutive. Note: potential ordinary shares are 'dilutive' when there might have been a reduction or 'dilution' in EPS if they had been actual ordinary shares during the financial period.

Diluted EPS is calculated by adjusting the earnings and number of shares figures used in the basic EPS calculation.

Earnings is adjusted to remove the effect of dividends or interest that have been recognised during the year for the potential ordinary shares, and for any other income or expense that would alter as a result of the conversion of the potential ordinary shares into actual ordinary shares.

The main items of dividend or interest to adjust for are dividends on convertible preference shares and interest on convertible debentures (convertible bonds). The dividend or interest reduces total earnings. However, if they had already been converted into ordinary shares (and the calculation of diluted EPS is based on this assumption) the dividends or interest would not have been payable. Total earnings would therefore have been higher. To calculate the diluted EPS, total earnings are adjusted to allow for this.

The weighted average number of shares must also be adjusted. The method of making this adjustment is different for:

- convertible bonds or convertible preference shares; and
- share options or warrants.

3.3 Diluted EPS: convertible preference shares and convertible bonds

When there are convertible bonds or convertible preference shares, diluted EPS is calculated as follows, by making adjustments to total earnings and the number of shares in issue used in the basic EPS calculation.

Total earnings

Total earnings are adjusted because the entity would not have to pay the dividend or interest on the convertible securities.

- For **convertible preference shares**, add back the preference dividend paid in the year. Total earnings will be increased by the preference dividend saved.
- For **convertible bonds**, add back the interest charge on the bonds in the year less the tax relief relating to that interest. Total earnings will increase by the interest saved less tax.

Number of shares

The weighted average number of shares is increased, by adding the maximum number of new shares that would be created if all the potential ordinary shares were converted into actual ordinary shares.

The additional number of shares is normally calculated on the assumption that they were in issue at the beginning of the year.

Example: Diluted EPS (convertible bonds)

Company G has 12,000,000 ordinary shares and ₦4,000,000 5% convertible bonds in issue.

As at 31 December Year 2, there have been no new issues of shares or bonds for several years.

The bonds are convertible into ordinary shares in Year 3 or Year 4, at the following rates:

At 30 shares for every ₦100 of bonds if converted at 31 December Year 3

At 25 shares for every ₦100 of bonds if converted at 31 December Year 4

Total earnings for the year to 31 December Year 2 were ₦36,000,000.

Tax is payable at a rate of 30% on profits.

The basic EPS and diluted EPS for Year 2 are calculated as follows:

Basic EPS:

Year to 31 December Year 2: ₦36,000,000/12 million = ₦3 per share

Diluted EPS:

	Number of shares	Earnings (₦)	EPS (₦)
Basic EPS figures	12,000,000	36,000,000	3
Dilution:			
Number of shares 4,000,000 × 30/100	1,200,000		
Add back interest:			
5% × ₦4,000,000		200,000	
Less tax at 30%		(60,000)	
Adjusted figures	13,200,000	36,140,000	2.74

Diluted EPS: ₦36,140,000/13.2 million = ₦2.74 per share

Note: The number of potential shares is calculated using the conversion rate of 30 shares for every ₦100 of bonds, because this conversion rate produces more new shares than the other conversion rate, 25 shares for every ₦100 of bonds.

New issue of convertibles in the year

If new convertibles are issued during the course of the year, the additional number of shares and the earnings adjustment are included only from the time that the convertibles were issued.

Example: Diluted EPS (New issue of convertibles in the year)

Company H has 10,000,000 ordinary shares in issue.

There has been no new issue of shares for several years. However, the company issued ₦2,000,000 of convertible 6% bonds on 1 April Year 5.

These are convertible into ordinary shares at the following rates:

On 31 March Year 10	25 shares for every ₦100 of bonds
On 31 March Year 11	20 shares for every ₦100 of bonds

Tax is at the rate of 30%.

In the financial year to 31 December Year 5 total earnings were ₦40,870,000.

The Year 5 basic EPS and diluted EPS are calculated as follows:

Basic EPS

Year 5 = ₦40,870,000/10,000,000 = ₦4.087 per share

Diluted EPS:

	Number of shares	Earnings (₦)	EPS (₦)
Basic EPS figures	10,000,000	40,870,000	4.087
Dilution:			
Number of shares			
2 million × 25/100 × 9/12	375,000		
Add back interest:			
6% × ₦2,000,000 × 9/12		90,000	
Less tax at 30%		(27,000)	
Adjusted figures	10,375,000	40,933,000	3.94

Diluted EPS: ₦40,933,000/10.375 million = ₦3.94 per share

3.4 Diluted EPS: options and warrants

A different situation applies with share options and share warrants.

Options (warrants) are contracts issued by a company which allow the holder of the option to buy shares off the company at some time in the future at a pre-agreed price.

If the option holder exercises this right the number of shares would increase and the company would receive the cash paid for the shares and this would be available to invest in the business and in turn this would be expected to boost its earnings. However, it is impossible to predict how total earnings will be affected when the cash is eventually received.

This presents a problem. Including the shares in the diluted EPS calculation without adjusting the earnings would be inconsistent but it is not possible to adjust the earnings.

IAS 33 solves this problem in quite a neat way. The amount that would be received on exercise of the options is treated as cash received from selling shares at full price with the remaining shares having been given away. The shares sold at full price are not considered to be dilutive as any cash would be invested to earn the same return as earned in the period. It is only the free shares that are dilutive.

The following steps must be taken:

Step 1: Calculate the cash that would be received if the options are exercised.

Step 2: Calculate the number of shares that could be sold at full market price to raise the same amount of cash. (Divide the figure from step 1 by the average share price in the period).

Step 3: Identify the number of shares that will be issued if all the options are exercised.

Step 4: Subtract the number of shares in step 2 from the number at step 3. These shares are treated as having been given away for free and is added to the existing number of shares in issue, to obtain the total shares for calculating the diluted EPS.

Example: Diluted EPS (options)

Company J had total earnings during Year 3 of ₦25,000,000.

It has 5,000,000 ordinary shares in issue.

There are outstanding share options on 400,000 shares, which can be exercised at a future date, at an exercise price of ₦25 per share.

The average market price of shares in Company J during Year 3 was ₦40.

The diluted EPS for Year 3 may be calculated as follows:

Step 1:	Cash proceeds from exercise of the options	
	400,000 × ₦25	₦10,000,000
Step 2:	Divide by the average share price in the period	₦40
	Shares issued at full price	250,000
Step 3	Number of shares issued on exercise of the option	400,000
Step 4	Shares issued for free	150,000

Diluted EPS calculation

	Number of shares	Earnings (₦)	EPS (₦)
Basic EPS figures	5,000,000	25,000,000	5
Dilution:			
Number of shares	150,000		
Adjusted figures	5,150,000	25,000,000	4.85

Diluted EPS: ₦25,000,000/5.15 million = ₦4.85 per share

Options are only included in the diluted EPS calculation if the average share price in the year is greater than the exercise price of the option. If this were not the case the option would not be exercised. (Nobody would pay an exercise price of ₦100 for something worth only ₦80).

- When the exercise price of the option is less than the share price they are said to be ***in the money***.
- When the exercise price of the option is more than the share price they are said to be ***out of the money***.

In the money options are always dilutive. Out of the money options are always not dilutive (or antidilutive as IAS 33 describes them).

3.5 Diluted EPS: Employee share options

Employee share options that have vested are treated in exactly the same way as any other option as explained above.

Unvested options

The situation in respect of unvested options is a little more complicated. When a company issues options to its employees it recognises an expense for options over the vesting period in accordance with IFRS 2. This means that the company will recognise an expense in the future for those options which are unvested at the reporting date.

This expense represents the service of the employee that will be consumed and used by the company in the future.

Thus, the company will receive cash when the option is exercised and service until it vests. IAS 33 requires that the future "service" received per share be added to the exercise price for the purpose of calculating the number of dilutive shares.

The following steps must be taken:

Step 1: Calculate the cash that would be received if the options are exercised and the future expense that is expected to be charged to profit or loss.

Step 2: Calculate the number of shares that could be sold at full market price to raise an amount of cash equal to the future benefit identified at step 1. (Divide the figure from step 1 by the average share price in the period).

Step 3: Identify the number of shares that will be issued if all the options are exercised.

Step 4: Subtract the number of shares in step 2 from the number at step 3. These shares are treated as having been given away for free and is added to the existing number of shares in issue, to obtain the total shares for calculating the diluted EPS.

Example: Diluted EPS (employee share options)

Company K had total earnings during Year 5 of ₦30,000,000. It has 6,000,000 ordinary shares in issue.

There are unvested employee share options on 500,000 shares, which can be exercised at a future date, at an exercise price of ₦210 per share.

The future expense that the company expects to recognise in respect of these options up to the vesting date is ₦15,000,000.

The average market price of shares in Company J during Year 5 was ₦300.

The diluted EPS for Year 3 may be calculated as follows:

Step 1:	Estimate the future benefit	
	Cash proceeds from exercise	
	500,000 × ₦210	₦105,000,000
	Future employee service	₦15,000,000
		₦120,000,000
Step 2:	Divide by the average share price in the period	₦300
	Shares issued at full price	400,000
Step 3	Number of shares issued on exercise of the option	500,000
Step 4	Shares issued for free	100,000

Diluted EPS calculation

	Number of shares	Earnings (₦)	EPS (₦)
Basic EPS figures	6,000,000	30,000,000	5
Dilution:			
Number of shares	100,000		
Adjusted figures	6,100,000	30,000,000	4.91

ALTERNATIVE WAY OF DETERMINING THE FREE NUMBER OF SHARE OPTION

(Share option X (market price-exercise price)/market price) - (related expenses/market price)

(500 x (300-210)/market price) – (15000/300) = 150-50=100 free share options.

3.6 Potential ordinary shares that are not dilutive

Only dilutive potential ordinary shares are included in the dilutive EPS calculation.

When there are several types of potential ordinary share in issue, they should be ranked in order of dilution, with the most dilutive potential ordinary shares ranked first. In order to carry out the ranking the earnings per incremental share is found for each potential ordinary share. This is the earnings adjustment that would be necessary divided by the number of shares that would come into being if the share were included in the calculation of diluted EPS.

Note that in the money options always rank first as they increase the number of shares in the calculation without affecting the earnings.

A diluted EPS should then be calculated in stages, taking in one potential ordinary share at a time, to establish whether any of them are not dilutive.

The following example illustrates the technique.

Example: Order of dilution

The following information relates to Company L for the year ended 31 December Year 5.

Number of ordinary shares in issue	5,000,000
Reported earnings in the year	₦15,000,000
Average market price of shares during the year	₦80
Potential ordinary shares:	
Options	600,000 options, with an exercise price of ₦60
4% convertible bond: ₦5,000,000	Each bond is convertible in Year 10 into ordinary shares at the rate of 40 new shares for every ₦100 of bonds
100,000 7% convertible preference shares of ₦10 each	Each preference share is convertible in Year 9 into ordinary shares at the rate of 1 ordinary share for every 20 preference shares
Tax rate = 30%	

Diluted EPS for the year to 31 December Year 5 can be calculated as follows.

Example (continued): Order of dilution

If all the options are exercised, the cash received will be 600,000 × ₦60 = ₦36,000,000.

This would purchase 450,000 shares (₦36,000,000/₦80) at the average market price in Year 5.

The dilutive increase in the number of shares would therefore be (600,000 – 450,000) = 150,000.

	Increase in earnings.	Increase in number of shares	Earnings per incremental share	Ranking
	₦		₦	
Options	0	150,000	0.00	1st
Convertible bonds				
4% × ₦5,000,000	200,000			
less tax 30%	(60,000)			
	140,000			
₦5,000,000 × 40/100		2,000,000		
	140,000	2,000,000	0.07	2nd
Preference shares				
7% × ₦1,000,000	70,000			
100,000 × 1/20		5,000		
(7% × ₦1,000,000)	70,000	5,000	14.0	3rd

Diluted EPS is calculated as follows (taking these three dilutive potential ordinary shares in order of their ranking):

	Earnings	Number of shares	EPS	
	₦		₦	
As reported, basic EPS	15,000,000	5,000,000	3.000	
Options	0	150,000		
Diluted EPS, options only	15,000,000	5,150,000	2.913	Dilutive
Convertible bonds	140,000	2,000,000		
Diluted EPS, options and convertible bonds	15,140,000	7,150,000	2.12	Dilutive
Convertible preference shares	70,000	5,000		
Diluted EPS, options and all convertibles	15,210,000	7,155,000	2.13	Not dilutive

The convertible preference shares are not dilutive, and the reported diluted EPS should be ₦2.12 (and not ₦2.13).

3.7 Contingently issuable shares

A company might enter into a contract where it will issue shares on the occurrence of some future event. Such shares have no effect on the basic EPS calculation until the condition is actually met.

They are taken into account in the diluted EPS only if the conditions leading to their issue have been satisfied. For this purpose the reporting date is treated as the end of the contingency period.

Contingently issuable shares are included in the diluted EPS calculation from the later of the beginning of the period or the date of the contingently issuable share agreement.

Example: Contingently issuable shares

Company M has 12,000,000 ordinary shares in issue.

As at 31 December Year 2, there have been no new issues of shares or bonds for several years.

Company M acquired a new business during Year 1. As part of the purchase agreement Company M would issue a further 1,000,000 shares to the vendor on 30 June Year 3 if the share price was ₦500 at that date.

The share price was ₦600 on 31 December Year 2.

Earnings for the year to 31 December Year 2 were ₦100,000,000.

Basic EPS:

Year to 31 December Year 2: ₦100,000,000/12 million = ₦8.33 per share **Diluted EPS:**

	Number of shares	Earnings (₦)	EPS (₦)
Basic EPS figures	12,000,000	100,000,000	8.33
Dilution:			
Number of shares	1,000,000		
Adjusted figures	13,000,000	100,000,000	7.69

Diluted EPS: ₦100,000,000/13 million = ₦7.69 per share

Shares that are issuable after a period of time are not contingently issuable shares because passage of time is a certainty. When there is an agreement to issue shares at a point of time in the future they must be included in the diluted EPS calculation.

3.8 Actual conversion during the year

If a conversion right is exercised during the year, interest paid to the holders of the convertible bond stops from the date upon which they exercise their right to the shares and the new shares are included as part of the weighted average number of shares used in the basic EPS calculation.

When this happens, the new shares issued and the resulting interest saving must be included in the diluted EPS calculation as an adjustment for the period before the right was exercised.

Example: Diluted EPS (Conversion right exercised in the year)

Company N has 10,000,000 ordinary shares and ₦2,000,000 of convertible 6% bonds in issue at the start of the year.

The conversion right was exercised on 1 April resulting in the issue 500,000 new shares.

Tax is at the rate of 30%.

In the financial year to 31 December total earnings were ₦40,870,000.

The basic EPS and diluted EPS are calculated as follows:

Basic EPS

	Number of shares
At start of the year	10,000,000
Conversion:	
Number of shares	
500,000 × 9/12	375,000
Weighted average	10,375,000

Diluted EPS: ₦40,870,000/10.375 million = ₦3.94 per share

Diluted EPS:

	Number of shares	Earnings (₦)	EPS (₦)
Basic EPS figures	10,375,000	40,870,000	3.94
Dilution:			
Number of shares up to the date of conversion			
500,000 × 3/12	125,000		
Add back interest up to the date of conversion			
6% × ₦2,000,000 × 3/12		30,000	
Less tax at 30%		(9,000)	
Adjusted figures	10,500,000	40,891,000	3.89

Diluted EPS: ₦40,891,000/10.500 million = ₦3.89 per share

This is difficult to understand but imagine two identical convertible bonds that allow conversion at any time over a period.

- Bond A is converted during the year.
- Bond B is held for a future conversion.

The conversion of Bond A has an impact on the basic EPS from the date of conversion.

An adjustment is made in respect Bond B for the whole period in the diluted EPS calculation.

If no further adjustment is made Bond A is shown as being less dilutive than Bond B because it is only included from the date of conversion. How can actual shares be less dilutive than potential shares?

In order to correct this anomaly, an adjustment must be made in respect of Bond A in the diluted EPS calculation for the part of the year before conversion.

4 IAS 33: PRESENTATION AND DISCLOSURE REQUIREMENTS

Section overview

- Presentation requirements
- Disclosure requirements
- Alternative measures of earnings per share

4.1 Presentation requirements

The following must be presented in the statement of comprehensive income:

- ❑ basic EPS and diluted EPS for profit (or loss) attributable to the ordinary shareholders; and
- ❑ basic EPS and diluted EPS for profit (or loss) from continuing operations attributable to the ordinary shareholders.

For consolidated accounts, this is the EPS and diluted EPS attributable to the owners of the parent company.

The basic EPS and diluted EPS should be presented with equal prominence for all the periods presented (the current year and the previous year). These figures are presented at the end of the statement of profit or loss.

If the entity presents a separate statement of profit or loss:

- ❑ the EPS and diluted EPS should be shown in this statement, and
- ❑ not in the statement of comprehensive income.

If there is a **discontinued operation**, the basic EPS and diluted EPS from the discontinued operation should be shown either on the face of the statement of profit or loss or in a note to the financial statements.

The basic and the diluted EPS should be presented, even if it is a negative figure (i.e. even if it is a loss per share).

4.2 Disclosure requirements

IAS 33 also requires disclosure in a note to the financial statements of the following:

- ❑ The total amounts used as the numerators (total earnings figures) to calculate the basic EPS and diluted EPS, and a reconciliation of these numerator figures to the profit or loss for the period
- ❑ The total amounts used in the denominators (weighted average number of shares) to calculate the basic EPS and diluted EPS, and a reconciliation of these two denominator figures to each other.

4.3 Alternative measures of earnings per share

IAS 33 allows an entity to disclose an alternative measure of EPS in addition to the EPS calculated in accordance with IAS 33. For example, EPS could be calculated after adjusting earnings for large and unusual items.

If an alternative EPS figure is presented, IAS 33 states that:

- a reconciliation must be shown between the earnings figure used in the alternative measure and the amounts shown in the statement of profit or loss;
- the alternative EPS must use the same weighted average number of shares as the IAS 33 calculation;
- basic and diluted EPS should both be disclosed with equal prominence; and
- the alternative figure must only be shown in the notes, **not** on the face of the statement of profit or loss.

5 EARNINGS PER SHARE AS A PERFORMANCE MEASURE

Section overview

- Earnings per share and trends
- Limitations of earnings per share

5.1 Earnings per share and trends

Investors and their advisers pay close attention to an entity's net profit for the period. However, profit for the period can include large and unusual items and also the results of discontinued operations. This may make it volatile: liable to fluctuate rapidly up and down. Users can then find it difficult to assess trends in the profit figure or to use the current year's profit to predict an entity's performance in future years.

The trend (improvement or deterioration) in an entity's published EPS figure can sometimes be a more reliable indicator of future performance. There are a number of reasons for this.

- The standard version of both basic and diluted EPS is based on profit from continuing operations. This means that the results of discontinued operations (which may distort total profit) are excluded.
- An entity may also choose to present one or more alternative versions of EPS. These normally exclude large or unusual items so that EPS is based on 'normal' recurring earnings.
- EPS measures an entity's performance from the viewpoint of investors. It shows the amount of earnings available to each ordinary shareholder. This means that EPS takes the effect of preference dividends (if any) into account. It also takes share issues into account.
- Diluted EPS can provide an 'early warning' of any changes to an investor's potential return on their investment due to future share issues.

5.2 Limitations of earnings per share

EPS is probably the single most important indicator of an entity's performance. It is a very useful measure when it is used as the starting point for a more detailed analysis of an entity's performance.

However, EPS can have serious limitations:

- Not all entities use the same accounting policies. It may not always be possible to make meaningful comparisons between the EPS of different entities.
- EPS does not take account of inflation, so that growth in EPS over time might be misleading.
- EPS measures an entity's profitability, but this is only part of an entity's overall performance. An entity's cash flow can be just as important as its profit (and more essential to its immediate survival). Changes in the value of assets (holding gains) can also be an important part of performance for some entities.

- Diluted EPS is often described as an 'early warning' to investors that the return on their investment may fall sometime in the future. However, diluted EPS is based on current earnings, not forecast earnings. This means that it may not be a reliable predictor of future EPS.

One of the main problems with EPS can be the way that it is used by investors and others. Users often rely on EPS as the main or only measure of an entity's performance. Management know this and try to make EPS appear as high as possible. They may attempt to manipulate the figure by using 'creative accounting'. They may also make decisions which increase EPS in the short term but which damage the entity in the longer term.

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain why a standard calculation of earnings per share is important
- Calculate basic earnings per share
- Calculate diluted earnings per share

SOLUTIONS TO PRACTICE QUESTIONS

Solution **1**

Date	Number of shares	Time factor	Weighted average number
1 January to 30 April	9,000,000	× 4/12	3,000,000
New issue on 1 May	1,200,000		
1 May to 30 September	10,200,000	× 5/12	4,250,000
New issue on 1 October	1,800,000		
1 October to 31 December	12,000,000	× 3/12	3,000,000
			10,250,000

EPS = ₦36,900,000/10,250,000 = ₦3.6

Notes

(1) The first new share issue is in May, after 4 months. Therefore the number of shares at the beginning of the year is given a time factor of × 4/12.

(2) There are 5 months between the two share issues, therefore the time factor to apply to the number of shares after the first issue is × 5/12.

(3) The total number of shares in issue from 1 October to the end of the year (three months) is 12,000,000. These are given a time weighting of × 3/12.

Solution **2**

The weighted average number of shares in Year 2 is calculated as follows.

Date	Number of shares	Time factor	Bonus fraction	Weighted average number
1 January to 31 March	2,000,000	× 3/12	× 3/2	750,000
Issue at full price on 31 March	500,000			
1 April to 30 June	2,500,000	× 3/12	× 3/2	937,500
Bonus issue on 1 July	1,250,000			
1 July to 31 December	3,750,000	× 6/12		1,875,000
				3,562,500

EPS in Year 2 = ₦85,500,000/3,562,500 = ₦24 per share.

The Year 1 EPS restated as: ₦30 × 2/3 = ₦20.

Solution **3**

After the rights issue, there will be 1 new share for every 2 shares previously in issue

Theoretical ex-rights price

		₦
2 existing shares have a 'cum rights' value of	(2 × ₦50)	100
1 new share is issued for		20
3 shares after the issue have a theoretical value of		120

Theoretical ex-rights price = ₦120/3 = ₦40.

Rights issue bonus fraction:

Actual cum rights price/Theoretical ex rights price = 50/40

Weighted average number of shares

Date	Number of shares	Time factor	Rights fraction ×	Weighted average number of shares
1 January to 31 March	3,000,000	× 3/12	50/40	937,500
Rights issue on 1 April	1,500,000			
1 April to 31 July	4,500,000	× 4/12		1,500,000
Issue at full price on 1 August	400,000			
1 August to 31 December	4,900,000	× 5/12		2,041,667
				4,479,167

Calculation of EPS

EPS Year 7 = ₦17,468,750/4,479,167 = ₦3.9 per share

EPS Year 6 = ₦35 × 40/50 = ₦2.

Professional level
Corporate Reporting

CHAPTER 29

Analysis and interpretation of financial statements

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

E	**Analysis of financial and other reports to appraise entity's financial performance and position**		
	2	**Analyses, interpretation and appraisal of financial and other reports**	
		a	Evaluate relevant indicators of financial and non-financial performance.
		b	Analyse and evaluate the performance, including stock market performance, liquidity, efficiency and solvency of an entity using different techniques of analysis, such as: horizontal; vertical; ratios; trends; and common size.
		c	Adjust reported earnings of an entity to make it comparable over time, with similar entities and industry average.
		d	Assess the potential complex economic environment in which an entity operates, and its strategies based on financial and operational information contained within the annual report (such as Chairman and CEO/CFO business and performance reports, management commentary, corporate governance disclosures, financial summaries and highlights).
		e	Make inferences from the analyses of information taking into account the limitations of the information, the analytical methods used and the business environment in which the entity operates.
		f	Discuss and evaluate earnings management and creative accounting and assess their impact on the usefulness of ratios.
	3	**Limitations of financial analyses**	
		a	Appraise the limitations of financial analyses.
		b	Appraise the significance of inconsistencies and omissions in reported information in evaluating performance.

Exam context

This chapter explains interpretation of financial statements. It is a large chapter but a lot of it should be very familiar to you from your previous studies.

At the end of this chapter, you should be able to:

- Explain and use common size analysis;
- Calculate and interpret return on capital employed and similar ratios;
- Calculate and interpret profitability ratios, working capital ratios, liquidity ratios, debt ratios and gearing ratios;
- Analyse performance of a company from information provided; and
- Explain the limitations of financial statements and interpretation.

1 INTRODUCTION TO FINANCIAL ANALYSIS

Section overview

- Introduction to interpretation
- Users and their information needs

1.1 Introduction to interpretation

Financial statements are used to make decisions. They are used by a number of different groups including shareholders and investors, and also by lenders, as well as by management. The financial statements contain a large number of figures, but the figures themselves do not necessarily have much meaning to a user of the financial statements. However, there are techniques of analysis that can be used to interpret the information.

Two key techniques are:

- common size analysis; and
- ratio analysis.

Techniques can be used in different ways to provide:

- vertical analysis;
- horizontal analysis; and
- trend analyses (a form of horizontal analysis).

Analysis by comparisons

Making sensible comparisons sit at the heart of financial analysis. There are different types of comparisons that might be made including:

- Comparisons within financial statements. (For example if revenue has increased by 10% it might be expected that gross profit increased by a similar amount). (Vertical analysis).
- Comparisons over a number of years. By looking at the ratios of a company over a number of years, it might be possible to detect improvements or deterioration in the financial performance or financial position of the entity. Ratios can therefore be used to make comparisons over time, and to identify changes or trends. (Horizontal analysis).
- Comparisons with the similar ratios of other, similar companies or to industry averages for the same period or over the same periods. (Vertical and horizontal analysis).

1.2 Users and their information needs

There are several groups of people who may use financial statements. They include:

- investors and potential investors;
- lenders;
- employees;
- suppliers;
- customers;
- government and government agencies; and
- the general public.

Each user group has different information needs, but as a general rule financial statements prepared in accordance with IFRSs should provide all user groups with most of their needs. Each group is interested in financial performance, financial position and cash flows, but some users are mainly interested in performance and profitability, while others may be more interested in liquidity and gearing or other matters.

For example:

- A private investor needs to know whether to continue to hold shares or to sell them. He or she will tend to be most interested in profitability ratios (such as gross and net profit margin and return on capital employed) and investor ratios (such as earnings per share, dividend cover and price earnings ratio).
- A potential acquirer needs information about an entity's profitability and probably also information about whether or not the entity is managed efficiently. The acquirer's management is likely to focus on profit margins, return on capital employed, asset turnover and working capital ratios.
- A bank that has been approached to lend money to an entity needs to know whether it will receive interest payments when these are due and whether the money that it lends will eventually be repaid. A bank manager will normally be most interested in cash flows and liquidity ratios (current ratio, acid test ratio) gearing and interest cover. A potential lender will also be interested in predicting future performance as without sales there will be no cash.

Any analysis should focus on the needs of the user. What do they need to know? What are they interested in? What decision do they need to make?

The table below lists the user groups, indicates the information that they require from published reports and accounts, and suggests which items in the financial statements will be of most interest to each group.

User	Information needs	Items of interest
Investors/ potential investors	▪ Risks and returns relating to their investment ▪ Security of dividend payments ▪ Information to make decisions about buying, selling or holding shares ▪ Future growth prospects.	▪ Trend analysis: changes in revenue, costs and profits over the past few years ▪ Dividend cover ▪ Events and announcements after the reporting period ▪ Share price ▪ Corporate governance reports. Narrative business review.
Employees	▪ Stability of the company (job security and job prospects) ▪ Information about the company's ability to pay bonuses or higher salaries.	▪ Profitability and cash position ▪ Increases in salaries (%) relative to increases in profit and dividends ▪ Directors' remuneration
Lenders (banks, etc.)	▪ Whether the entity has sufficient cash flow to repay loans ▪ The entity's ability to pay interest ▪ The adequacy of collateral/ security for loans and bonds	▪ Cash flow ▪ Total borrowing by the entity: financial gearing ▪ Interest cover ▪ New charges created over the entity's assets
Suppliers	▪ The entity's ability to settle its liabilities ▪ The entity's ability to survive and continue as a customer	▪ Net current assets ▪ Growth record
Customers	▪ The entity's ability to survive and continue as a supplier	▪ Growth record ▪ Cash flow
Government	▪ The entity's contribution to the economy ▪ Regulation of activities ▪ Taxation ▪ Obtaining government statistics	▪ Revenue and profit ▪ Market share
General public	▪ Environmental and social awareness ▪ Contributions to the local economy	▪ Environmental and social reports ▪ Directors' report ▪ Narrative business review

Management are not included as a user group because they should have access to much more detailed information about the company's financial position and performance, from internal reports and budgets.

2 COMMON SIZE ANALYSIS

Section overview

- Introduction to common size analysis
- Examples of analysis of statement of profit or loss
- Examples of analysis of statement of financial position
- Making reported earnings comparable

2.1 Introduction to common size analysis

Common size analysis involves expressing each line in a financial statement as a percentage of the base amount for that period.

- The common base amount in the statement of financial position is total assets. A statement of financial position can be constructed showing all lines as a percentage of that number.
- The common base amount in the statement of profit or loss is revenue. A statement of profit or loss can be constructed showing all lines as a percentage of that number.

The analysis helps to understand the impact of each item in the financial statement and its contribution to the resulting figure.

Common size analysis can be conducted in two ways:

- vertical analysis – analysis of specific line items in relation to a base item within the same financial period; and
- horizontal analysis – analysis of specific line items with comparison to the same line item in the previous or subsequent financial period.

2.2 Examples of analysis of statement of profit or loss

Example: Vertical analysis of statement of profit or loss

	Year 1 ₦000	*as % of revenue*	Year 2 ₦000	*as % of revenue*
Revenue	1,500	*100.0%*	1,600	*100.0%*
Cost of sales	(500)	*(33.3%)*	(700)	*(43.8%)*
Gross profit	1,000	*66.7%*	900	*56.3%*
Distribution costs	(400)	*(26.7%)*	(450)	*(28.1%)*
Administrative expenses	(300)	*(20.0%)*	(310)	*(19.4%)*
Net profit	300	*20.0%*	140	*8.8%*

Revenue has increased in year 2 by ₦100,000. However, in year 1 the cost of sales was only 33.3% of revenue giving a gross margin of 66.7% and in year 2 the cost of sales grew to 43.8% of the sales figure leading the gross margin to fall to 56.3%.

Distribution costs as a percentage of sales are slightly higher in Year 2 and administrative expenses slightly lower but the reduction in gross margin has fed through to a big reduction in net margin (20% to 8.8%).

Example: Horizontal analysis of statement of profit or loss

	Year 1 ₦000	Year 2 ₦000	*Percentage change from year 1 to year 2*
Revenue	1,500	1,600	*6.7%*
Cost of sales	(500)	(700)	*40.0%*
Gross profit	1,000	900	*(10.0%)*
Distribution costs	(400)	(450)	*12.5%*
Administrative expenses	(300)	(310)	*3.3%*
Net profit	300	140	*(53.3%)*

Revenue has increased in year 2 by 6.7%

However, the cost of sales has increased by 40.0%.

Furthermore, both distribution costs and administrative expenses have increased disproportionately to sales.

The overall effect is a 53.3% fall in net margin.

The vertical and horizontal analysis taken together can provide powerful insights in changes in performance.

2.3 Examples of analysis of statement of financial position

Example: Vertical analysis of statement of financial position

	Year 1 ₦000	*as % of revenue*	Year 2 ₦000	*as % of revenue*
Non-current assets	4,000	*50.0%*	5,000	*60.2%*
Current assets				
Inventories	1,000	*12.5%*	1,500	*18.1%*
Receivables	2,000	*25.0%*	1,000	*12.0%*
Cash	1,000	*12.5%*	800	*9.6%*
	4,000	*50.0%*	3,300	*39.8%*
Total asset	8000	*100.0%*	8300	*100.0%*
Share capital and reserves	3,500	*43.8%*	2,800	*33.7%*
Non-current liabilities	2,000	*25.0%*	2,500	*30.1%*
Current liabilities	2,500	*31.3%*	3,000	*36.1%*
	8000	*100.0%*	8300	*100.0%*

Non-current assets have increased as a percentage of total assets from 50.0% to 60.2%. As a percentage of the total assets this is an increase of 10.2%.

The increase of 1,000 has been funded in part by new long term debt which has increased from 25% of net assets to 30.1%. As a percentage of the total assets this is an increase of 5.1%.

The rest of the investment in non-current assets has been funded by an increase in current liabilities which have increased from 31.3% of total assets to 36.1%.

There working capital situation is deteriorating with inventory increasing and receivables and cash both decreasing as a percentage of total assets.

The figures also indicate a loss for the year as share capital and reserves have fallen by 700.

Example: Horizontal analysis of statement of financial position

	Year 1 ₦000	Year 2 ₦000	*Percentage change from year 1 to year 2*
Non-current assets	4,000	5,000	*25.0%*
Current assets			
Inventories	1,000	1,500	*50.0%*
Receivables	2,000	1,000	*(50.0%)*
Cash	1,000	800	*(20.0%)*
	4,000	3,300	*(17.5%)*
Total asset	8000	8300	*3.8%*
Share capital and reserves	3,500	2,800	*(20.0%)*
Non-current liabilities	2,000	2,500	*25.0%*
Current liabilities	2,500	3,000	*20.0%*
	8000	8300	*3.8%*

Non-current assets have increased by 25% in the year.

Both non-current liabilities and current liabilities have increased.

The working capital situation seems to have deteriorated (Note that we would need to see the statement of profit or loss figures to be certain). The figures indicate a possible worrying increase in inventory levels compared to previous years. However, receivables seem to have been collected more quickly. The cash position has worsened.

The figures indicate a poor financial performance as share capital and reserves have fallen by 20%.

2.4 Making reported earnings comparable

Sometimes, in order to make information more comparable it might be necessary to adjust figures onto a common basis.

Example: Adjustment to take account of inflation

The following figures show the revenue of a company at two year-ends.

20X4	20X5	Growth rate
1,000	1,200	20%

The increase looks quite impressive. However, inflation in the year was15%.

The 20X4 figure would need to be rebased to 20X5 prices in order to make the comparison more meaningful. Thus, the 20X4 figure would be rebased to 1,150 (1,000 $\times$ 1.15).

The result is as follows:

20X1	20X5	Growth rate
1,150	1,200	4.3%

3 INTRODUCTION TO RATIO ANALYSIS

Section overview

- Ratio analysis as a tool
- Categories of financial ratios

3.1 Ratio analysis as a tool

It is difficult to assess a company's financial performance by analysing the financial results for one year. Better information is obtained by making comparisons with financial performance in the previous year, or perhaps over several periods (trend analysis).

Ratio analysis is a key tool used for performance analysis, because ratios summarise financial information, often by relating two or more items to each other, and they present financial information in a more understandable form. Ratios also identify significant relationships between different figures in the financial statements.

Illustration: Good or bad?

For example, knowing that the profit of a company is ₦50,000 is not particularly useful information on its own, because the expected amount of profit should be dependent on the size of the business and the amount of its sales turnover.

If the company generated a profit of ₦50,000 from ₦150,000 of sales, then it has performed well.

However, if a profit of ₦50,000 has been made from sales of ₦5 million, then the profit level is much weaker.

The profit margin (the ratio of profit to sales) is a basic and widely-used ratio for analysing the strength of a company's financial performance.

A ratio on its own does not provide useful information. Ratios are useful because they provide a basis for **making comparisons**. Comparisons might indicate that performance or the financial position is better or worse than it should be, or is getting better or worse than in the past.

Illustration: Comparisons

For example, suppose that a company measures its profit margin in the current year as 20%. Is this good or bad? To evaluate performance, the current year profit margin of 20% should be interpreted, by comparing it with:

a. last year's profit margin, or the company's profit margin for the past few years
b. the budgeted profit margin (available to investors, perhaps, through company announcements)
c. the industry average (the average profit margin for companies in the industry)
d. the profit margin reported by individual competitors.

For example, if the budgeted profit margin was 25%, an actual profit margin of 20% might suggest that management have under-performed in the period

Note that a ratio does not **explain** why any under-performance or out-performance has occurred. Ratios are used to indicate areas of good or weak performance, but management then have to investigate to identify the cause.

Example: Possible explanations

A company achieved a profit margin of 6% in the year just ended. This was less than the budgeted profit margin of 10%, and less than the profit margin in the previous year, which was 8%.

The actual profit margin of 6% indicates disappointing performance, but management should investigate the cause or causes.

For example, they might find that any of the following reasons might explain the low profit margin:

a. Increased competition has forced down sales prices and so reduced profit margins.

b. Advances in technology have lowered costs but prices have come down even more.

c. Raw material costs have risen and the higher costs could not be passed on to the customers.

d. There have been higher employment costs due to pay rises for manufacturing employees, but these could not be passed on to the customers.

e. The company buys most of its supplies from foreign countries, and adverse movements in exchange rates for its purchases have increased costs and reduced profit margins.

f. There has been a change in the company's sales mix, and the company has sold a larger proportion of cheaper and lower-margin products than expected.

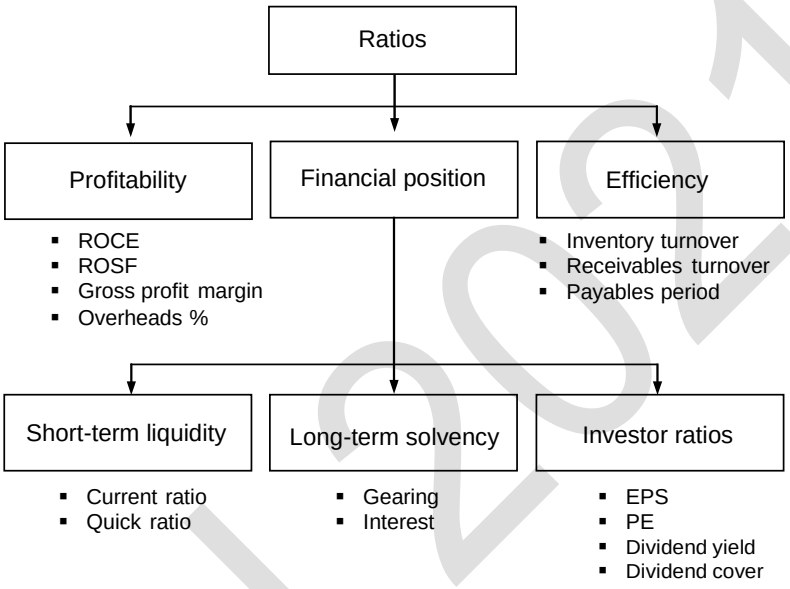
3.2 Categories of financial ratios

Financial ratios can help the user of the financial statements to assess:

- the financial position of the entity; and
- its financial performance.

The basic financial ratios should already be familiar to you. Ratios can be divided into five categories:

Illustration:



The main ratios will be considered in more detail. For the purpose of your examination, you need to know how to calculate each ratio, but you must also understand why each ratio, or each category of ratios, might be of particular interest to a specific user group.

An examination question may ask you to provide an analysis of financial statements for a particular user. It will not tell you which ratios to calculate. Instead, you will have to decide for yourself which ratios may provide useful information for that user. Therefore you should learn to identify and select the appropriate ratios for each user group, and then analyse what the ratio appears to show, from the point of view of that user.

4 RETURN ON CAPITAL, PROFITABILITY AND ASSET TURNOVER

Section overview

- Return on capital employed
- Return on shareholder capital
- Return on assets
- Analysing return: profitability and asset utilisation
- Profit/sales ratio (and cost/sales ratios)
- Asset turnover ratio
- Percentage annual growth in sales

4.1 Return on capital employed

The aim of 'profitability ratios' is to assess the financial performance of a profit-making entity and the return that it makes on the capital invested.

Profit-making companies should try to make a profit that is large enough in relation to the amount of money or capital invested in the business. The most important profitability ratio is probably return on capital employed or ROCE.

For a single company:

Formula:

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{(Share capital and reserves + long-term debt capital + preference share capital)}} \times 100\%$$

Capital employed is the share capital and reserves, plus long-term debt capital such as bank loans, bonds and loan stock.

Where possible, use the average capital employed during the year. This is usually the average of the capital employed at the beginning of the year and end of the year.

Example: Return on capital employed

The following figures relate to Company X for Year 1.

	1 January Year 1	31 December Year 1
	₦	₦
Share capital	200,000	200,000
Share premium	100,000	100,000
Retained earnings	500,000	600,000
Bank loans	200,000	500,000
	1,000,000	1,400,000

	₦
Profit before tax	210,000
Income tax expense	(65,000)
Profit after tax	145,000

Interest charges on bank loans were ₦30,000.

ROCE is calculated as follows:

ROCE = 240,000 **(W1)**/1,200,000 **(W2)** × 100 = 20%

W1	**Profit before interest and tax**	₦
	Profit before tax	210,000
	Add back interest deducted	30,000
	Profit before interest and tax	240,000

W2	**Capital employed**	₦
	Capital employed at the beginning of the year	1,000,000
	Capital employed at the end of the year	1,400,000
		2,400,000
		÷2
	Average capital employed	1,200,000

This ROCE figure can be compared with the ROCE achieved by the company in previous years, and with the ROCE achieved by other companies, particularly competitors.

Groups of companies and ROCE

To calculate the ROCE for a group of companies, it is necessary to decide what to do with any non-controlling interest (minority interest). Since capital employed includes all the debt capital in the group, it makes sense to include the non-controlling interest (minority interest) in the capital employed.

ROCE should therefore be measured as profit before interest and tax as a proportion of total capital employed, including the non-controlling interest.

4.2 Return on shareholder capital

Return on shareholder capital (ROSC) measures the return on investment that the shareholders of the company have made. This ratio normally uses the values of the shareholders' investment as shown in the statement of financial position (rather than market values of the shares).

Formula: Return on shareholder capital

$$\text{ROSC} = \frac{\text{Profit after taxation and preference dividend}}{\text{Share capital and reserves}} \times 100$$

The average value of shareholder capital should be used if possible. This is the average of the shareholder capital at the beginning and the end of the year.

Profit after tax is used as the most suitable measure of return for the shareholders, since this is a measure of earnings (available for payment as dividends or for reinvestment in the business).

Example: Return on shareholder capital

The following figures relate to Company X for Year 1.

	1 January Year 1	31 December Year 1
	₦	₦
Share capital	200,000	200,000
Share premium	100,000	100,000
Retained earnings	500,000	600,000
Shareholder capital	800,000	900,000
Bank loans	200,000	500,000
	1,000,000	1,400,000

	₦
Profit before tax	210,000
Income tax expense	(65,000)
Profit after tax	145,000

Interest charges on bank loans were ₦30,000.

ROSC is calculated as follows:

ROSC = 145,000/850,000 **(W2)** × 100 = 17.06%

W1 Shareholder capital	₦
Shareholder capital at the beginning of the year	800,000
Shareholder capital at the end of the year	900,000
	1,700,000
	÷2
Average shareholder capital	850,000

Groups of companies and ROSC

When calculating the ROSC for a group of companies, the main focus of attention is normally the return on the investment of the shareholders in the parent company. The ROSC should therefore be calculated as:

Formula: Return on shareholder capital of a group

$$\text{ROSC} = \frac{\text{Profit after taxation and non-controlling interest}}{\text{Equity attributable to equity holders of the parent company}} \times 100$$

The share capital and reserves should not include the non-controlling interest in the equity reserves.

Using ROCE or ROSC

- It is not necessary to calculate both these ratios. The ratio that you calculate should be the ratio that is of the greatest interest to the particular user or user group. For example, management may be most interested in ROCE, but an equity investor would be interested in ROSC.
- ROCE or ROSC could be compared to real interest rates that are currently available to investors in the market. For example, if a company has a ROCE of 3% when interest rates of 5% are available in the bond markets, a shareholder might be advised to consider selling his shares. However, it is important to remember that bond yields are returns calculated from the market price of bonds; whereas ROCE and ROSC are calculated from financial statements and are not market rates of return.
- Bank overdrafts might be included as part of capital employed in the ROCE ratio, because many companies 'roll over' their overdraft facility and use it as long-term funding. When a bank overdraft is large, the interest cost of the overdraft might be high, and it would therefore be appropriate to include the bank overdraft 'below the line' in capital employed, because the overdraft interest is included 'above the line' in profit before interest and tax.
- A company may be able to 'manipulate' its ROCE or ROSC ratios by using accounting policies or financing strategies, such as:
  - using operating leases or finance leases
  - choosing to re-value non-current assets or choosing the historical cost model
  - timing the acquisition of non-current assets or the timing of new financing so as to have the minimal adverse impact on ROCE.

4.3 Return on assets

Formula: Return on assets

$$\text{ROA} = \frac{\text{Profit before interest and taxation}}{\text{Assets}} \text{ X } 100\%$$

The normal convention is to use 'total assets' which includes both current and non-current assets. However, other variations are sometimes used such as non-current assets only.

4.4 Analysing return: profitability and asset utilisation

The size of the return on capital employed, or the size of the return on shareholders' capital, depends on two factors:

- the profitability of the goods or services that the entity has sold
- the volume of sales that the entity has achieved with the capital and assets it has employed: this is known as asset utilisation or asset turnover.

4.5 Profit/sales ratio (and cost/sales ratios)

The profit/sales ratio is the ratio of the profit that has been achieved for every ₦1 of sales.

Formula: Profit/sales ratio

$$\text{Profit/sales ratio} = \frac{\text{Profit}}{\text{Sales}} \times 100$$

Profit/sales ratios are commonly used by management to assess financial performance, and a variety of different figures for profit might be used.

The definition of profit can be any of the following:

- Profit before interest and tax
- Gross profit (sales minus the cost of sales) = 'gross profit ratio'
- Net profit (profit after tax) = 'net profit ratio'.

It is important to be consistent in the definition of profit, when comparing performance from one year to the next.

The gross profit ratio is often useful for comparisons between companies in the same industry, or for comparison with an industry average.

It is also useful to compare the net profit ratio with the gross profit ratio. A high gross profit ratio and a low net profit ratio indicate high overhead costs for administrative expenses and selling and distribution costs.

Example: Profit to sales ratios

The following figures relate to Company X for Year 1.

	₦
Profit before tax	210,000
Income tax expense	(65,000)
Profit after tax	145,000

Interest charges on bank loans were ₦30,000.

Sales during the year were ₦5,800,000.

Profit to sales ratios are calculated as follows:

a) If profit is defined as profit before interest and tax:

= 240,000 **(W1)**/5,800,000 × 100 = 4.14%

b) If profit is defined as profit after interest and tax:

= 145,000 **(W1)**/5,800,000 × 100 = 2.5%

W1 Profit before interest and tax	₦
Profit before tax	210,000
Add back interest deducted	30,000
Profit before interest and tax	240,000

It is also useful to monitor the ratio of different types of cost to sales. The following ratios can be useful to highlight an unexpected change in a period or to indicate a difference between the company and another in a similar industry:

- Cost of sales/Sales) × 100%
- Administration costs/Sales) × 100%
- Selling and distribution costs/Sales) × 100%

4.6 Asset turnover ratio

The asset turnover ratio is the ratio of sales to capital employed.

It measures the amount of sales achieved during the period for each ₦1 of investment in assets.

Formula: Asset turnover ratio

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Share capital + reserves + long term debt}} \times 100$$

It is measured as a multiple (so many times a year).

The asset turnover ratio is also the ratio of sales to (assets – current liabilities). This is because capital employed = total assets minus liabilities excluding long-term debt.

Example: Asset turnover ratio

The following figures relate to Company X for Year 1.

Average capital employed (as given before) ₦1,200,000

Profit before interest and tax = 240,000 (as given before)

Sales during the year were ₦5,800,000.

ROCE = 240,000 /1,200,000 × 100 = 20% (as given before)

Asset turnover

Asset turnover ratio = ₦5,800,000/₦1,200,000 = 4.83 times.

Note that: ROCE = Profit/sales ratio × Asset turnover ratio (where profit is defined as profit before interest and taxation).

Using the figures shown earlier:

ROCE	=	Profit/sales	×	Sales/capital employed
$\frac{240,000}{1,200,000}$	=	$\frac{240,000}{5,800,000}$	×	$\frac{5,800,000}{1,200,000}$
20%	=	4.14%	×	4.83 times

4.7 Percentage annual growth in sales

It can be useful to measure the annual growth (or decline) in sales, measured as a percentage of sales in the previous year.

For example, if sales in the year just ended were ₦5,800,000 and sales in the previous year were ₦5,500,000, the annual growth in sales has been (₦300,000/₦5,500,000) × 100% = 5.45%.

5 WORKING CAPITAL EFFICIENCY RATIOS

Section overview

- Purpose of working capital efficiency ratios
- Average time to collect (receivables days or days sales outstanding)
- Average time for holding inventory (inventory turnover)
- Average time to pay suppliers
- Cash operating cycle/working capital cycle

5.1 Purpose of working capital efficiency ratios

Working capital efficiency ratios measure the efficiency with which the entity has managed its receivables, inventory and trade payables. The ratios are usually measured in terms of an average number of days.

The working capital ratios are a useful measure of whether the entity has too much or too little invested in working capital.

Excessive investment in working capital is indicated by a long cash cycle (a long working capital cycle) that appears to be getting even longer. When too much is invested in working capital, the return on capital employed and ROSC will be lower than they should be.

Under-investment in working capital is an indication of possible liquidity difficulties. When working capital is low in comparison with the industry average, this might indicate that current assets are being financed to an excessive extent by current liabilities, particularly trade payables and a bank overdraft.

(The cash cycle, also called the operating cycle and the working capital cycle) is explained later).

5.2 Average time to collect (receivables days or days' sales outstanding)

This ratio estimates the time that it takes on average to collect the payment from customers after the sale has been made. It could be described as the average credit period allowed to customers or the 'average collection period'.

Formula: Average time to collect (average collection period or average receivables days)

$$\text{Average time to collect} = \frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

Trade receivables should be the average value of receivables during the year. This is the average of the receivables at the beginning of the year and the receivables at the end of the year.

However, the value for receivables at the end of the year is also commonly used.

Sales are usually taken as total sales for the year. However, if sales are analysed into credit sales and cash sales, it is probably more appropriate to use the figure for credit sales only.

The average time to collect money from credit customers should not be too long. A long average time to collect suggests inefficient collection of amounts due from receivables.

5.3 Average time for holding inventory (inventory turnover)

This ratio is an estimate of the average time that inventory is held before it is used or sold.

Formula: Average time for holding inventory (Inventory holding period or average inventory days)

$$\text{Average inventory days} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

In theory, inventory should be the average value of inventory during the year. This is the average of the inventory at the beginning of the year and the inventory at the end of the year.

However, the value for inventory at the end of the year is also commonly used, particularly in examinations.

5.4 Average time to pay suppliers

The average time to pay suppliers may be calculated as follows:

Formula: Average time to pay suppliers (Average payables days)

$$\text{Average time to pay} = \frac{\text{Trade payables}}{\text{Purchases}} \times 365 \text{ days}$$

Trade payables should be the average value of trade payables during the year. This is the average of the trade payables at the beginning of the year and the trade payables at the end of the year.

However, the value for trade payables at the end of the year is also commonly used

When the cost of purchases is not available, the **cost of sales** should be used instead. This figure is obtained from the profit and loss information in the statement of comprehensive income.

Example: Working capital efficiency ratios

The following information is available for Company Y for Year 1.

	1 January Year 1	31 December Year 1
	₦	₦
Inventory	300,000	360,000
Trade receivables	400,000	470,000
Trade payables	150,000	180,000

Sales in Year 1 totalled ₦3,000,000 and the cost of sales was ₦1,800,000.

The Working capital efficiency ratios are calculated as follows:

Efficiency ratios

Average days to collect = [435,000/3,000,000] × 365 days = 52.9 days

Inventory turnover period = [330,000/1,800,000] × 365 days = 66.9 days

Average time to pay = [165,000/1,800,000] × 365 days = 33.5 days.

Workings

Average inventory = [₦300,000 + ₦360,000]/2 = ₦330,000 Average trade receivables = [₦400,000 + ₦470,000]/2 = ₦435,000

Average trade payables = [₦150,000 + ₦180,000]/2 = ₦165,000.

Turnover ratios (multiples)

Turnover ratios can be used as an alternative way of telling the same story as the efficiency ratios. These show the number of times a balance in the statement of financial position is ***turned over*** in the period.

They are multiples which provide the same insight as the efficiency ratios but in a different way.

Formulae: Working capital turnover ratios

$$\text{Receivables turnover} = \frac{\text{Credit sales}}{\text{Trade receivables}}$$

$$\text{Inventory turnover} = \frac{\text{Cost of sales Inventory}}{\text{Inventory}}$$

$$\text{Payables turnover} = \frac{\text{Purchases}}{\text{Trade payables}}$$

5.5 Cash operating cycle/working capital cycle

The cash operating cycle or working capital cycle is the average time of one cycle of business operations:

- from the time that suppliers are paid for the resources they supply
- to the time that cash is received from customers for the goods (or services) that the entity makes (or provides) with those resources and then sells.

A cash cycle or operating cycle is measured as follows.

Illustration: Cash operating cycle

	Days/weeks/ months
Average inventory holding period	X
Average trade receivables collection period	X
	X
Average period of credit taken from suppliers	(X)
Operating cycle	X

The working capital ratios and the length of the cash cycle should be monitored over time. The cycle should not be allowed to become unreasonable in length, with a risk of over-investment or under-investment in working capital.

Example: Constructing a cash operating cycle

The following figures have been extracted from a company's accounts:

Statement of profit or loss	**₦**
Sales	1,200,000
Cost of sales:	
Opening inventory	250,000
Purchases	1,000,000
	1,250,000
Closing inventory	(250,000)
Cost of sales	(1,000,000)
Gross profit	200,000

Statement of financial position	
Trade receivables	400,000
Trade payables	166,667

Average inventory holding period:

$$\text{Average inventory holding period} = \frac{\text{Average inventory}}{\text{Annual cost of sales}} \times 365 \text{ days}$$

$$\text{Average inventory holding period} = \frac{250{,}000}{1{,}000{,}000} \times 365 \text{ days} = 91 \text{ days}$$

Average receivables collection period:

$$\text{Average receivables collection period} = \frac{\text{Average trade receivables}}{\text{Annual sales}} \times 365 \text{ days}$$

$$\text{Average receivables collection period} = \frac{400{,}000}{1{,}200{,}000} \times 365 \text{ days} = 122 \text{ days}$$

Average payables period:

$$\text{Average payables period} = \frac{\text{Average trade payables}}{\text{Annual purchases}} \times 365 \text{ days}$$

$$\text{Average payables period} = \frac{166{,}667}{1{,}000{,}000} \times 365 \text{ days} = 61 \text{ days}$$

Cash operating cycle:	Days
Average inventory holding period	91
Average trade receivables collection period	122
Average period of credit taken from suppliers	(61)
	152

6 LIQUIDITY RATIOS

Section overview

- The meaning of liquidity
- Current ratio
- Quick ratio or acid test ratio
- Liquidity ratios and consolidated accounts

6.1 The meaning of liquidity

Liquidity means having cash or access to cash readily available to meet obligations to make payments.

For the purpose of ratio analysis, liquidity is measured on the assumption that the only sources of cash available are:

- cash in hand or in the bank, plus
- current assets that will soon be converted into cash during the normal cycle of trade.

It is also assumed that the only immediate payment obligations faced by the entity are its current liabilities.

There are two ratios for measuring liquidity:

- current ratio
- quick ratio, also called the acid test ratio.

The more suitable ratio for use depends on whether inventory is considered a liquid asset that will soon be used or sold, and converted into cash from sales.

6.2 Current ratio

The current ratio is the ratio of current assets to current liabilities.

Formula: Current ratio

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The amounts of current assets and current liabilities in the statement of financial position at the end of the year may be used. It is not necessary to use average values for the year.

It is sometimes suggested that there is an 'ideal' current ratio of 2.0 times (2:1).

However, this is not necessarily true and in some industries, much lower current ratios are normal. It is important to assess the liquidity ratios by considering:

- changes in the ratio over time
- the liquidity ratios of other companies in the same period
- the industry average ratios.

Liquidity should be monitored by looking at changes in the ratio over time.

6.3 Quick ratio or acid test ratio

The quick ratio or acid test ratio is the ratio of current assets excluding inventory to current liabilities. Inventory is excluded from current assets on the assumption that it is not a very liquid item.

Formula: Quick ratio

$$\text{Quick ratio} = \frac{\text{Current assets excluding inventory}}{\text{Current liabilities}}$$

The amounts of current assets and current liabilities in the statement of financial position at the end of the year may be used. It is not necessary to use average values for the year.

This ratio is a better measurement of liquidity than the current ratio when inventory turnover times are very slow, and inventory is not a liquid asset.

It is sometimes suggested that there is an 'ideal' quick ratio of 1.0 times (1:1).

However, this is not necessarily true and in some industries, much lower quick ratios are normal. As indicated earlier, it is important to assess liquidity by looking at changes in the ratio over time and comparisons with other companies and the industry norm.

6.4 Liquidity ratios and consolidated accounts

Liquidity ratios are more informative when they are calculated for individual companies. When liquidity ratios are calculated from a consolidated statement of financial position, they are average measures for all the companies in the group. The average liquidity ratios for the group might hide the fact that there may be poor liquidity in some of the subsidiaries in the group.

7 DEBT RATIOS

Section overview

- Gearing ratio (leverage)
- Interest cover ratio

Debt ratios are used to assess whether the total debts of the entity are within control and are not excessive.

7.1 Gearing ratio (leverage)

Gearing, also called leverage, measures the total long-term debt of a company as a percentage of either:

- the equity capital in the company, or
- the total capital of the company.

Formula: Debt to equity ratio

$$\text{Debt to equity ratio} = \frac{\text{Long term debt}}{\text{Share capital + reserves}} \times 100$$

Alternatively:

Formula: Gearing ratio

$$\text{Gearing ratio} = \frac{\text{Long term debt}}{\text{Share capital + reserves + long term debt}} \times 100$$

It is usually appropriate to use the figures from the statement of financial position at the end of the year. However, a gearing ratio can also be calculated from average values for the year.

When there are preference shares, it is usual to include the preference shares within debt capital.

A company is said to be **high-geared** or **highly-leveraged** when its debt capital exceeds its share capital and reserves. This means that a company is high-geared when the gearing ratio is above either 50% or 100%, depending on which method is used to calculate the ratio.

A company is said to be **low-geared** when the amount of its debt capital is less than its share capital and reserves. This means that a company is low-geared when the gearing ratio is less than either 50% or 100%, depending on which method is used to calculate the ratio.

A high level of gearing may indicate the following:

- The entity has a high level of debt, which means that it might be difficult for the entity to borrow more when it needs to raise new capital.
- High gearing can indicate a risk that the entity will be unable to meet its payment obligations to lenders, when these obligations are due for payment.

The gearing ratio can be used to monitor changes in the amount of debt of a company over time. It can also be used to make comparisons with the gearing levels of other, similar companies, to judge whether the company has too much debt, or perhaps too little, in its capital structure.

Gearing and consolidated accounts

The gearing ratio for a group of companies is difficult to interpret, because the debt will be spread over several entities in the group.

When measuring gearing, the total capital or equity capital (the denominator in the ratio) should include non-controlling interests (minority interests).

7.2 Interest cover ratio

Interest cover measures the ability of the company to meet its obligations to pay interest.

Formula: Interest cover

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges in the year}}$$

Profit before interest and taxation is calculated by adding the interest charges for the year to the figure for profit before taxation.

An interest cover ratio of less than 3.0 times is considered very low, suggesting that the company could be at risk from too much debt in relation to the amount of profits it is earning.

Example: Gearing ratios

The following information is available for Company Z for Year 6

At 31 December Year 6

	₦000
Total assets	5,800
Share capital	1,200
Reserves	2,400
	3,600
Long-term liabilities (Bank loans)	1,500
	5,100
Current liabilities	700
	5,800

For the year to 31 December Year 6	₦000
Profit before interest and taxation	700
Interest	(230)
	470
Taxation	(140)
Profit after taxation	330

The following ratios can be calculated to shed light on the company's gearing in Year 6 (compared to previous years or to other companies).

Gearing ratio: 1,500/5,100 × 100 = 29.4%

Debt to equity ratio: 1,500/3,600 × 100 = 41.7%

Interest cover: 700/230 = 3.04 times

8 INVESTOR RATIOS

Section overview

- Earnings per share (EPS)
- Price earnings ratio (P/E ratio)
- Dividend yield
- Dividend cover

Investor ratios are of interest to investors in shares and bonds and their advisers. Some of these measure stock market performance. Earnings per share (EPS) and the price earnings ratio (P/E ratio) were described in an earlier chapter.

8.1 Earnings per share (EPS)

EPS is normally viewed as a key measure of an entity's financial performance. It measures the profit earned for each equity share of the entity.

Basic EPS is calculated as follows:

Formula: Basic EPS

$$\frac{\text{Net profit (or loss) attributable to ordinary shareholders during a period}}{\text{weighted average number of shares in issue during the period}}$$

8.2 Price-earnings ratio (P/E ratio)

The price/earnings (P/E) ratio measures how expensive or cheap a share is in relation to its annual earnings. A P/E ratio of 10, for example, means that investors are prepared to pay a price for the share equal to 10 years of earnings (at the level of EPS in the previous year). A high P/E ratio is usually a sign of confidence in an entity, because it suggests that its earnings are expected to grow in future years. A low P/E ratio usually means that an entity's future prospects for EPS growth are expected to be poor, so that investors do not put a high value on the shares.

The P/E ratio is calculated as follows:

Formula: Price earnings ratio

$$\text{P/E ratio} = \frac{\text{Market value of share}}{\text{Earnings per share}}$$

8.3 Dividend yield

The dividend yield measures the dividend paid by an entity in relation to its price. It is calculated as follows:

Formula: Dividend yield

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Current market price per share}} \times 100$$

This is a measure of the return that a shareholder can obtain (the dividend received) in relation to the current value of the investment in the shares (the price of the shares). A high dividend yield might seem attractive to investors, but in practice companies with a high dividend yield might have a relatively low share price.

There are two things to note:

- Dividend yield reflects the dividend policy of the entity, not its actual performance. Management decides on the amount of the dividend and this may not only depend on earnings, but on the amount that must be retained for future investment in EPS growth.
- The ratio is based on the most recent dividend, but the current share price may move up and down in response to the market's expectations about future dividends. This may lead to distortion in the ratio.

8.4 Dividend cover

The dividend cover ratio measures the number of times that an entity's dividends are 'covered' by profits (how many times an entity could pay the current level of dividend from its available profits).

It is calculated as follows:

Formula: Dividend cover

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per share}}$$

or

$$= \frac{\text{Earnings}}{\text{Dividends}}$$

A low dividend cover (for example, less than 2), suggests that dividends may be cut if there is a fall in profits.

Example: Dividend yield and dividend cover

The following amounts relate to Entity Q.

The current market price of its equity shares is ₦5.50 per share.

Profit for the most recent period was ₦1.4 million and equity dividends paid were ₦450,000.

There are 1.2 million ₦1 equity shares in issue.

$$\text{Earnings per share} = \frac{1{,}400{,}000}{1{,}200{,}000} = ₦1.17.$$

$$\text{P/E ratio} = \frac{5.50}{1.17} = 4.7$$

$$\text{Dividend per share} = \frac{450{,}000}{1{,}200{,}000} = 0.38c$$

$$\text{Dividend yield} = \frac{0.38}{5.50} \times 100\% = 6.9\%$$

$$\text{Dividend cover} = \frac{1{,}400{,}000}{450{,}000} = 3.1 \text{ times or } \frac{1.17}{0.38} = 3.1 \text{ times}$$

9 LIMITATIONS OF INTERPRETATION TECHNIQUES

Section overview

- Introduction
- Differences in accounting policy
- Current cost accounts and current purchasing power accounts
- Other limitations in the use of financial ratios
- Using historical information
- Creative accounting
- Related party relationships and transactions
- Using figures from the statement of financial position
- Non-financial information
- Other information

9.1 Introduction

There are several limitations or weaknesses in the use of interpretation techniques for analysing the financial position and financial performance of companies. Some of these are limitations of ratio analysis (the method of interpretation most often used) and some are limitations of financial statements and financial information.

Most of the data for calculating financial ratios comes from the financial statements.

- The reliability of ratios is therefore affected by the reliability of the financial statements themselves.
- In addition, when ratios are used to compare different companies, the comparability is affected if companies use different accounting policies to prepare their financial statements.

In addition, when comparing a ratio against that of a competitor or the industry average, it is important to remember that, even within an industry, companies can have different characteristics. It is very important to remember this when you are analysing the financial statements of a company, and possibly comparing its performance and financial position with other companies.

9.2 Differences in accounting policy

One of the uses of financial ratios is to compare the financial position and performance of one company with those of similar companies for the same period.

Comparisons between companies might not be reliable, however, when companies use different accounting policies, or have different judgements in applying accounting policies or making accounting estimates. For example:

- Entities might have different policies about the revaluation of non-current assets.
- Entities might use different methods of depreciation.

- Entities might use different judgements in estimating the expected profitability on incomplete construction contracts.
- Entities might use different judgements in assessing whether a liability should be treated as a provision or a contingent liability.

IAS 8 states that an entity should not change its accounting policies unless the change is required by an accounting standard or it will result in more relevant and reliable information. Therefore changes should not happen often.

Where there has been a change in an accounting policy, IAS 8 also requires comparative figures to be restated and information to be disclosed. However, changes in accounting policies and accounting estimates can still make it difficult to compare the financial statements of an entity over time, particularly if analysis is based on extracts rather than the full published financial statements.

9.3 Current cost accounts and current purchasing power accounts

Historical cost accounts can also be misleading because they do not accurately show the effects of inflation over time. They do not take into consideration changes in the real value of money.

The biggest problem is the valuation of non-current assets. Companies have different policies towards the revaluation of non-current assets. Some companies revalue some categories of non-current assets regularly, and in particular land and buildings. However, not all categories of non-current assets are revalued.

When the rate of inflation is quite high, many non-current assets are probably under-valued in the financial statements, in comparison with their current net replacement value.

In addition, when the rate of inflation is high, the reported profit with historical cost accounting will be higher than it would be using an 'inflation accounting' system such as current cost accounting (CCA) or current purchasing power (CPP) accounting.

With CCA and CPP accounting, particularly during a period of high inflation:

- The reported profit will be less (or the loss will be higher) than with historical cost accounting (HCA).
- The asset turnover or asset utilisation will be lower, because asset valuations are higher with CCA and CPP than with historical cost accounting (even when some non-current assets are re-valued in HCA).
- The return on capital employed will be lower, because the reported profit will be lower and the value of capital employed will be higher.

9.4 Other limitations in the use of financial ratios

There are other problems with the use of financial ratios, particularly where these are used to compare the performance and position of different entities or of an entity with an industry average.

- It is possible to calculate the same ratio in different ways. For example, there are several variations of return on capital employed (ROCE) and gearing. Comparisons can be misleading if different calculations are used.
- Even where two entities operate in the same industry, comparisons can be misleading. Entities can operate in different markets (for example, high volume/low margin sales and low volume/high margin sales). The size of an

entity can affect the way it operates and therefore its ratios. For example, large entities can often negotiate more favourable terms with suppliers than small ones.

- Financial statements are published infrequently. If ratios are used to study trends and developments over time, they are only useful for trends or changes over one year or longer, and not changes in the short term.
- Ratios can only indicate **possible** strengths or weaknesses in financial position and financial performance. They might raise questions about performance, but do not provide answers. They are not easy to interpret, and changes in financial ratios over time might not be easy to explain.

It can be argued that financial position and financial performance should be analysed using market values rather than accounting values. For example, it can be argued that investment yield is more relevant for the assessment of financial performance than return on capital employed.

9.5 Using historical information

Financial statements are often used to predict the future performance of an entity. Where comparative figures are available for several years it may be possible to extrapolate trends and to base forecasts on these. If comparative figures are only available for one or two years, predictions may be unreliable.

There may be some limited information about future transactions in the notes to the financial statements. For example, details of contingent liabilities and non-adjusting events after the reporting period must be disclosed. However, published financial statements present historical information.

Generally, financial statements do not reflect future transactions or events. They do not anticipate the effect of significant changes to the entity after the financial statements have been authorised for issue. These may include events beyond the control of management (for example, the liquidation of a major customer) or events that could not possibly have been foreseen at the time the most recent financial statements were issued.

It should also be remembered that financial statements are not normally published until several months after the year end. The financial statements are often out of date by the time that they become available.

9.6 Creative accounting

Management may use various forms of **creative accounting** to manipulate the view given by the financial statements while complying with all applicable accounting standards and regulations.

Some of the techniques that can be used have been discussed in earlier chapters. They include:

- **Window dressing**: an entity enters into a transaction just before the year end and reverses the transaction just after the year end. For example, goods are sold on the understanding that they will be returned immediately after the year end; this appears to improve profits and liquidity. The only reason for the transaction is to artificially improve the view given by the financial statements.
- **'Off balance sheet' finance:** transactions are deliberately arranged so as to enable an entity to keep significant assets and particularly liabilities out of the statement of financial position (= 'off balance sheet'). This improves

gearing and return on capital employed. Examples include sale and repurchase agreements and some forms of leasing.

- **Changes to accounting policies or accounting estimates**: for example, an entity can revalue assets (change from the cost model to the revaluation model) to improve gearing or change the way in which it depreciates assets to improve profits.
- **Profit smoothing:** manipulating reported profits by recognising (usually) artificial assets or liabilities and releasing them to profit or loss as required.
- **Aggressive earnings management**: artificially improving earnings and profits by recognising sales revenue before it has been earned.
- **Capitalising expenses**: recognising 'assets' which do not meet the definition in the IASB Conceptual Framework or the recognition criteria. Examples include: human resources, advertising expenditure and internally generated brand names.

Most of these are now effectively prevented by accounting standards. However, management may still attempt 'creative accounting', especially if the entity is suffering falling profits or poor cash flow.

If directors' salaries or bonuses are based on profits or on particular measures, (such as earnings per share), they may try to manipulate that particular measure so that it is as favourable to them as possible.

9.7 Related party relationships and transactions

A user of financial statements will normally expect the financial statements to reflect transactions that have taken place on normal commercial terms ('at arm's length'). The user of the financial statements would want to be informed if:

- transactions have taken place that were not at 'arm's length', or
- there are parties that could enforce transactions on the entity that are not on an 'arm's length' basis.

For example, an entity might sell an asset such as a property to another company owned by one of its directors on more favourable terms than it would sell to a third party.

In this situation, the financial performance or financial position reported by the financial statements would be misleading. There is a special relationship between the parties to the business transactions. This is referred to as a 'related party relationship'.

Related parties of an entity can include:

- parents, subsidiaries and fellow subsidiaries
- associates
- key management personnel (such as directors)
- close family members of any of the above.

A related party transaction is:

- a transfer of resources, services, or obligations between related parties
- whether or not a price is charged.

Examples of related party transactions include:

- purchases or sales of goods
- purchases or sales of property and other assets
- rendering or receiving of services
- leases
- finance arrangements (such as loans or contributions to equity).

Related party relationships and transactions are a normal part of business and there is nothing wrong with entering into them. However, a related party relationship can have an effect on the profit or loss, or on the financial position of an entity, because related parties might enter into transactions with each other on terms that other entities or individuals (unrelated parties) would not. For example, where an entity sells goods to a related party, its profits may not be comparable with those of a similar entity that only trades with third parties on normal commercial terms.

9.8 Using figures from the statement of financial position

In practice, ratio calculations are often based on figures in the year-end statement of financial position. These may be very similar to average values for the period, but this is not always the case.

Some businesses are seasonal and make a high proportion of their sales at a specific time of year (for example, in the few months before a national holiday period). Seasonal businesses often arrange their year-ends so that they fall when inventories and receivables are at their lowest (probably just after the main period for sales). Where this happens, ratios such as inventory turnover will be lower than they would be if they were based on the average figure for the year. This means that ratios may not be strictly comparable with those of other businesses or with industry averages.

Major purchases of assets can have a significant effect on figures in the statement of financial position and on ratios if they take place near the end of the accounting period.

- The carrying value of non-current assets is unusually high, because cost has increased, but a full year's depreciation has not been charged.
- Return on capital employed and asset turnover are reduced, because assets have increased but revenue and profits have not. New assets should generate increased profits, but they have not yet been owned for long enough to do so.

9.9 Non-financial information

One of the most serious limitations of traditional financial statements is that they only reflect the financial effects of transactions. Items are not recognised unless they can be measured reliably in money terms.

There are two problems here:

- Businesses and the transactions that they enter into are becoming increasingly complex. Much information that is relevant to users cannot be expressed easily in monetary terms or in numbers.
- Businesses increasingly accept that they are not only accountable to investors and lenders, but to a much wider group of people, or

'stakeholders'. Stakeholders can include customers, suppliers, employees, the local community as a whole and (for some large public entities) society as a whole. These groups are often more interested in the non-financial effects of an entity's activities, (for example, its effect on the natural environment), than in its financial performance.

Most large and listed entities now include a Business Review, or an Operating and Financial Review (sometimes called Management Discussion and Analysis) in their published financial statements. This is a narrative report which sets out management's analysis of the business. Such a review is a legal requirement for many companies within the European Union.

At present entities reporting under IFRSs do not have to publish any non-financial information of this kind. Recently the IASB issued a non-mandatory "Practice Statement on Management Commentary". It is up to companies or individual legal jurisdictions to decide whether to follow this guidance.

Useful non-financial information

Useful non-financial information could include the following:

- a description of the business, objectives and strategies of the entity
- a narrative review of the performance of the business during the period
- a description of the main risks and uncertainties facing the entity and the ways in which these risks are managed
- details of any significant factors or events that may have an impact on the entity's performance in future
- details of any significant factors or events that may have an impact on the entity's cash flows in future
- information about key relationships with other entities and transactions with related parties, including management
- a description of the entity's research and development activities (if any) and of any material intangible assets, including internally generated intangible assets that have not been recognised in the balance sheet
- additional explanations of amounts included in the financial statements, where appropriate (for example, where these are based on estimates)
- information about the entity's policies in relation to environmental matters, in relation to its employees and on social and community issues.

9.10 Other information

Size of company

Large companies should be able to benefit from economies of scale and so should be more profitable than smaller companies in the same industry and market. Larger companies should also attract better management, so (in theory) the business should be run more efficiently, and so should achieve higher profit margins.

Market area

Companies operating in the same industry may achieve very different results because they operate in different sectors or segments of the market. For example, two companies selling furniture might have very different profit margins

because they operate in different parts of the market. One company may be selling antique furniture at high profit margins and the other may be selling self-assembly furniture in larger volumes but with lower profit margins.

Stage in the supply chain

Companies operating in the same industry may operate at different stages in the supply chain. A supplier of raw materials, a manufacturer and a retailer would be expected to have very different financial ratios, even though they may operate in the same industry.

For example, it would be difficult to compare the financial ratios of a timber supplier, a furniture manufacturer and a furniture retailer.

Timing of transactions

The timing of a key transaction can distort financial ratios. For example, a company may acquire a subsidiary at the end of the financial year. The subsidiary would then be consolidated in the group statement of financial position but its profits would not be included in group profit or loss because they are all pre-acquisition profits.

Ratios that compare profit figures with items in the statement of financial position will therefore be distorted, unless a suitable adjustment is made to allow for the transaction.

Year-end date

In most countries, companies are allowed to decide for themselves what their financial year-end date should be. The choice of dates can affect the financial ratios. For example a manufacturer of ski equipment will probably have some very busy trading months (during the ski-ing holiday season) and some very quiet months. If it selects the end of the high-selling season as its year-end, its inventory levels will be abnormally low and its receivables balance may be abnormally high.

Such ‘distortions’ in the financial statements can be eliminated by calculating ratios using a monthly average for any measures taken from the statement of financial position, such as inventory, receivables and trade payables.

Management strategy

Financial ratios should be interpreted in the context of all other relevant information that is available about the company. For example, management may have decided on a strategy of cutting profit margins in the short term in order to win market share. This would affect the current profit margin, but in the long run should result in higher sales and more profits.

10 FINANCIAL RATIOS AND EXAMINATION TECHNIQUE

Section overview

- Introduction
- Approach to questions
- Avoiding pitfalls

10.1 Introduction

Examination questions on financial ratio analysis usually require sound examination technique to construct a good answer. The following guidelines suggest the approach you should take and indicate the mistakes and pitfalls to avoid.

At this level, you are unlikely to get a question that asks you just to calculate ratios. It is more likely that you will get a question that asks you to consider the accounting treatment of particular items in the financial statements and the effect that this will have on the entity's ratios.

For example, if an entity has incorrectly treated a sale and repurchase transaction as a 'genuine' sale and not as a loan secured on an asset, then there will be a significant effect on the entity's ratios. For example, the gearing ratio will not show the true position of the entity's debt as it will exclude the secured loan. Return on capital employed will also be affected as the incorrect treatment of the transaction removes the asset from the statement of financial position, thus increasing ROCE.

Additionally, consider the points below which provide specific guidance on aspects of the question that you may have to answer.

10.2 Approach to questions

Analyse the requirement

Start by recognising the person or organisation who has asked for the financial analysis.

- ❑ Who is the user?
- ❑ What information is the user interested in? Why has the user requested the report?
- ❑ How should the information be presented to the user – in the form of a memo or a more formal report? Don't forget there are presentation marks available for well-presented reports.

Background information

Establish some of the basic 'background' information.

- ❑ What industry does the company operate in?
- ❑ Note the financial year end. This may possibly be significant.
- ❑ Is the business seasonal? If so, seasonal trading may 'distort' the year-end figures in the statement of financial position, particularly for inventory, receivables, cash and payables.

- Have there been any key transactions during the year that may affect comparisons with previous years? For example, has the company raised a substantial amount of new finance, or has it acquired a major new subsidiary, entered a new market with a new product, or disposed of a business operation?

Review of the financial information

Before calculating **any** financial ratios, perform a thorough review of the financial information provided. Look for items that will affect the measurement of key financial ratios.

Statement of financial position:

- Non-current assets.
  - (1) Have there been any revaluations? Check the revaluation reserve. Has it changed since the previous year? (This can also be checked by looking at the statement of profit or loss and other comprehensive income.)
  - (2) Capital expenditure. Has the company incurred significant capital expenditure? Look at the increase in non-current assets since the previous year. How has the expansion been financed? Look at share capital and reserves, and at levels of debt.
- Investments.
  - (1) Has the company invested in a new industry?
  - (2) Has the company acquired a new subsidiary or invested in a new associate or joint venture? If so, consider the timing of the acquisition – if an acquisition happened in mid-year the subsidiary's profits will have been included in profit or loss for only six months but it will be included in full in the year-end group statement of financial position.
- Working capital.
  - (1) Has the total working capital increased or decreased in proportion with the increase or decrease in sales turnover (compared with the previous year)?
  - (2) Look at the amounts of current assets and current liabilities. Does the company have net current assets or net current liabilities?
- Loans.
  - (1) Have any loans been repaid in the year? If so, how was the repayment financed?
- Share capital and reserves
  - (1) Have there been any new issues of shares during the year? If so, is it clear why the new shares were issued? For example, have new shares been issued to raise money to repay debt? Or to finance an expansion of the business?
  - (2) Have there been any significant changes in reserves during the year?

Statement of profit or loss

Compare sales growth with profit growth. Are they about the same rates of growth? If not, you may need to think about reasons for the different growth rates.

- Interest. Is the interest charge high in relation to the amount of debt in the statement of financial position? If it is high, has any debt been repaid in the year?
- Dividends. Look at the amount of dividend payments, the dividend cover, and the trend in dividend payments over the past few years.
- Did the company make a profit or a loss?
- Are there any unusual 'one-off' items in profit or loss? If so, what are they?

You should have an expectation in your mind about the measurements and ratios that you should expect to find. If the actual measurements or ratios are different from what you expect, you may need to think about the reasons for the unexpected results.

For example, you may expect the company to be profitable. If it made a loss, you will need to look for the reasons.

Calculate financial ratios

Having reviewed the financial information, you should calculate relevant key ratios.

- Present the ratios you have calculated as an appendix to your memo or report.
- Show the formulae and numbers you have used to calculate the ratios. Do not just write down the ratio by copying it from your calculator. The examiner will want to see where your figure came from, to make sure that you understand what you are doing.
- Be selective. Only calculate a ratio if it will add to your answer. Do not simply calculate as many ratios as possible.
- Go for variety in the ratios you select.
- If the examination question provides some financial ratios, look for ratios that have not been given. Could any of the 'missing' ratios be significant?

Further information

An examination question might ask for suggestions about what further information might be helpful. If so, set up your answer as an appendix to your memo or report, and build your answer as you work through your answer to the question. Examples of information that might be 'missing' include the following:

- Additional information to calculate further ratios, such as the share price for calculating the P/E ratio or dividend yield
- Segmental analysis
- Industry average figures, for making comparisons with similar companies in the same industry
- Changes in management policy (such as changes in the credit terms offered to customers)
- The accounting policies used

- Reasons for specific changes not explained by the information given in the question.

Writing your answer

Make comments that are relevant to the question. Always think about the requirements of the question when you write your answer. You will not earn marks for anything that is not relevant.

- Make sure you answer all the requirements of the question. If you don't you will lose marks.
- Use short sentences and bullet points.

10.3 Avoiding pitfalls

There are a number of common mistakes in writing answers to an interpretation question.

- Most marks in the exam are likely to be for specific, relevant comments rather than solely for computations. **Do not calculate too many ratios** as it is time-consuming and you will not have time to write your answer. Be selective and only calculate a ratio if it will add value to your answer.
- Good points can be identified by looking at absolute changes in the figures between one year and the next. For example, if sales have increased 25%, it would be expected that inventory, receivables and payables should have increased in line with the increase in sales.
- Use all the information. Some valuable information about the company is usually given in the introductory paragraph in an examination question. Make sure that you read and use this information.
- When making comparisons, make sure that the 'benchmark' you select for the comparison is suitable. For example, if two companies are being compared:
  - Are they the same size?
  - Do they operate in exactly the same area of the market?
  - Are their financial statements for the same time period?
- When making an observation about differences (such as differences in comparison with another company, or the previous year), suggest reasons for the difference. Don't just make an observation without making a comment. For example, stating that "There has been a fall in non-current asset" has no value on its own. A better answer would be "Non-current assets have decreased despite a rise in sales." You might then go on to comment that non-current assets are being over-used and are not being replaced, perhaps because of the poor cash position of the company.
- The highest marks will be awarded for linking together the information that you analyse. For example: "Interest charges have remained more or less the same as in the previous year, despite a decrease in the debt in the statement of financial position. This may be explained by the company repaying a large amount of debt shortly before the year end."
- Structure your answer around each of the requirements in the question. In many cases, profitability and long term solvency could be used as main headings within your answer.

- Use the company name in your answer. This will help you to focus your mind on the circumstances of the company, and avoid writing about financial ratios in general terms (and so failing to answer the question).

11 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain and use common size analysis
- Calculate and interpret return on capital employed and similar ratios
- Calculate and interpret profitability ratios, working capital ratios, liquidity ratios, debt ratios and gearing ratios
- Analyse performance of a company from information provided
- Explain the limitations of financial statements and interpretation

Professional level
Corporate Reporting

CHAPTER 30

IFRS 1: First time adoption of IFRS

Contents

INTRODUCTION

Aim

This syllabus extends candidates' coverage of generally accepted accounting principles (GAAP), deepens their understanding of Financial Reporting and their ability to apply principles and practices to more complex situations.

Detailed syllabus

The detailed syllabus includes the following:

D	Current developments in and beyond Financial Reporting		
	1	Global convergence of Financial Reporting and Nigerian Generally Accepted Accounting Principles (NGAAP)	
		a	Determine, discuss and apply the accounting treatment of issues arising from the first-time transition to international accounting standards such as IFRS from NGAAP.
		b	Discuss accounting issues relating to applicable Nigerian accounting standards after IFRS adoption.

IFRS 1 is an examinable document.

Exam context

This chapter explains the rules that must be applied when a company adopts IFRS for the first time.

At the end of this chapter, you should be able to:

- Define and explain the meaning of the terms *first IFRS financial statements*, *opening IFRS statement of financial position* and *date of transition to IFRSs;*
- Explain full retrospective application;
- Explain permitted exceptions to the requirement for full retrospective application of IFRS;
- Explain mandatory exceptions to the requirement for full retrospective application of IFRS; and
- Explain the presentation and disclosure requirements concerning first time adoption.

1 ACCOUNTING FOR THE TRANSITION TO IFRS

Section overview

- Introduction and terminology
- Opening IFRS statement of financial position
- Full retrospective application of IFRS
- Permitted exceptions to full retrospective application of IFRS
- Mandatory exceptions to full retrospective application of IFRS

1.1 Introduction and terminology

Changing from one GAAP to another is a major undertaking which has wide reaching implications for the company undertaking this step.

IFRS 1 First Time Adoption of International Financial Reporting Standards explains how the transition to IFRS should be accounted for.

Definitions

First time adopter: An entity that presents its first IFRS financial statements

First IFRS financial statements: The first annual financial statements in which an entity adopts IFRS by an explicit and unreserved statement of compliance with IFRS.

The first IFRS financial statements will include the current year, which is the first period published entirely according to IFRS and comparatives, which were originally published under previous GAAP, and have been restated into IFRS

A first-time adopter must prepare an opening statement of financial position according to IFRS as at the date of transition to IFRS.

Definitions

Date of transition to IFRSs: The beginning of the earliest comparative period for which an entity presents full comparative information under IFRS in its first IFRS financial statements.

Opening IFRS statement of financial position: An entity's statement of financial position at the date of transition to IFRSs.

In Nigeria, the date of transition was established by the provisions in the *National Road Map on adoption of IFRS*.

The opening IFRS statement of financial position is prepared by full retrospective application of all IFRS extant at the first IFRS reporting date.

Definition

First IFRS reporting date: The latest reporting date covered by the entity's first IFRS financial statements.

1.2 Opening IFRS statement of financial position

As stated above, the opening IFRS statement of financial position is prepared by full retrospective application (subject to permitted exemptions and mandatory exceptions) of all IFRS extant at the first IFRS reporting date. The standards extant at the reporting date are used to reconstruct the statement of financial position as at the date of transition. This means that if a rule in existence at the date of transition was changed by the first IFRS reporting date, it is the new rule that is applied in building the opening IFRS statement of financial position.

The opening IFRS statement of financial position becomes the basis for accounting moving forward. It is constructed at the start of the comparative period. The company will already have prepared and filed financial statements for this period under its previous GAAP. These have to be restated to IFRS to become the IFRS comparatives to the first IFRS financial statements.

Example: Terminology

A company is preparing its first IFRS financial statements for the year ending 31 December 20X9.

The company operates in a regime that requires a single period of comparative information.

The company drafts its opening IFRS statement of financial position as at 1 January 20X8.

It will have published financial statements under its previous GAAP to cover the year end 31 December 20X8.

These are restated to become comparatives in the first IFRS financial statements.

1.3 Full retrospective application ofIFRS

Full retrospective restatement means that all of the figures from the previous GAAP statement of financial position should be restated to what they would have been if IFRS had always been applied.

This means that in the opening IFRS statement of financial position, a first-time adopter must:

- recognise all assets and liabilities whose recognition is required by IFRSs
- not recognise assets or liabilities if IFRSs do not permit such recognition
- re-classify items recognised under the previous GAAP as one type of asset, liability or component of equity if IFRSs require that they should be classified differently
- apply IFRSs in measuring all assets and liabilities.

These adjustments are made at the date of transition and lead to restructuring of the comparative statement of financial position

Full retrospective restatement is a difficult task. IFRS must be applied in its entirety from the date of transition but there are two categories of exception to full retrospective restatement before this. These are:

- exceptions which are permitted; and
- exceptions which are mandatory.

1.4 Permitted exceptions to full retrospective application of IFRS

A first-time adopter may elect to use one or more available exemptions from the application of IFRSs.

There are over twenty possible exemptions to full retrospective application in a number of areas including the following:

- business combinations;
- cost of non-current assets (deemed cost);
- cumulative translation differences;
- investments in subsidiaries, associates and joint ventures (IAS 27); and
- designation of previously recognised financial instruments.

Business combinations

The “business combination” exemption is actually a series of exemptions relating to:

- IFRS 3: Business combinations;
- Consolidation, equity accounting and joint arrangements (IFRS 10, IFRS 11 and IAS 28);
- IAS 21: The effects of Changes in Foreign Exchange Rates

The rules on business combinations must be applied to all transactions arising after the date of transition but do not have to be applied retrospectively.

However, IFRS 1 allows the rules to apply from any date before the date of transition. In effect, this means that a company could pick any date before the date of transition from which to start applying IFRS and if this is the case both IFRS 3 and IFRS 10 must be applied to all subsequent combinations.

This is not allowed in Nigeria. All subsidiaries must be accounted for under Nigerian GAAP until the date of transition.

Alternative rules apply if IFRS 3 is not applied retrospectively (Appendix C to IFRS 1). These include:

- assets and liabilities recognised under previous GAAP forms the basis for the recognition of assets and liabilities under IFRS at the date of transition (subject to adjustments);
- the carrying amount of assets and liabilities under previous GAAP is deemed cost for IFRS;
- goodwill written off is not reinstated;
- goodwill at transition is subject to impairment test.

IAS 21 requires that goodwill and fair value adjustments arising on acquisition of a foreign operation are retranslated at each reporting date. IFRS 1 allows that this requirement does not have to be applied to business combinations before the date of transition.

Deemed cost

This exemption applies to:

- Property, plant and equipment;
- Intangible assets (conditions apply);
- Investment property; and
- Exploration and evaluation assets for oil and gas under IFRS 6, and assets recorded in respect of rate-regulated activities

It might be difficult to retrospectively construct the IFRS cost of non-current assets at the date of transition.

IFRS 1 allows the use of one of the following to establish the IFRS cost of an asset at the date of transition:

- fair value;
- cost adjusted by changes in an inflation index;
- a fair value established at a date before the date of transition in accordance with previous GAAP;
- cost as determined under previous GAAP (oil and gas, rate-regulated activities).

In Nigeria, a previous revaluation can only be used to as a deemed cost if it was carried out by duly certified and professionally qualified/registered valuer.

Cumulative translation differences

IAS 21 requires cumulative translation differences (CTDs) arising on translation of foreign operations to be classified as a separate component of equity and recycled through the statement of profit or loss on disposal of the subsidiary.

A first time adopter does not have to identify CTDs that arose before the date of transition

Investments in subsidiaries, joint ventures and associates

If an entity prepares separate financial statements *IAS 27* Separate *Financial Statements* requires it to account for investments in subsidiaries, jointly ventures and associates either:

- at cost; or
- in accordance with IFRS 9.

IFRS 1 allows one of the following amounts to be used to establish a cost for IFRS in the separate opening IFRS financial statements:

- cost determined in accordance with IAS 27; or
- deemed cost;
- fair value (in accordance with IFRS 9) at the date of transition; or
- previous GAAP carrying amount at that date

Designation of previously recognised financial instruments

IFRS 9 Financial Instruments allows classification on initial recognition of:

- a financial asset as fair value through profit or loss (conditions); and
- a financial liability as fair value through profit or loss (conditions)

IFRS 1 allows such designation to be made at the date of transition

1.5 Mandatory exceptions to full retrospective application of IFRS

IFRS 1 prohibits the retrospective application of some IFRSs for the opening IFRS statement of financial position.

Exceptions that must be used concern the following:

- derecognition of financial assets and liabilities;
- hedge accounting;
- non-controlling interests;
- classification and measurement of financial assets;
- impairment of financial assets;
- embedded derivatives; and
- government loans

Derecognition

If an asset was derecognised under previous GAAP but would not have been under IFRS, full retrospective application would bring it back onto the statement of financial position. This is not allowed by IFRS 1.

The IFRS 9 derecognition rules must be applied prospectively for transactions occurring on or after the date of transition to IFRSs.

- non-derivative financial assets and liabilities derecognised in a period beginning before transition are not re-recognised; however
- an entity may apply the rules retrospectively from any date of its choosing but only if the information needed was obtained at the date of the transaction.

Note that some financial assets that were derecognised before the date of transition might still be brought back onto the opening IFRS statement of financial position due to the rules requiring consolidation of special purpose vehicles. If a financial asset had been derecognised in a sale or transfer to an entity which would be defined as a subsidiary under IFRS, that financial asset would be brought back into the opening IFRS statement of financial position by consolidation.

Hedge accounting

Hedge accounting relationships cannot be designated retrospectively

At transition;

- all derivatives are measured at fair value;
- deferred gains/losses previously reported as assets and liabilities are eliminated;
- hedge accounting can only be used if the hedge qualifies under rules in IFRS.

Non-controlling interests

IFRS 10 contains rules:

- on accounting for changes in ownership of a subsidiary that do and do not result in a loss of control; and
- that require total comprehensive income to be attributed to the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;

These rules must be applied prospectively from the date of transition

If a first-time adopter elects to apply IFRS 3 retrospectively to past business combinations, it must also apply IFRS 10 from the same date.

2 PRESENTATION AND DISCLOSURE

Section overview

- Presentation by a first time adopter
- Disclosure by a first time adopter

2.1 Presentation by a first time adopter

IFRS 1 requires that a first-time adopter must include at least one year of comparative information in its first IFRS financial statements. (This is why the date of transition to IFRS cannot be later than the beginning of the previous financial year).

Presentation

To comply with IAS 1 the first IFRS financial statements must include at least:

- ❑ 3 statements of financial position:
  - Current year (the date to which the first IFRS financial statements are prepared);
  - Last year (the comparatives to the first IFRS financial statements which were originally published under the previous GAAP);
  - Start of last year (date of transition).
- ❑ 2 statements of profit and loss and other comprehensive income (current year with comparatives);
- ❑ 2 statements of cash flows (current year with comparatives);
- ❑ 2 statements of changes in equity (current year with comparatives); and
- ❑ 2 sets of related notes to the financial statements (current year with comparatives).

2.2 Disclosure by a first-time adopter

The company must explain how the transition to IFRS affected its reported:

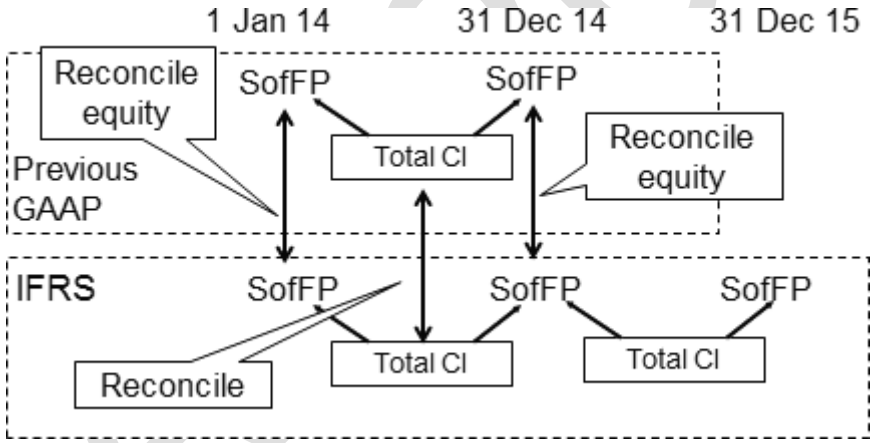
- financial position;
- financial performance; and
- cash flows.

IFRS 1 requires that a company publish reconciliations of amounts in the previous GAAP financial statements to those in the IFRS financial statements.

The first IFRS financial statements must include:

- reconciliations of equity (net assets):
  - at the date of transition; and
  - at the end of latest period presented under previous GAAP;
- a reconciliation of the profit or loss for the latest period presented under previous GAAP

Illustration: Reconciliations



SofFP = Statement of financial position

Total CI = Total comprehensive income

IFRS 1 provides an illustrative example in columnar form.

The adjustment to each previous GAAP figure must be explained in notes to the financial statements.

A simple example follows to show the presentation for the reconciliation of net equity.

Example: Reconciliation of equity

A simplified example of a reconciliation of equity is shown below.

	Previous GAAP	IFRS adjustments	IFRSs
Property, plant and equipment	2,000	300	2,300
Intangible assets	400	(50)	350
Total non-current assets	2,400	250	2,650
Trade and other receivables	1,200	0	1,200
Inventory	800	(70)	730
Cash	50	0	50
Total current assets	2,050	(70)	1,980
Total assets	4,450	180	4,630
Loans	800	0	800
Trade payables	415	0	415
Current tax liability	30	0	30
Deferred tax liability	25	220	245
Total liabilities	1,270	220	1,490
Total assets less total liabilities	3,180	(40)	3,140
Issued capital	1,000	0	1,000
Revaluation reserve	0	190	190
Retained earnings (balance)	2,180	(230)	1,950
Total equity	3,180	(40)	3,140

3 CHAPTER REVIEW

Chapter review

You should now be able to:

- Define and explain the meaning of the terms first IFRS financial statements, opening IFRS statement of financial position and date of transition to IFRSs
- Explain full retrospective application
- Explain permitted exceptions to the requirement for full retrospective application of IFRS
- Explain mandatory exceptions to the requirement for full retrospective application of IFRS
- Explain the presentation and disclosure requirements concerning first time adoption

Professional level
Corporate Reporting

CHAPTER 31

Technology and soft skills in corporate reporting

Contents

31.1 Application of technologies in corporare reporting

31.1.1 Introduction

There are so many areas of financial reporting that could be enhanced by the use of technology.

They include:

a) **Data collation**: The starting point of the financial reporting process is identification and collection of data from multiple sources within and outside the organisation. Data identification and collation can actually be automated through the integration of the entity's accounting software with the various data sources. It is equally possible to convert the unstructured and 'dirty' data into a format and structure ready for entry into the accounting system with the help of some advanced technology tools.

b) **Data recording**: Once data is collated from various sources, the next course of action is to enter (record) the data into the accounting system. Technology tool such as optical character recognition (OCR) has made it possible for organisations to capture and record data seamlessly with little or no human intervention. The data in source documents (customer orders; invoices and delivery notes) are captured through scanners or mobile device cameras and posted into the appropriate ledgers within the accounting system.

c) **Report preparation**: A well-designed and automated accounting system will be able to aggregate all relevant information from individual ledger accounts to the general ledger which forms the basis of preparing the trial balance and ultimately, the financial statements and other products of financial reporting. Modern technology can enhance this process efficiency by replacing mechanistic human processing of underlying transactions and transforming the various data into proper accounting and management information, which ultimately feeds into a company's annual reports.

d) **Report distribution**: Traditionally, annual reports of companies are published several months after the financial year end and sent to shareholders and other stakeholders through the postal or courier services. In recent times, many organisations through the adoption of relevant technology tools have started hosting the annual reports on their websites or put them on CDs and send to the stakeholders. Also, there are instances where the soft copies of the annual reports are sent to each stakeholder's email address for downloading. In highly regulated sectors, such as banking industry, the regulators could provide a web portal where each operator is required to submit the annual reports and other returns electronically.

e) **Report consumption**: Once the various stakeholders and investors receive the annual reports of an entity, they attempt to analyse and make useful meaning from them. Most institutional investors are already using technology to enhance effectiveness of investment analysis by extracting meaning and value, not only from company reporting, but also from various sources of alternative data. Data analytic solutions can be used to perform detailed analysis of any company's information for a deeper insight that would aid decision making of investors.

31.1.2 Technology tools for financial reporting

Digital transformation inspired by unprecedented pace of technological advancement is disrupting nearly every industry, and accounting is no exception. Some of the new technologies disrupting the accounting profession include:

(a) **Cloud computing technology:** There are quite a good number of accounting software that are hosted in the cloud. Like many other enterprises, accounting businesses must leverage on cloud computing and switch to cloud-based accounting to stay relevant and competitive now and in the future. Popular accounting solutions, such as QuickBooks; Sage; SAP; etc are all available in the cloud.

When an accountant subscribes to a cloud-based solution, it relieves him of the need to invest in physical onsite computer servers and incurring the costs associated with its maintenance and support.

Cloud-based accounting solutions afford the accountant the opportunity to work remotely from practically any device with internet connection and serve clients from any location, at any time. It further helps accounting firms to facilitate collaborations among themselves and clients.

Moreover, business entities that subscribe to cloud-based accounting can easily upscale and downscale their resource needs depending on the requirements at any point in time, without making huge investments.

(b) **Artificial intelligence and robotics:** Artificial intelligence (AI) is widely used, though it is not taken note of. Every time a search is made using Apple Siri, search Google or ask Amazon's Alexa a question, a form of artificial intelligence is in use. Many banks in Nigeria have equally deployed AI as part of their internet banking platforms. The technology has also radically altered processes like buying an airline ticket and making a hotel reservation.

Major accounting firms are using artificial intelligence to sort through contracts and deeds during audits. The computer does a risk assessment and flags potential problems.

Traditionally, accountants put a lot of efforts to collate, analyse and report historical financial data in order to serve their clients. Generally, accountants facilitate decision making by computing various financial ratios and generating elaborate reports. Artificial Intelligence (AI) and Robotics make it easier for accountants to simplify and accelerate various data-related tasks. Robotic Process Automation (RPA) software have been demonstrated to be effective in handling routine and monotonous aspects of the accountants' job.

AI is capable of making accountants more productive as its algorithms allow machines to take over time-consuming, repetitive, and redundant tasks. Rather than just crunch numbers, accountants will be able to spend more time delivering onhigher value aspects, such as business strategy implementation and financial advisory. Machines can help reduce costs and errors by streamlining operations.

Much of the standard data-entry that are common-place in accounting could be performed by machines. Machines could manage invoices and low-level bookkeeping tasks. The machine would reduce the chance that numbers are entered incorrectly, which can cause major problems to the entire accounting operation.

For instance, the optical character recognition (OCR) technology enables practising firms to automate and accelerate manual entries by converting textual data to digital files using scanners and mobile device cameras.

Apart from automating the repetitive and mundane tasks, AI would enable accountants track changes in business finances and create comprehensive reports by extracting financial information from various sources.

(c) **Blockchain technology:** Blockchain technology became popular globally through the advancements in digital currency transactions such as Bitcoin. Many businesses now leverage on the blockchain technology to record their financial and non-financial transactions in an open, secured and decentralised ledger.

In addition to keeping the financial transactions transparent and auditable, blockchain further makes the transaction records accessible to authorised users at any time and any location.

Blockchain enables quick funds transfer, recording of financial transactions accurately, recording smart contracts, protecting and transferring ownership of assets, verifying people's identities and credentials, and much more. Once blockchain is widely adopted, and challenges around industry regulation are overcome, it will benefit businesses by reducing costs, increasing traceability, and enhancing security.

Blockchain allows for the encryption of data through blocks, which track the time and date of a transaction. The technology could be used to make audit process more efficient, because it would keep an accurate record of when a transaction occurred and who authorised it. Blockchain would limit the chances of an electronic record being altered.

Blockchain technology can then be combined with Artificial Intelligence to investigate the integrity of transactions. The computer will do a lot of the work, leaving the auditor to conduct the final analysis. Under this scenario, auditors will spend most of their time designing, reviewing, and verifying how information flows between systems. Rather than audits being conducted on a periodic basis, blockchain and AI create the possibility of a continuous audit. The machine is always working, and a person would be notified when a potential problem is spotted.

(d) **Data analytics technology:** Data has become the new cash, as it is extremely crucial to make useful business financial decisions. Today, data is not just numbers and spreadsheets that accountants have been familiar with for years; it also includes unstructured data that can be analysed through automated solutions.

Data analytic software can allow for real-time status monitoring of financial matters. Data is the fuel that powers other technology trends that are transforming finance and accounting. In the financial realm, data produces valuable insights, drives results and creates better experiences for clients. Since everything leaves a digital footprint, the unprecedented digitalisation of our world is creating opportunities to glean new insights from data that was not possible before.

These insights help accountants to improve internal operations and build valuable insights for their organisation or clients. Through Data analytics software, accounting firms could offer more valuable advisory to their clients.

Examples of top data analytics software include:

- MySQL Workbench;
- Datapine;
- R-Studio;
- SAS Forecasting for Desktops;
- Erwin Data Modeler;
- Talend;
- Apache Spark; and
- RapidMiner.

31.2 Soft skills in corporate reporting

Understanding of the following soft skills are needed in corporate reporting:

31.2.1 Multiple capitals

Introduction

The study of the concept of multiple capitals is essential to future ready accountants as integrated reporting takes centre stage in the near future. Integrated reporting is assuming greater importance as many investors, particularly, institutional investors observe the inadequacies of the financial reporting framework in accounting for the resources employed by an entity to achieve the reported performance. It is stated that organisationsutilise more capitals than financial capital (accounted for by the current financial reporting framework), giving rise to the demand for integrated reporting.

The pervasive global climate change has accentuated the need for integrated reporting, as unchecked depletion of capitals other than financial capital may lead to going concern challenges for an organisation. It is therefore essential for a professional to study the concept of multiple capitals and how each capital impacts the process of adding value, which is at the core of the profitability and sustainability of the operations of an entity.

To ensure that prospective accountants appreciate the link between these capitals and the process of creating value to generate the bottom line and ensure the sustainability of the entity, there is a need to have an overview of integrated reporting framework.

a) Definition integrated reporting

i. Integrated reporting is a process founded on integrated thinking that results in a periodic integrated report by an organisation about value creation over time and related communications regarding aspects of value creation.

ii. An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term.

b) Overview of the integrated reporting framework

This framework was developed by the International Integrated Reporting Council (IIRC).

Objective

The purpose of the framework is to establish guiding principles and content elements that govern the overall content of an integrated report, and to explain the fundamental concepts that underpin them. The framework is written primarily in the context of private sector, for-profit companies of any size, but it can also be applied, adapted as necessary, by public sector and not-for-profit organisations.

The framework identifies information to be included in an integrated report use in assessing an organisation's ability to create value. However, it does not set benchmarks for such things as the quality of an organisation's strategy or the level of its performance. In the framework, reference to the creation of value includes instances when value is preserved and when it is eroded and relates to value creation over time.

Fundamental concepts

There are three fundamental concepts underpinning the framework, these are:

- Value creation, preservation or erosion for the organisation and for others;

- The capitals, which are identified in the framework as financial, manufactured, intellectual, human, social and relationship, and natural capital; and
- Process through which value is created, preserved or eroded.

Purpose and content of an integrated report <IR>
The <IR> framework sets out the purpose of an integrated report as follows:

The primary purpose of an integrated report is to explain to providers of financial capital how an organisation creates, preserves or erodes value over time. It therefore, contains relevant information, both financial and otherwise. An integrated report benefits all stakeholders interested in an organisation's ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policy-makers.

Guiding principles
These underpin the preparation of an integrated report, informing the contents of the report and how information is presented. They include:

- Strategic focus and future orientation;
- Connectivity of information;
- Stakeholder relationships;
- Materiality;
- Conciseness;
- Reliability and completeness; and
- Consistency and comparability.

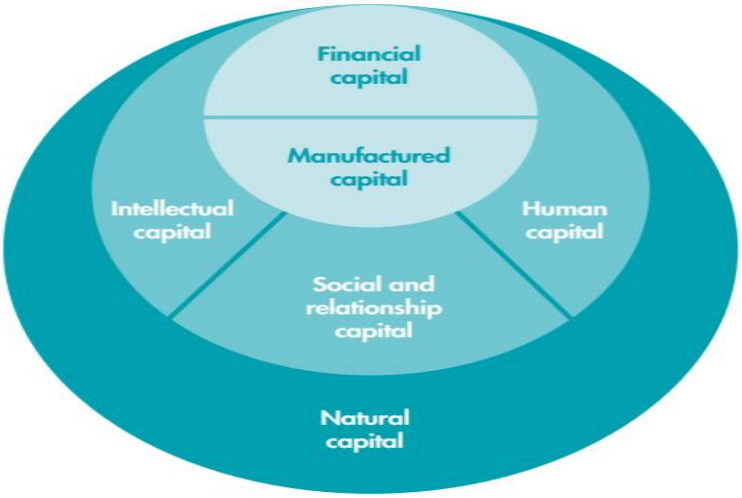
The main contents of integrated report have been discussed in the previous chapter.

(c) The six capitals

The IIRC defined six different types of capitals that represent stocks of value that are increased, decreased, or transformed through the activities and outputs of an organisation. The diagram below is one way to depict the capitals and it is not intended to imply a hierarchy. Rather, organisations will rely on and deploy multiple capitals to create value for themselves and others.

Financial and manufactured capitals are those reported on most frequently by organisations. Other capitals, covering intellectual, social and relationship, and human capitals are linked to the activities of humans. Natural capital represents the exogenous environment in which the remaining capitals sit. Natural capital is obviously most relevant to the business models of extractive industries, which draw directly on natural resources, but is also relevant to other organisations that rely on renewable and non-renewable resources and processes to provide goods or services.

Not all capitals are equally relevant or applicable to all organisations. While most organisations interact with all capitals to some extent, these interactions might be relatively minor or so indirect that they are not sufficiently important to be included in integrated thinking and, ultimately, in an integrated report.



The Capitals-Integrated Reporting Source https://www.integratedreporting.org

The six capitals model provides a basis for understanding sustainability in terms of the economic concept of wealth creation or 'capital'. A sustainable organisation will maintain and where possible enhance these stocks of capital assets, rather than deplete or degrade them.

The use of the six capitals model

The six capitals model can be used to allow organisations to develop a vision of what sustainability will be for its own operations, products and services. The vision is developed by considering what an organisation needs to do in order to maximise the value of each capital. However, an organisation needs to consider the impact of its activities on each of the capitals in an integrated way in order to avoid 'trade-offs'. Using the model in this way for decision-making can lead to more sustainable outcomes.

Sustainable development is the best way to manage these capital assets in the long-term. It is a dynamic process through which organisations can begin to achieve a balance between their environmental, social and economic activities. The best way to achieve a sustainable future is through system change.

The six capitals are discussed below:

(a) Natural Capital

This is any stock or flow of energy and material that produces goods and services.

It includes:

i. Resources - renewable and non-renewable materials;
ii. Sinks - that absorb, neutralise or recycle wastes; and
iii. Processes - such as climate regulation.

Natural capital is the basis not only of production, but also for sustenance of life itself;

(b) Human Capital

This consists of people's health, knowledge, skills and motivation. These are required for productivity at work. Enhancing human capital through education and training is central to a flourishing economy;

(c) Intellectual capital

This is the result of mental processes that form a set of intangible objects that can be used in economic activity and bring income to its owner, that is. the organisation. It is the sum of everything everybody in a company knows that gives

it a competitive edge. The term is used to account for the value of intangible assets not listed explicitly on a company's statement of financial position (balance sheets);

(d) Social Capital

This concerns the institutions that help us maintain and develop human capital in partnership with others; e.g., families, communities, businesses, trade unions, schools, and voluntary organisations;

(e) Manufactured Capital

Thiscomprises material goods or fixed assets which contribute to the production process rather than being the output itself – e.g., tools, machines and buildings; and

(f) Financial Capital

This capital plays an important role in our economy, enabling the other types of capital to be owned and traded. But unlike the other types, it has no real value itself but is representative of the natural, human, intellectual, social or manufactured capital, e.g., shares, bonds or banknotes.

The world is facing a sustainability crisis because we are consuming our stocks of natural, intellectual, human and social capital faster than they are being produced. Unless the rate of this consumption is controlled, we cannot sustain these vital stocks in the long-term.

It is possible to maintain and even increase stocks of these capital assets, in an attempt to generate income without reducing the capital itself. However, for this to happen, it is the responsibility of every organisation, business or otherwise, to manage these capital assets in a sustainable manner.

31.2.2 Features of a sustainable society

This 12-feature model helps organisations evaluate the sustainability of their projects.

The features fit into the separate six capitals. If an organisation invests appropriately in all capital stocks, and achieve the flow of benefits, they will represent the outcome of a successful capital investment strategy for sustainable development; that is, a sustainable society.

(a) Natural capital

The following considerations are necessary in the use of natural capital:

i. In their extraction and use, ensure that substances taken from the earth do not exceed the environment's capacity to disperse, absorb, recycle or otherwise neutralise their harmful effects (to humans and/or the environment);
ii. In their manufacture and use, ensure that artificial substances do not exceed the environment's capacity to disperse, absorb, recycle or otherwise neutralise their harmful effects (to humans and/or the environment); and
iii. Ensure that the capacity of the environment to provide ecological system integrity, biological diversity and productivity is protected or enhanced.

(b) Human capital

The following are considerations in the use of human capital, ensure that:

i. At all ages, individuals enjoy a high standard of health;
ii. Individuals are adept at relationships and social participation, and throughout life set and achieve high personal standards of their development and learning; and

iii. There is access to varied and satisfying opportunities for work, personal creativity, and recreation.

(c) Social capital

The following are considerations in the use of social capital, ensure that:

i. There are trusted and accessible systems of governance and justice;
ii. Communities and society at large share key positive values and a sense of purpose;
iii. The structures and institutions of society promote stewardship of natural resources and development of people; and
iv. Homes, communities and society at large provide safe, supportive living and working environments.

(d) **Manufactured capital**

Ensure that all infrastructures, technologies and processes make minimum use of natural resources and maximum use of human innovation and skills; and

(e) **Financial capital**

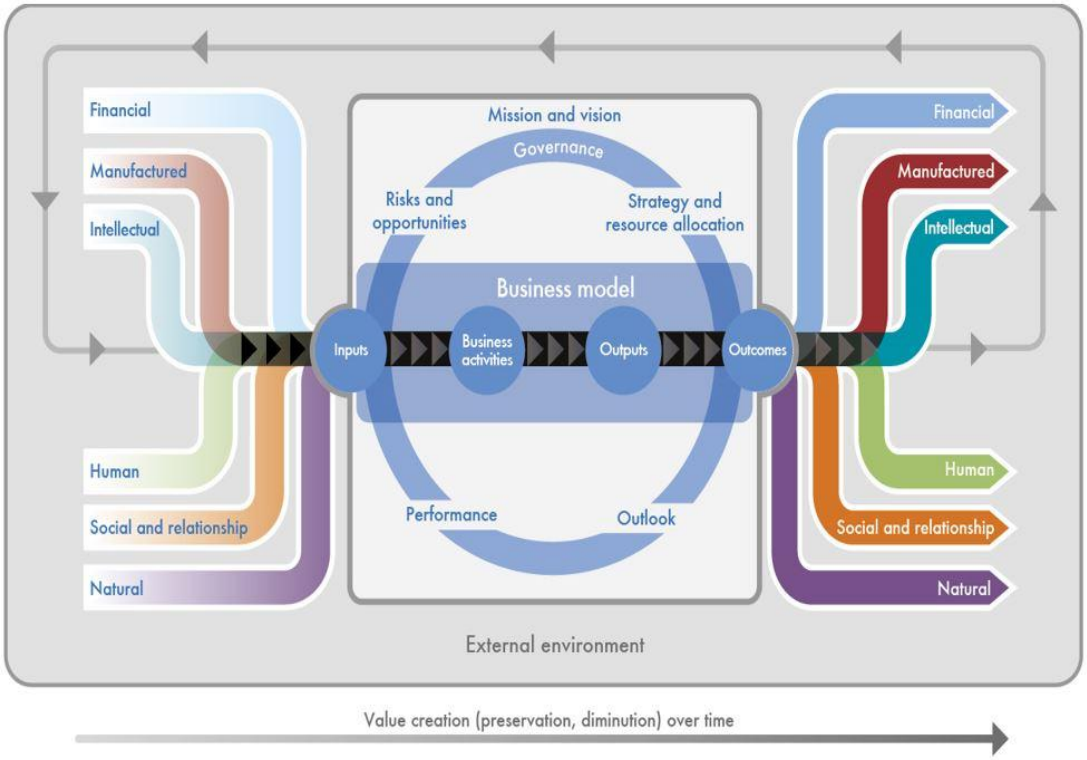
Ensure that financial capital accurately represents the value of natural, human, intellectual, social and manufactured capital.

31.2.4 The role of the six capitals in integrated reporting

The following are some means by which the six capitals contribute to integrated reporting:

a. The primary purpose of an integrated report is to explain to financial capital providers how an organisation creates value over time. The best way to do so is through a combination of quantitative and qualitative information, which is where the six capitals come in;
b. The capitals are stocks of value that are affected or transformed by the activities and outputs of an organisation. The framework categorises them as financial, manufactured, intellectual, human, social and relationship, and natural. Across these six categories, all the forms of capital an organisation uses or affects should be considered; and
c. An organisation's business model draws on various capital inputs and shows how its activities transform them into outputs.

Below is a graphic depiction of the contributions of the six capitals into the value-creation process:



Source: https://integratedreporting.org/wp-content/uploads/2021/01/InternationalIntegratedReportingFramework.pdf

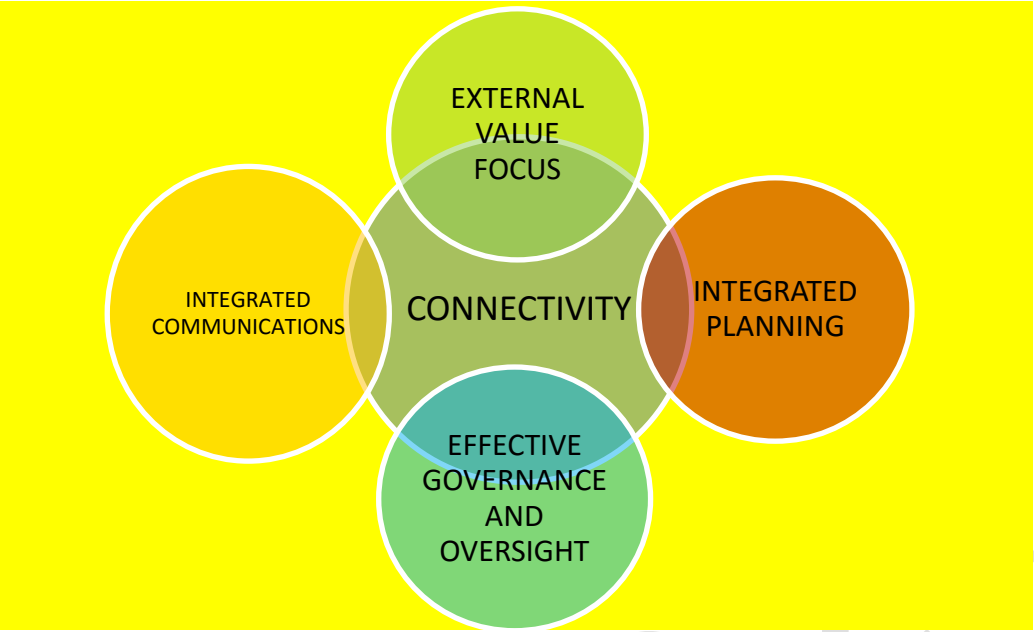
31.2.4 The contribution of the finance functions to integrated thinking

The Chief Finance Officer (CFO), as head of the finance functions, is a critical part in the chain of actors, including the governing body, Chief Executive Officer, audit committee, auditor; etc., all of whom share the responsibility for ensuring sustainable value creation, as well as relevant organisational reporting. The advantages the training, expertise, and experience the professional accountants bring to the CFO role are not always recognised, especially professional accountants' combination of ethical and technical mindsets with business acumen and organisational awareness.

CFOs and their finance functions play a central role in supporting integrated thinking in the following areas:

a. Connectivity

A connected approach supports the other four key areas of integrated thinking: an external value integrated focus, integrated planning, effective governance and oversight, and integrated communications. Integrated thinking depends on greater connectivity throughout the organisation. This is represented diagrammatically below:



With their broader view of an organisation, the CFO and the finance function can ensure that all aspects involving people, processes, and systems are better connected. Greater connectivity between management and reporting processes, and between different organisational functions, involves developing an integrated planning approach that brings together people with different expertise and professional backgrounds, and with different perspectives of the organisation.

b. External value focus

Resilient and agile organisations typically have internal processes and information that provide a relentless focus on creating sustainable value in the context of the external environment. Identifying and understanding relevant matters for decision making involves bringing together information and analysis from various sources including:

i. Analysing the impact of mega trends and changes in the business environment; Understanding the impact their products and services have on society and on markets; and

ii. Understanding what impacts the organisation's reputation and public perception, and the overall customer experience have on the organisation.

c. Integrating planning

The insights gained from an external value focus form the basis of integrated planning, which should incorporate a comprehensive process of identifying and managing significant matters affecting value creation over the short, medium, and long term. Integrated planning allows the board and management to be aware of the significant risks and opportunities the organisation needs to manage proactively as part of their decision making. Ultimately, relevant matters potentially impacting value need to be built into setting organisational objectives and targets, managing risk and opportunity, undertaking project and investment appraisals, aligning performance to objectives with relevant performance measures, and information collection systems and key metrics for internal processes.

Executing integrated thinking involves creating integrated planning processes that help to define and connect how the six capitals are relevant to the organisation and the multiple and complex connections between them, and for those moving to integrated reporting, the eight content elements in the international integrated reporting framework.

The CFO and finance function traditionally has the definitive input on the impact of decisions on the financial statements. Value creation based on today's financial statements often leads to short-term thinking focused only on achieving near-term shareholder value in the capital markets. Integrated thinking requires decision-support information reflecting causal resource and process relationships, not just interpretation according to financial reporting standards.

d. Budgeting

Restructuring budgeting processes to reflect the integrated planning process and a broader set of capitals is critical since the budget process defines the practical application of planning, near-term strategy implementation, and expected performance. The budgeting process involves the development of action plans, targets, and performance measures.

As part of the budgeting process, the CFO and finance function need to be comfortable with measuring the relevant capitals and challenging the validity and usefulness of performance indicators used to represent those capitals. Their focus needs to be on measuring the extent to which the organisation has achieved its strategic objectives and its outcomes in terms of effects on the capitals. Quantitative indicators, such as KPIs and monetised metrics, need to be designed to provide information on how an organisation creates value and how it uses and affects various capitals.

In advising on and establishing relevant financial and non-financial performance metrics, CFOs and their finance teams need to ensure that the budgeting process is dynamic and provides individual managers with the flexibility to seize opportunities as they become apparent and make appropriate trade-offs among their portfolio of performance objectives. Within this process, financial targets should not derail achieving critical goals that are less financially measurable.

e. Performance management

Integrated thinking typically leads to new areas of performance needing measurement and monitoring. In these areas, it is important to consider how to obtain the necessary information and analysis, and present it in a manner that allows managers at all levels to use it to make effective decisions. Performance metrics and control structures need to be established for the new information so the level of performance can be highlighted to the appropriate levels of management for action.

f. Effective governance and oversight

Board commitment, backed by management ownership of integrated thinking facilitated by CFOs, establishes the basis for integrated reporting. The change in dialogue as integrated thinking becomes established should gradually instil confidence among investors and other stakeholders. The eventual adoption of integrated reporting leading to an integrated report should result in a leap in credibility among stakeholders arising from the governance and oversight applied to the reporting process and the demonstration that integrated reporting reflects information that is actively used and relevant to an organisation.

g. Integrated communications

Integrated thinking requires strong governance and leadership to ensure an organisation is communicating effectively on the full range of issues impacting value creation across the broad range of the six capitals. This is a new perspective for many organisations, and the shift from a financial focus requires communication by leadership in ways that significantly influence the organisation'sbehaviour, and that

flow naturally from an integrated planning approach. The CFO and finance organisation can play a significant role assisting the organisation's board and senior management's creation of a more integrated environment by reinforcing the relevance of the capitals in the performance management cycle.

Integrated communications extend to regulated reporting and disclosures, including management commentary providing context for financial statements and operational performance. Such reports should also demonstrate an organisation's capacity for integrated thinking to investors, creditors, and other stakeholders. Ultimately, integrated thinking and reporting should lead to a mindset and approach enabling greater connectivity within the organisation that is obvious in its external reporting.

h. Next steps for the profession and professional accountants

Improved dialogue with all providers of capital and key stakeholders, should result in a stronger and more rewarding finance profession at the heart of the organisation. CFOs and finance functions can undertake various activities to bring about integrated thinking.

IFAC will continue to engage the profession on further developing and promoting integrated thinking and reporting via the Professional Accountancy Organisation (PAO) Integrated Reporting Network.

31.2.5 Integrated thinking

Introduction

Integrated thinking has been defined as "a term that refers to the conditions and processes that are conducive to an inclusive process of decision making, management and reporting, based on the connectivity and interdependencies between a range of factors that affect an organisation's ability to create value over time" (CIMA, 2017).

Martin (2009), sees integrative thinking as "the ability to face constructively the tension of opposing ideas and instead of choosing one at the expense of the other, generate a creative resolution of the tension in the form of a new idea that contains elements of the opposing ideas but is superior to each".

The philosophy of integrative thinking

Roger Martin presented a heuristic model, The Philosophy of Integrative Thinking, as a basis for integrative thinking.[3] It comprises four interrelated elements as follows:

(a) Salience;
(b) Causality;
(c) Architecture; and
(d) Resolution.

This philosophy encourages high tolerance for change, openness, flexibility and disequilibrium. This is contrary to the common managerial endeavour to attain predictability and measurable clarity.

Salience

Salience is the determination of information or variables relevant to the decision. As many relevant variables as possible are considered. This approximates better to reality. For example, when a company decides to relocate a factory from one place to another, the company may only consider the economic benefit to the shareholders, not bearing in mind the political implication of such a move. This may be a wrong decision by the company.

Causality

In dealing with causes of observations, integrative thinkers do the following:

- establish causal relationship between the variables and the decision;
- consider non-linear and multi-directional causal relationship, rather than simple, uni-directional relationships;
- create multiple causal models and developing many alternative theories to deal with any ambiguities observed; and
- deliberate on some unexplained observations, though, no causal relationship is established.

Architecture

The next step in integrative thinking is architecture. This is building a model to capture all the salient variables. This model incorporates the complexities in the process and considers the interrelationships between the salient variables. This method does not attempt to over-simplify the model, but deals with the complexity, by bringing most relevant parts at a point to the fore, while retaining the other parts in the background. At other times, focus will be on those other parts. In this way, no part of the causal map is ignored.

Resolution

Resolution is the final stage, at which decision must be made. At this stage the attitude of the decision-maker is critical. Less integrative thinkers get into a 'bind' i.e. seeing the choices being limited to either one or the other, when neither is fully satisfactory and dealing with it by proffering solutions to ameliorate the negative effects of the choice made. The integrative thinker will not see the challenge as a bind, but rather a tension to be creatively and flexibly managed, even if it requires a delay and continual rethinking and restructuring of the problem and its logic.

31.2.6 Importance of integrative thinking

a) Many managers achieve perplexing and uninspiring outcomes because of the gap between aspirations and outcome. These gaps arise because they over-simplify the models, because the links between cause and effect are usually not clear or obvious.

b) Over-simplification of the models gives a false sense of being in control of the situation, only leading to error in the end. This is referred to as 'narrow perfectionism' i.e., striving for perfection by narrowing the definition of the task to the point that perfection is guaranteed. When a disaster occurs, each participant aims at exonerating self by showing that they followed the specified steps, rather than attaining the objective.

c) This over-simplification and narrow perfectionism has led to over-specialisation into functional areas when conducting business research. Models are usually restricted to each functional area rather than engaging in integrative thinking to link the models to other functional areas to produce a holistic view. This makes many research efforts defective.

d) This malaise has also infected many managers during their training in business schools. They limit their thoughts to their functional areas rather than engaging in integrative thinking, thus, making their training defective, as they compartmentalise their knowledge. This is narrow perfectionism applies to the trainee managers as well.

e) Integrative thinking is responsible for the great success stories recorded by entrepreneurs with little or no formal business training or business leaders whose success stories cannot be explained by application of narrow models.

f) Integrative thinkers develop complex models to understand and drive action in a complex world of business. Their models capture the complicated, multi-faceted and multidirectional causal relationships between the many

salient variables. They consider customers, employees, internal capabilities, technology, competition, cost structures, industry evolution, regulatory environment, etc., not just a subset of these variables.

g) Integrative thinkers have holistic view of problems rather than compartmentalise them.

h) They creatively resolve tensions to produce a more powerful model rather than running into a bind of choosing one model over another when both are sub-optimal, but one is less so than the other.

i) Successful business leaders must develop their integrative thinking capacity to achieve success.

k) Though integrative thinking skills may be developed, some people possess innate integrative thinking skills. Major impediment to developing the skill is the fact that over-simplification and narrow thinking occur naturally to many people. Education does not help many, as it often encourages narrow thinking. Therefore, most people trained in integrative thinking do not keep the skill on a long-term basis.

31.2.6 Implementation of integrative thinking in an organisation

The following considerations will facilitate the adoption of integrative thinking in an organisation:

a. Understanding what value means in the context of the organisation and how its business model creates value;

b. Developing a clear explanation of the positive and negative impacts of trends shaping the company's current and future operating environment across the different types of capital;

c. Identifying non-financial metrics that are significant to the success of the business, gathering reliable data, conducting meaningful analysis, and reporting this information to the board as prominently as the key financial metrics;

d. Relating non-financial metrics to the long-term financial success of the business. Explaining why the non-financial factors being measured is important;

e. Demonstrating to the board linkages between strategy, strategic objectives, performance, risk, and incentives across financial and non-financial information; and

f. Being holistic in terms of what to report and focussing on the interconnectivity of different elements.

31.3 Chapter review

At the end of this chapter, readers should be able to discuss the following concepts in relation to corporate reporting:

a) Multiple capitals;
b) Integrated thinking;
c) Distributed ledger and related technologies;
d) Cloud computing; and
e) Reporting in a virtual environment.

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